

The Housing Market and the Business Cycle: The Good, the Bad, and the Ugly

The housing market has historically played an important role in the business cycle. If the economy overheated, the Federal Reserve (Fed) raised interest rates, the housing market slumped, and economic activity slowed. Short-run swings in macroeconomic activity significantly reflected the cycle in the housing market.

The booming housing market in Las Vegas raises questions about how the economy would respond to its slowdown or reversal. Even though the Fed has raised the interest rate on eleven occasions since late last year, we do not yet see the housing market slowing down or cooling off. Las Vegas did cool somewhat from its 2004 exuberance.

Low mortgage interest rates facilitate a housing market boom. Two reasons explain recent low interest rates. First, interest rates rise and fall with inflation and the Fed has engineered a period of low inflation. Second, policy makers gained more control over the business cycle, lowering aggregate economic risk. Thus, lower risk also induces lenders to lend at lower interest rates.

In sum, inflation remains low and low inflation coupled with a less risky economy associates with low mortgage rates. Finally, low mortgage rates support continued vigorous activity in the housing market. Of course, if the Fed continues to raise interest rates, eventually mortgage rates must rise, cooling off the housing market.

Alan Greenspan, Chairman of the Fed, suggests in a recent speech to the National Association of Business Economists that better control of the business cycle, a “good” thing, spawned significant inflation in asset prices, first in stocks and now in housing, a “bad” thing. Chairman Greenspan argues, however, that the Fed should not pop speculative bubbles. Rather, the Fed should continue to promote a flexible and resilient financial system that can absorb negative asset-price shocks. No reason exists to pop asset bubbles, according to Greenspan.

The Good

In the past, falling interest rates raised bank stock prices as their liabilities adjusted more quickly to falling rates than did their assets, since assets exhibit a longer average maturity. Saying that banks borrow short and lend long captures this maturity-mismatch idea. Conversely, rising interest rates squeezed banks’ performance and lowered their stock prices. Financial innovations, allowing banks to hedge the risks on their assets and

liabilities, muted these forces. For example, interest rate swaps and mortgage securitization can insulate banks from rising or falling interest rates.

The Bad

While hedging activity illustrates a good outcome from financial innovation, the same financial innovation can produce bad outcomes by causing higher, not lower, risk, when banks use the innovation for speculative purposes. With government-sponsored deposit insurance, banks that experience severe performance difficulties can “bet the bank” with higher-risk investments. If the investments prove successful, the bank wins; if the investments head south, the government (society) loses. Depositors, however, do not lose, given deposit insurance. This moral hazard problem justifies close government supervision of bank activity to prevent “bet-the-bank” behavior.

The Ugly

Chairman Greenspan argues that policy makers cannot easily differentiate speculative activity from sound investment decisions. Intuitively, asset bubbles exist when psychology turns from buying based on fundamentals to buying based on expected capital gains. Other events, however, also signal speculative activity. For example, “flipping” provides a strong signal. “Flippers” do not live in, or rent out, the property, but intend to resell quickly at a profit. Las Vegas recently experienced such activity.

Financial innovation also assists in the purchase of homes with ever-smaller equity shares. Mortgage seekers, who formerly did not qualify, now do. Interest only and other negative amortization mortgages prompt homebuyers to acquire mortgages with higher loan-to-value ratios, some above 100%.

A homeowner’s equity provides the bank with a hedge (i.e., collateral) against the risk of default. The conventional mortgage with its 80% loan-to-value ratio may appear quaint in today’s market. A 10% decline in home prices sinks all newly issued 90% or higher loan-to-value ratio mortgages underwater. Thus, declines in home prices can quickly precipitate higher mortgage defaults.

In sum, the housing market shows signs of speculative excesses in certain local markets in the U.S., including Las Vegas. Our close neighbors in Southern California exemplify the “good” and the “bad” things that can occur in the housing market. Whether that situation turns ugly, only time will tell. Southern Nevada, however, can use Southern

California as an early warning system. If their housing market tanks, then the risk of our collapse rises significantly.

Is a Recession in the Cards?

Some pundits caution that a recession lies around the corner. A number of signs support this assertion.

The average household stores almost 90% of their non-pension wealth in home equity. Recent financial innovations permit households to access the capital in home equity – for example, refinance existing mortgages and take cash out or seek a home equity (second) mortgage – to finance consumption spending. Thus, a reversal of fortunes in the housing market can trigger a recession, if consumption spending falls enough.

Additionally, given our large fiscal deficit and low national saving, we currently finance much investment spending with borrowed foreign money. If foreign holders of our debt “rebalance” their portfolios and sell that debt, then our interest rates would rise significantly, decreasing investment spending. Moreover, higher interest rates would trigger retrenchment in the housing market.

Finally, Hurricanes Katrina and Rita dropped consumer confidence like a rock, which can cause reduced consumer and investor spending. Those hurricanes also precipitated a dramatic run-up in energy prices, not a good sign for continued economic growth.

In sum, a reasonable story exists for a recession. But, in my view, the odds still favor Chairman Greenspan’s optimism for continued prosperity. Stay tuned.

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