The Housing Crash Recession and the Case for a Third Stimulus

Dean Baker

March 2009

Contents

About the Author

Dean Baker is an economist and co-director of the Center for Economic and Policy Research, in Washington, D.C.

Acknowledgments

Executive Summary

The overwhelming majority of economists, including all those in top policymaking positions, completely missed the growth of an $8 trillion housing bubble. Furthermore, even as the collapse of the bubble began to push the economy into recession, policymakers repeatedly downplayed its significance, minimizing any negative effects on the economy. As a result, the policy responses last year were too late and far too small to have much effect countering the downturn.

This paper argues that policymakers are still underestimating the severity of the downturn. Specifically, it argues that the unemployment rate by the end of 2009 is likely to be far higher than the most recent projections from the Congressional Budget Office and the Federal Reserve Board.

In this context, it argues for additional stimulus[1] in the neighborhood of 2-3 percent of GDP for two years ($300 billion to $450 billion annually). It suggests two specific mechanisms for getting this money into the economy quickly:

1) an employer tax credit of $3,000 for extending health insurance coverage to workers not already covered by health insurance. The tax credit can include an additional $1,000 per worker to make coverage more generous.

2) an employer tax credit of up to $2,500 per worker for increasing the amount of paid time off per worker. This paid time off can take the form of paid family leave, paid sick days, increased vacation, or shorter standard workweeks. This would both boost demand and lead to more employment at every level of GDP. For example, if the average number of hours per worker per year were reduced by just 3 percent, this would lead to 4.2 million more jobs at the same level of GDP.

The paper also argues for a housing policy that is focused on stabilizing housing prices, but only in markets where the bubble has deflated. To advance this goal, it should have Fannie Mae and Freddie Mac stop buying mortgages that were used to purchase homes at bubble inflated prices. (This can be determined by the ratio of the sale price-to-annual rent. As a national average, this ratio should not exceed 15 to 1, although there is some regional variation.)

Because they continue to buy mortgages on homes purchased at bubble-inflated prices, Fannie Mae and Freddie Mac are generating new losses for taxpayers, while providing no real benefit for homeowners. Homeowners in these markets will pay more in housing costs by owning rather than renting and still find themselves with no equity when they sell their home. By contrast, if relief was focused on markets where the bubble has deflated, prices could be stabilized and it is likely that taxpayers would actually profit in the long-run.

The last section points out that the frequently-discussed notion that investors will flee the dollar is actually not to be feared at all. It is in fact necessary, since the dollar must fall to correct the country's huge trade imbalance. The rest of the world has more to fear from a free-falling dollar

---

[1] The first stimulus was passed by Congress and signed by President Bush in February of 2008 and consisted almost entirely of tax cuts and individual rebates. The second stimulus was passed by Congress and signed by President Obama in February of 2009 and included a variety of efforts to counter the economic downturn the U.S. is now in.

than the United States, since a very low dollar would make U.S. goods hyper-competitive in the world economy. As a result, other countries would have no alternative but to act to prevent the dollar from falling too far.

Therefore, concerns about a loss of international confidence in the dollar are completely unfounded. This should not be a basis for limiting the size of future stimulus packages.

Most economists now acknowledge that the collapse of the housing bubble is leading the country into the worst downturn since the Great Depression. However, even as newly released economic data consistently come in worse than expected, policymakers still do not appear to have grasped the seriousness of the downturn. The policies that have been put forward to date are in some cases tangential to solving the economy's real problems and almost certainly not large enough to reverse the economy's slide.

The first part of this paper summarizes the evidence indicating that the recession is likely to be worse than is generally expected and that the stimulus approved by Congress thus far will be inadequate to boost the economy back to full employment. The second section outlines two tax credits that would be effective forms of short-term stimulus while also providing long-term benefits to the economy. The third section discusses the inadequacy of the Obama administration's plans for dealing with the housing market. The fourth part briefly explains why concerns about an investor flight from the dollar are misplaced, and why these concerns should not be a basis for limiting the size of future stimulus packages.

The Downturn Will Be Worse Than Expected

The bulk of the economics profession somehow overlooked the growth of an $8 trillion housing bubble. As the bubble first began to deflate in 2006 and 2007, economists consistently dismissed the consequences of the decline in housing values. Even as the collapse of housing prices has thrown the world financial system and the world economy into the most severe downturn since the Great Depression, most economists are still underestimating the impact of the housing crash.

At the most basic level, the projections for unemployment and GDP loss being used in official analyses seem far too optimistic in light of recent data releases. For example, the latest projections from the Congressional Budget Office's (CBO) Budget and Economic Outlook, which include the projected impact of the second stimulus, show that the unemployment rate will average between 7.8 percent and 8.5 percent in the fourth quarter of 2009.[2] Federal Reserve Board Chairman Ben Bernanke recently told Congress that the Fed's projections show the unemployment peaking at 8.8 percent in 2010.[3]

Given the recent pace of job loss, these numbers seem overly optimistic. The Bureau of Labor Statistics (BLS) reports that the economy has lost more than 670,000 jobs per month from December through February. In fact, the reported rate of job loss almost certainly understates the true rate because of the way in which BLS imputes jobs for new firms not included in the survey.

BLS imputed slightly less job loss in total over the five months from October through February (the data is not seasonally adjusted and employment typically falls in winter months relative to the year-round average) than it did for the corresponding months of the prior year as shown in **Figure 1**.

---

[2] See http://www.cbo.gov/ftpdocs/100xx/doc10008/03-02-Macro_Effects_of_ARRA.pdf.

[3] Goodman, P. "Sharper Downturn Clouds Obama Spending Plans," *New York Times*, February 27, 2009.

FIGURE 1
Jobs Imputed for New Firms 2007-2008 and 2008-2009
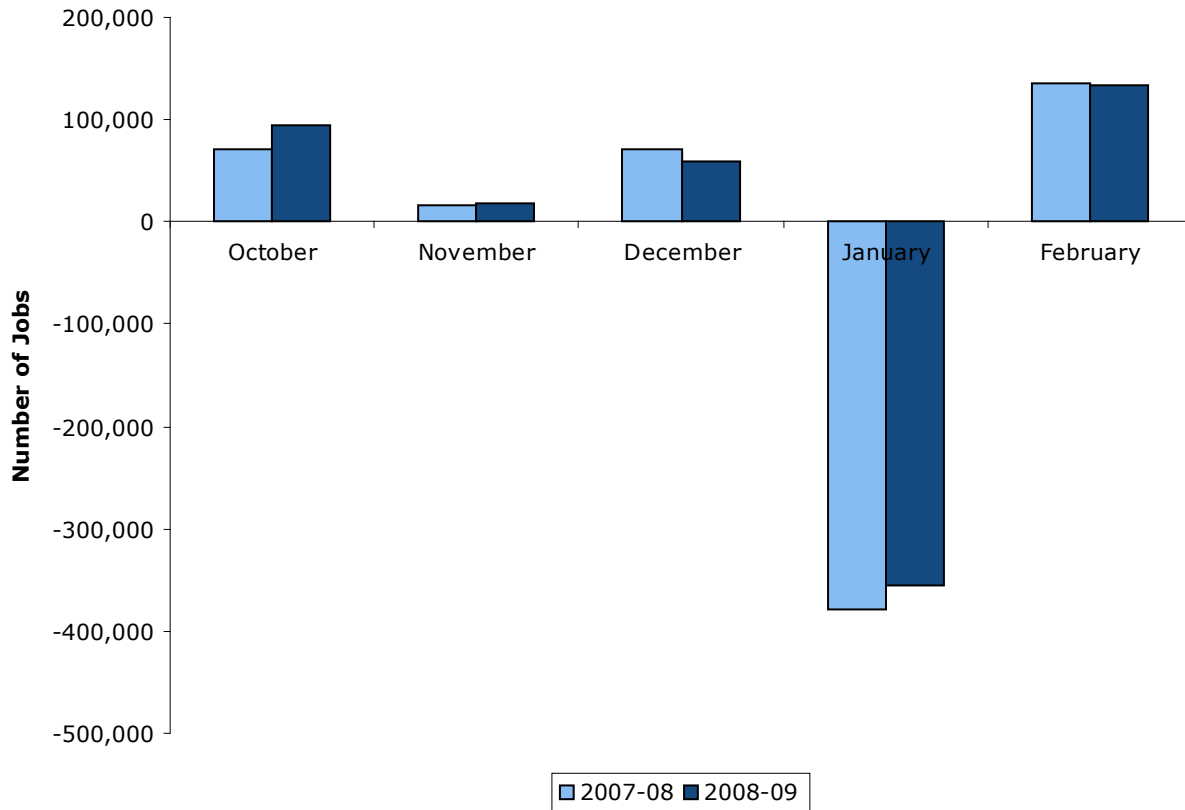
Source: Bureau of Labor Statistics, see Appendix.

This seems implausible on its face. In reality, the true monthly rate of job loss could have been between 30,000 to 60,000 larger than shown by the BLS data. These data are subject to a benchmark revision each year based on the much more complete employment data available from the filings of unemployment insurance taxes. Past benchmark revisions around downturns have been as high as 500,000 jobs. This is a year-round total, so the overstatement in the worst months was likely considerably larger than the 40,000 average for the year.

As bad as the employment reports have been over the last four months, they seem almost certain to get worse. The number of weekly filings for unemployment insurance has been rising in the last two months. This indicates that the monthly rate of reported job loss is likely to rise, with the reported job loss in March possibly exceeding 700,000. With the labor market shedding jobs at this rate, the unemployment rate is likely to cross 8.5 percent in March and continue to rise into the summer.

While the rate of job loss will presumably slow (in part because there are many fewer jobs left to lose in hard-hit sectors like residential construction and manufacturing), it is difficult to see a scenario in which the unemployment rate does not reach 9.0 percent by the summer. Even if the downward momentum dissipates and the most recent stimulus helps to provide a boost by the end of the year, it is likely that the unemployment rate will be closer to 9.5 percent in the fourth quarter of 2009, considerably above the rate in CBO's more optimistic forecast.

The worse-than-expected data in a number of different sectors provide further support for this pessimistic outlook. Real spending on investment and software fell at a 28.0 percent annual rate in the fourth quarter. New orders for non-defense capital goods were falling even more rapidly. The nominal value of new orders in the three months from November to January fell at an incredible 52.1 percent annual rate from the prior three months, as shown in **Figure 2**.

FIGURE 2
Non-Defense Capital Goods: Shipments and New Orders
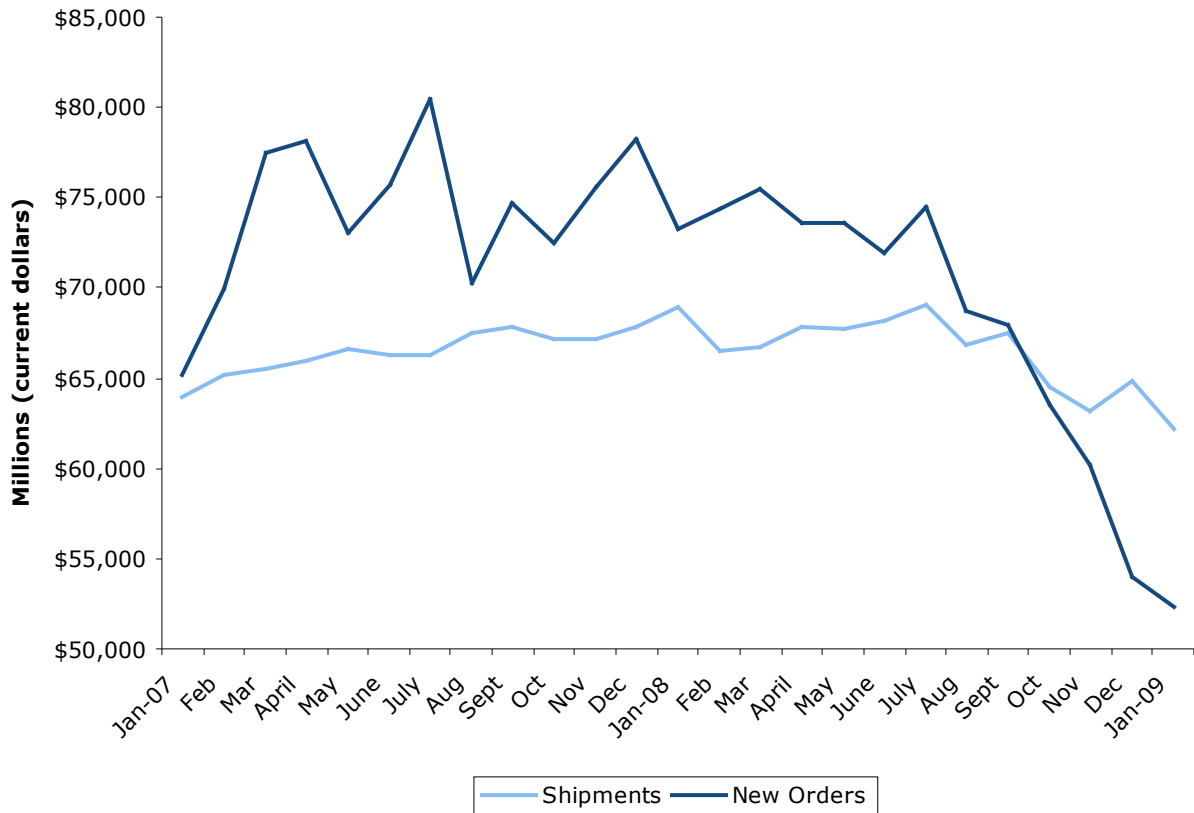
Source: Census Bureau, see Appendix.

The latest data indicate that the commercial real estate bubble is now deflating at an accelerating pace. Nominal non-residential construction fell at an 11.3 percent annual rate in the three months from November to January compared with the average for the prior three months. Office construction fell at a 20.6 percent annual rate over this period, while retail construction fell at a 30.7 percent rate and hotel construction fell at 37.8 percent rate, as shown in **Figure 3**.

FIGURE 3
Non-Residential Construction
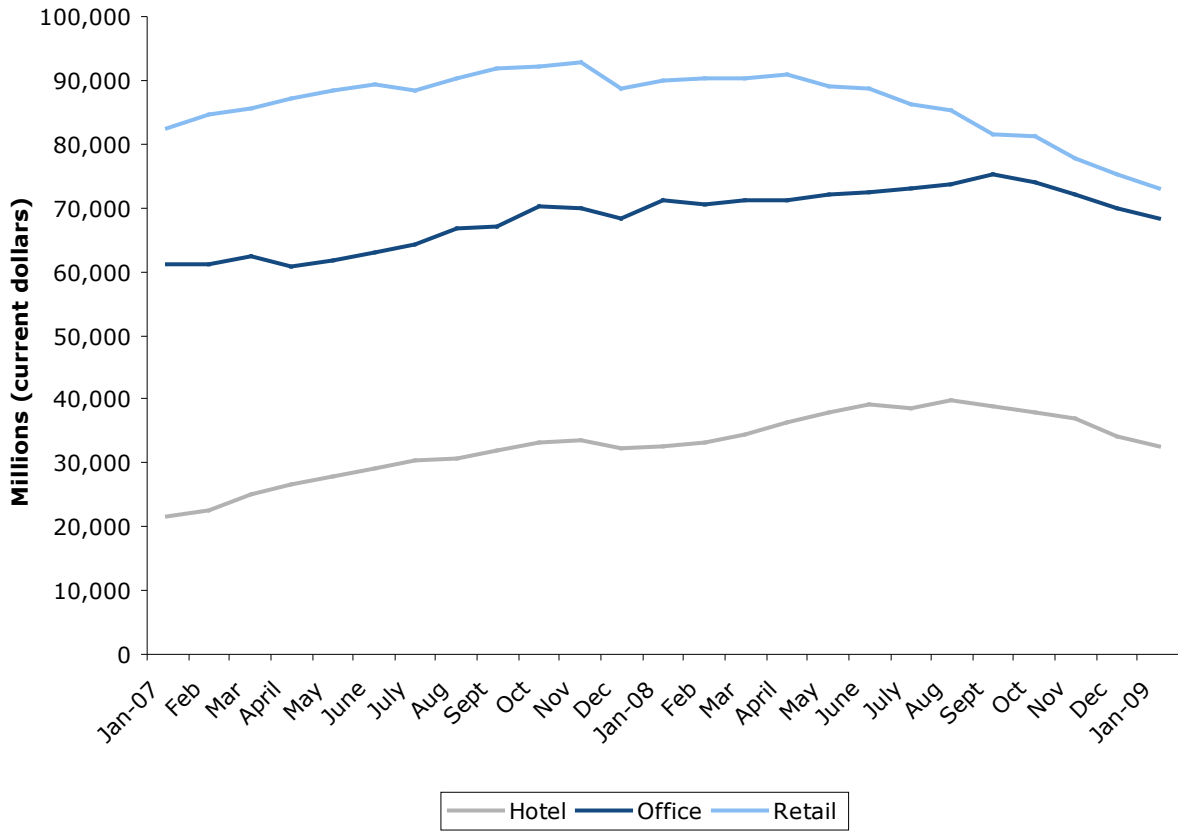
Source: Census Bureau, see Appendix.

The non-residential construction sector now accounts for more than 4.0 percent of GDP. Given the enormous overcapacity in this sector, it is likely to fall back by 30 to 40 percent from its peak over the next six quarters. For the most part, projects that are already underway will be finished, but new projects will not be started. Of course, the banks will suffer another big hit due to bad debt connected with loans to this sector when developers end up defaulting on their loans.

As bad as the news on residential housing had been, it keeps getting worse. It looks increasingly likely that price declines will overshoot trend levels. According to the Case-Shiller 20-City index, nominal prices were falling a 24.5 percent annual rate in the three months centered on December compared with the three months centered on September. At this rate of decline, this index will return to its January 2000 (the inception of this index) real value by November of 2009.

However, it appears as though the rate of price decline may be accelerating. The National Association of Realtors' Existing Home Sales index for January showed a drop of 3.3 percent in the median price of an existing home and 2.2 percent for the average price compared with the month earlier measure. These data, like the Case-Shiller series, reflect sales prices. Since there are typically six to eight weeks between the time a contract is signed and when the sale is actually closed, the January existing home price data primarily reflect contracts signed in November.

More recent price data are available from the Commerce Department's New Home Sales series, since these data show contracted prices. This series shows the median price of new homes falling by 9.0 percent from December to January. The average price of a new home fell 9.8 percent. These numbers translate into annual rates of price decline of 71.4 percent and 71.6 percent, respectively. While the sample in the new home series is small, and therefore the prices are erratic (and can be affected by changes in the mix of homes sold), these numbers do suggest that the rate of house price decline may have accelerated sharply in recent months.

Given the enormous oversupply of homes, it would be reasonable to expect the rate of price decline to accelerate. The vacancy rate for rental housing is near a record high at 10.1 percent, while the 2.9 percent vacancy rate for ownership units is at an all-time high, more than 50 percent above the peak reached prior to the current downturn. Inventories of existing homes and new homes are equal to 9.6 and 13.3 months' supply, respectively. In both cases there is evidence that homes are pulling off the market as sellers wait for better times.[4] This suggests that a large quantity of homes may be thrown on the market at the first sign of any recovery.

Perhaps even more importantly, the demand side of the market is being badly hit by both rising unemployment and falling home prices. The extraordinary rate of job loss in recent months is knocking hundreds of thousands of would-be home buyers out of the market. Those who lose their job, see large cutbacks in hours, or fear losing their job will be unlikely to buy a new home. Of course, many job losers will also be forced to sell their current home, adding to the glut of inventory on the market.

In addition, plunging house prices are rapidly eliminating the equity that many current homeowners expected to use to buy a new home. Some estimates put as many as 20 percent of current mortgage holders underwater.[5] After closing costs on their current home, a much larger number will find they have little if anything to use as a down payment on the purchase of a new home.

According to the Federal Reserve's data, at the end of the third quarter of 2008, the aggregate ratio of equity-to-value for all homeowners was just 44.8 percent.[6] With roughly one-third of homeowners owning their homes outright, this means that the two-thirds of homeowners with mortgages had equity that was, on average, equal to roughly 20 percent of the sale price at the end of September. With house prices falling at close to a 20 percent annual rate, the average ratio of equity-to-value for those with mortgages is rapidly approaching zero.[7] In other words, the number of current homeowners who will have sufficient equity to make a down payment on a new home is falling rapidly.

---

[4] In the case of new homes, the inventory of started and completed homes for sale has fallen by 121,000 (28.4 percent) from July through January, even though housing starts have consistently outpaced sales over this period. This indicates that builders may not be putting their homes up for sale in the current environment. In the case of existing homes, the inventory of unsold homes has fallen by 970,000 from July to January even though the annual rate for monthly sales over this period was just 4,800,000. Given the current population, this rate is approximately the sustainable rate of existing home sales (ignoring the extraordinary economic times), which means that the drop in inventory likely represents homes that people expect to put on the market when they perceive conditions as improving.

[5] This estimate came from First America Core Logic, reported in "20 Percent of Mortgages Underwater," by Amy Hoak, *Seattle Times*, March 5, 2009.

[6] Federal Reserve Board Flow of Funds, Table B100, Line 51.

[7] The plunge in the stock market also means that fewer families have sufficient financial wealth to cover a down payment.

In a context where there is a record level of oversupply of homes on the market, a substantial portion of potential buyers have lost their jobs or fear losing them, and tens of millions of homeowners no longer have sufficient equity to make a down payment on a new home, it is virtually certain that prices will continue to decline and will likely overshoot their trend level.

The plunge in house values will also have a further dampening effect on consumption. The savings rate fell to almost zero during the peak years of the housing bubble, as homeowners consumed based on the equity created by the growth of the bubble. Now that this wealth has largely disappeared, homeowners will be saving at much higher rates. In some cases they will have no choice, since they had been borrowing against their home equity to sustain their consumption. Now that most or all of this equity has vanished, homeowners can no longer use home equity to support their consumption. In other cases, homeowners will curtail consumption because they have seen much of their wealth disappear and now must save to meet their goals for retirement or other needs.

The plunge in the stock market since its peak in November of 2007 will also depress consumption. The stock market has lost close to half its value over this period, approximately $8 trillion in wealth. As a result, tens of millions of workers have seen much of the wealth in their retirement accounts evaporate.

In the years following World War II until the 1990s, the savings rate out of disposable income averaged more than 8 percent. The saving rate declined sharply in the 1990s due to the stock bubble and went still lower in the current decade as a result of the housing bubble. If the saving rate returns to the average of the pre-bubble period, it would imply a fall in annual consumption of more than $850 billion compared with the saving rate at the peak of the bubble years.[8] It is possible that the saving rate could rise even higher than the pre-bubble level since the huge baby boom cohort is in its peak saving years and desperately needs to make up for the wealth lost in the collapse of the housing bubble.

As of the fourth quarter of 2008, the saving rate had risen to almost 4.0 percent, approximately halfway to its 8 percent average over the decades prior to 1990. (The adjusted saving rate shown in **Figure 4** effectively uses an output side measure of income. It adds the statistical discrepancy in the GDP accounts to disposable income and personal saving. In the peak bubble years, the statistical discrepancy was negative, which leads this adjustment to show lower income and saving.) If the saving rate were to rise by another 4 percentage points, it would imply a loss of another $430 billion in annual demand. If the saving rate rises above the trend level – say to 10 percent – as baby boomers try to make up for their saving shortfall, then the further reduction in annual demand will be approximately $640 billion.

---

[8] Disposable personal income was $10.7 trillion in the fourth quarter of 2008. Bureau of Economic Analysis, National Income and Product Accounts, Table 2.1, Line 26.

FIGURE 4
Saving Rate, 1990 to 2008
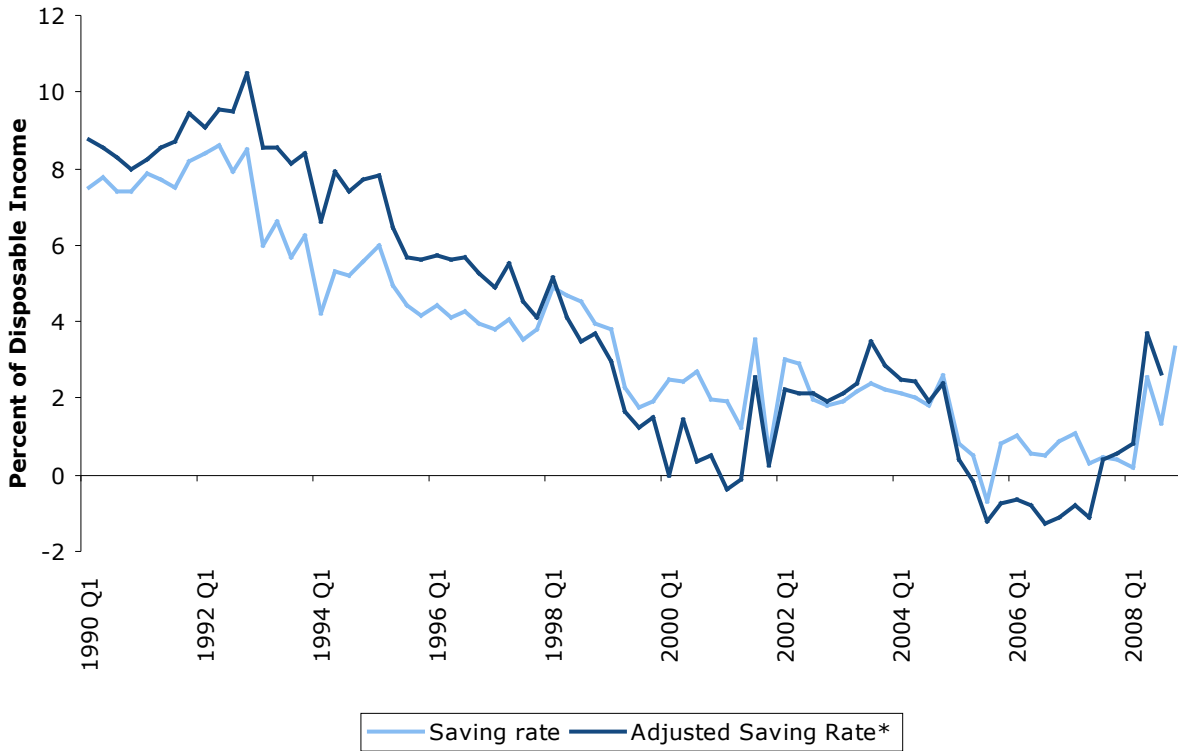
*Data not yet available to calculate 2008 Q4.
Source: Bureau of Economic Analysis, see Appendix.

The final component of private sector demand is trade. Here the picture is mixed. The trade deficit had been declining in 2007 and the first half of 2008 due to the fall in the dollar. However, the crisis reversed much of the dollar's decline, causing it to rise by more than 20 percent against the euro and other major currencies. As a result, the trade balance is no longer benefiting from a lower-valued dollar.

In addition, all of the United States' trading partners are either also in a recession or at least experiencing a sharp slowdown in growth, as is the case with China and India. As a result, demand for U.S. exports has fallen sharply. However, the downturn in the United States has also sharply reduced the demand for imports, just as it has reduced the demand for everything else. In the fourth quarter, the declines in exports and imports were roughly offsetting so that there was little net impact on growth. It is likely that these two effects will be roughly offsetting in future quarters also, which means that trade is unlikely to provide a substantial boost to growth in the foreseeable future.

With equipment investment, non-residential construction, residential construction, and consumption all contracting rapidly, and net exports remaining flat, the private sector offers little hope of a turnaround any time soon. This means that the economy will be dependent on the public sector for sustaining demand.

Here the picture is at best mixed. The state and local sector, which accounts for 12.7 percent of GDP, will contract without substantial support from the federal government. The sector is seeing plummeting revenue both as a result of the recession and the collapse of the housing bubble. Property tax collections are plummeting in deflating bubble markets. In addition, building fees, which were a substantial source of revenue for many governments, have collapsed along with the residential construction.

The collapse of revenue is leaving state and local governments with substantial shortfalls even as demand for government services, like unemployment benefits, food stamps, and Medicaid is rising rapidly. The Center on Budget and Policy Priorities calculated the shortfall in state budgets at $350 billion for 2009 through the first half of 2011. It also calculated that the recently passed stimulus package will reduce this shortfall by approximately $140 billion, leaving a gap of $210 billion.[9]

Since most state and local governments must balance their budgets, they are both raising taxes and cutting back services, as well as laying off workers. The result is that the state and local sector is now also a drag on the economy. It contracted at a 1.4 percent annual rate in the fourth quarter. Without additional aid from the federal government, the state and local sector will continue to be a drag on growth throughout 2009 and 2010.

---

[9] Johnson, N., E. McNichol, and I. Lav, 2009, "Funding for States in Economic Recovery Package Will Close Less Than Half of State Deficits," Washington, D.C.: Center on Budget and Policy Priorities, available at http://www.cbpp.org/2-20-09sfp.pdf.

The Federal Government and the Need for Additional Stimulus

The extent of the economy's weakness indicates a need for additional measures to boost growth. Most economic forecasters, including those at the Fed and CBO, have consistently underestimated the severity of this downturn. The country has paid an enormous price as a result of the failure to appreciate the depth of the recession.

If an ambitious stimulus package had been passed in the winter of 2008, when the economy first began shedding jobs, its full impact would be kicking in now. Infrastructure projects that have a substantial lead time would now be creating jobs, as would programs for retrofitting private buildings to promote energy efficiency. However, because Congress and President Bush did not realize at the time that the recession would be so severe and long-lasting, it did not approve a stimulus package that was appropriate for the size of the problem.

While it may be difficult politically to get another package through Congress, there can be little doubt that the economy is in desperate need of further stimulus. Ideally, the stimulus would be between 2-3 percent of GDP ($300 billion to $450 billion a year) and would take effect as soon as possible. The unemployment rate is likely to be over 9.0 percent in 2010 in a baseline scenario absent the already passed stimulus, and will still probably be near 8.0 percent, even with the recently approved stimulus package. This would still place the economy close to 7.0 percent below its potential output.[10] In this context, an additional stimulus equal to 2-3 percent of GDP is still modest, even if with a multiplier of 1.5.[11] In short, there need be little fear that a stimulus package of this size would lead to an overheated economy.

It is not only important that a new stimulus be sizable, there is also a need to inject the money into the economy quickly. The Obama administration and Congress has tried to develop mechanisms that could inject money into the economy as quickly as possible, but there are at least two useful ways to inject money into the economy that Congress did not try:

1) An employer tax credit for extending health insurance coverage; and
2) An employer tax credit for providing workers with paid time off (e.g. paid parental leave, paid sick days, paid vacation, or shorter standard workweeks).

In principle, these tax credits could be designed in ways that would provide a quick boost to demand. The basic story in both cases would be to provide employers with a powerful incentive to immediately provide benefits to workers that would be desirable to see workers have in any case. The tax credits in both cases would be temporary (2 years), but if employers and workers valued the

---

[10] This follows Okun's Law that a 2.0 percentage point gap in GDP is associated with 1.0 percent point of excess unemployment. If the economy can sustain a 4.5 percent unemployment rate and the actual unemployment rate is 8.0 percent, then the 3.5 percentage point gap would correspond to a GDP that is 7.0 percent below full employment.

[11] The estimated multiplier for most forms of government spending is close to 1.5, whereas for most tax cuts the multiplier is less than 1. See Zandi, Mark M. 2008. "Assessing the Macro Economic Impact of Fiscal Stimulus 2008," Moody's Economy.com, available at http://www.economy.com/mark-zandi/documents/assissing-the-impact-of-the-fiscal-stimulus.pdf.

benefit (or the system was restructured in the case of health care), perhaps the benefit would be retained even after the period that the tax credit was in place.

In the case of health care, the government could offer a substantial (e.g. $3,000 per worker) tax credit for providing insurance for workers who are not already covered. It can also provide a smaller tax credit (e.g. $1,000 per worker) to cover the costs of increasing the generosity of benefits for workers who are already covered.

In principle, such a measure could quickly inject a substantial amount of money into the economy. For example, if employers of half of the 42 million workers not currently covered through their employer received coverage as a result of this tax break, then it would involve a payment of an additional $63 billion a year to insurers (21 million workers receiving a tax credit of $3,000 each), not including employer or worker contributions. In addition, if half of the currently-insured workers received more generous benefits in the full amount allowed, it would cost another $50 billion a year (50 million workers at $1,000 each).[12]

To some extent this money would allow workers to receive medical care they could not otherwise afford. This would give a boost to the economy in the form of additional demand for medical services. Much of the tax break would effectively be substituting money paid to insurers for money paid out of pocket by workers. While this would provide less stimulus than actually increasing the provision of health care services, the new insurance policies would effectively free up income for these families to use for other purposes. Since the population of uninsured is disproportionately lower income, it is likely that they would spend a large fraction of their savings from lower health care costs on other items.

It would also be possible to link a short-term stimulus with a longer-term health care reform agenda, for example, by allowing workers and their employers to buy into a Medicare-type system. Since Medicare already enrolls more than 3 million new beneficiaries each year, it should be able to expand quickly enough to enroll formerly uninsured people who would get coverage as a result of this tax credit.

Insofar as employers and workers bought into the Medicare system, it would provide somewhat less stimulus than if these people bought into private insurance. This is a result of the fact that Medicare employs fewer people to administer the program for each dollar of insurance than private plans. In other words, it is far more efficient. However, getting workers into a more efficient program could be an important first step toward reforming the health care system. In the long-run, the country will save money if it wastes fewer resources on the administration of the health care insurance system. It should not be necessary to promote waste in this sector to boost the economy.

The other obvious mechanism for quickly boosting demand is employer tax credits for giving workers paid time off. The paid time off can take a variety of forms, such as paid family leave, paid sick days, paid vacation days or a shorter workweek. The idea is that the government would give an employer a tax credit of up to $2,500 per worker per year to cover the cost of a reduction in work hours of up to 10 percent of their work time.

---

[12] The first stimulus package did include a substantial amount of funding for health care. A second stimulus could build on this funding to make important steps toward universal coverage.

This tax credit, like the health care tax credit, could be implemented with very little lead time and little bureaucracy. To qualify, an employer would need to post on a public website the reduction in paid work time that they have put in place. Since workers could see the work-time reduction claimed by their employer, they would be able to verify that the policy has in fact been put into place.

The arithmetic on this is straightforward. Suppose that employers of 60 million workers reduce their work time through family leave, sick days, or shorter hours by an average of 5 percent, at an average cost of $2,000 per worker. Since demand will not have changed (workers are getting paid just as much as they had previously), employers will in principle want to hire an additional 3 million workers to make up for the lost labor hours. This would imply 3 million new jobs, or jobs saved (in many cases, it may prevent layoffs that would have taken place otherwise), for an expenditure of $120 billion.

The great virtue of this sort of tax credit is that it is both boosting GDP and also increasing the number of jobs for every level of GDP. If everyone in the economy worked 5 percent fewer hours, and we had the same level of output, then we would have 5 percent more people working.[13] For this reason, it is the most efficient mechanism for bringing the economy back to full employment.

---

[13] This may not be strictly true, since there is some evidence that short work hours are associated with gains to productivity. Insofar as productivity growth can be increased by shortening workweeks or work years this is a further benefit from the policy. In effect, this means that we can all work shorter hours and still receive the same income. It is usually very difficult to bring about increases in productivity growth, if shorter workweeks or work years increase productivity, this would be an extremely painless way to achieve gains.

Stabilizing the Housing Market

The overwhelming majority of economists and economic analysts in policymaking positions managed to ignore the $8 trillion housing bubble as it was expanding. Remarkably, even after its collapse has led to the worst downturn since the Great Depression, the housing bubble is still being ignored by those crafting housing policy.

The basic story is that the bubble still has not fully deflated in much of the country. Prices are still far out of line with rents. It is ridiculous to believe that putting money into these housing markets will stabilize prices. Even if additional funding could slow the decline, it would only be temporary. The imbalance between rental prices and sale prices would eventually again put downward pressure on sales prices as rental units were converted to ownership units and would-be homeowners opted to save money by renting.

In contrast, it is reasonable for the government to try to stabilize house prices in markets where there either was never a bubble or the bubble has since deflated. This can be done by providing subsidized loans to homebuyers in these markets. An obvious mechanism would be to have the Fed buy enough bonds to lower the interest rate on Fannie/Freddie backed mortgages to 4.5 percent or even 4.0 percent, but restrict their lending to homes that are not purchased at bubble-inflated prices. (This can be determined by comparing the sale price to the annual rent. While certain metro areas have sustained higher ratios, the national average is approximately 15 to 1.)[14]

The government could also step in to buy properties directly in these markets if house prices fall far enough below trend levels. These properties can temporarily be converted to rental properties, which by definition would provide solid returns for taxpayers. (If the price-to-rent ratio fell to a very low level – say 12 to 1 – then the government would recover more than 8 percent of the purchase price each year in rent.) In addition to placing a floor on sales prices, this policy would also help to lower rents for those who are unable to buy or consider renting more desirable.

The government can contract out the management of its properties, if this seems a better route than having the government directly involved in renting out houses. In any case, the intention would be to only hold these houses as rentals units for a limited period of time until the market recovers, at which point they could be resold. This sort of investment undoubtedly would carry risk for taxpayers, but the fact that the homes would only be purchased at low price-to-rent multiplies means that the upside potential is likely to be far greater than the downside risk.

By contrast, the guarantees that Fannie Mae and Freddie Mac continue to issue on mortgages used to buy homes at bubble-inflated prices carry much greater risk. Given the current rate of price decline, many of these loans will soon be underwater, which virtually guarantees that the default rates will be far higher than normal. The failure of Fannie Mae and Freddie Mac to base their mortgages on appraisals of rental prices will likely result in much greater losses to these companies and therefore to taxpayers. A substantial portion of these losses is likely to be incurred on loans that were made after Fannie and Freddie were placed into conservatorship last summer.

---

[14] It would be reasonable to examine the historic pattern of sales prices to rents in each metro area to determine the proper ratio for that area.

Good housing policy going forward would seek to quickly bring down prices in the bubble-inflated markets, but then to stabilize house prices near trend levels in these and other markets. Unfortunately, housing policy is still being designed as though the housing bubble never happened.

The Falling Dollar, the Key to Long-Term Recovery

In many ways, the over-valued dollar can be seen as the root cause of the crisis. The high dollar, which first became seriously over-valued following the East Asian financial crisis, led to a large and growing trade deficit. At its peak in 2006, the trade deficit reached 6.0 percent of GDP, the equivalent of almost $900 billion in today's economy. This is the result of a high dollar, which makes imports cheap for people living in the United States, and therefore we import more goods. A high dollar also makes our exports expensive for foreigners, and therefore they buy fewer U.S. exports.

The trade deficit drains demand and jobs from the U.S. economy. (We are creating jobs in the countries from whom we are importing, not in the United States.) In order to sustain high levels of employment when we have a large trade deficit, we need to make up for this lost demand, either through the stimulus created by large budget deficits or the stimulus created by unusually high levels of consumption.[15] In this decade, we actually used both mechanisms to create demand. We ran large budget deficits and we also had a consumption boom spurred on by the wealth created in the housing bubble.

The bursting of the housing bubble has ended this consumption boom, so we are only left with large budget deficits as an effective method for boosting demand. While government budget deficits can stimulate the economy over the short-term, in the longer-term we need to restore the economy to a sustainable growth path. This will require more balanced trade, which will in turn require a lower-valued dollar.

The dollar had been falling against most currencies since 2002. This had begun to bring the trade deficit down in 2007 and the first half of 2008. However, the financial crisis caused the dollar to rise again as investors around the world view dollars as a safe haven. At some point in the future, when the crisis begins to subside, the dollar will begin to fall.

While this may raise concerns about a lack of investor confidence, in fact, a falling dollar will be a healthy and necessary development on the path to recovery. It is important that the dollar be allowed to fall. Any policies intended to prevent the fall – for example, increases in interest rates by the Fed or excessive deficit reduction by the government – will weaken the economy and threaten the survival of any recovery.

The notion that a strong dollar is inherently good is seriously misplaced. There will be costs associated with the weakening of the dollar, most importantly higher import prices and therefore somewhat higher inflation, but there is no alternative. The country cannot run large trade deficits indefinitely just as it cannot run large budget deficits indefinitely. The remedy for large budget deficits is tax increases and/or spending cuts. The remedy for large trade deficits is a lower-valued dollar. The public should welcome rather than fear the decline in the value of the dollar when it comes.

---

[15] In principle, high levels of investment can also boost demand, but it is difficult to use policy measures to substantially increase investment and almost impossible to increase investment by enough to offset a trade deficit equal to 6 percent of GDP.

It is also important to point out that the widely hyped fear of an investor panic leading to a run on the dollar is absurd on its face. Unlikely many small countries that must seriously fear a run on their currency, the United States need not have such fears because it has a huge, diversified economy.

Suppose the dollar were to fall to some very low level. Perhaps it will trade at 2.5 to a euro, and buy just 50 Japanese yen or 3 Chinese yuan. In this situation, the U.S. economy would suddenly be hyper-competitive. Foreign goods would be unable to compete in the U.S. market, while U.S. exports would be undercutting sales of domestically produced goods in countries around the world. The U.S. trade deficit would soon be transformed into a huge trade surplus.

Rather than see much of their manufacturing sectors wiped out by U.S. competition, foreign governments would almost certainly intervene to keep the dollar from falling too far. In other words, if investors became fearful about holding dollars, for whatever reason, foreign central banks would likely fill much of the void, limiting the extent to which the dollar would decline.

In the current economic climate, and most likely for many years in the future, foreign governments would have at least as much to fear from too large a decline in the dollar as the United States. For this reason, we can assume that they will not let it happen. The talk about a flight from the dollar is primarily a scare tactic used by those who seek to promote a specific policy or set of policies. It is not a scenario that has a foundation in reality.

Conclusion

The country is paying an enormous price for the failure of economic policymakers to recognize the growth of an $8 trillion housing bubble and to take effective measures to stop it. Even after failing to see the bubble, economists have repeatedly underestimated the consequences from its collapse. As a result, they have continued to advocate policies that were too small and too late to offset the negative impact on the economy.

This problem continues, as official forecasts are proving to be overly optimistic. It is essential that Congress take further steps to stimulate the economy quickly. The failure to do so will result in millions of workers being unemployed, possibly for many years into the future.

Appendix

Figure 1 – Data are taken from the Bureau of Labor Statistics, Net Birth/Death Adjustment, available at http://www.bls.gov/web/cesbd.htm.

Figure 2 – Data on shipments of non-defense capital goods are taken from the Census Bureau, series ANDEVS available at http://www.census.gov/indicator/www/m3/hist/naicsvsp.txt. Data on new orders of non-defense capital goods are taken from the series ANDENO, available at http://www.census.gov/indicator/www/m3/hist/naicsnop.txt.

Figure 3 – Data on non-residential construction was taken from the Census Bureau's January release on construction spending, available at http://www.census.gov/const/C30/release.pdf.

Figure 4 – The savings rate and adjusted rate were taken from Bureau of Economic Analysis, National Income and Product Accounts. The saving rate can be found on Table 2.1, line 34. The adjusted saving rate is equal to saving (Table 2.1, Line 33) plus the statistical discrepancy (1.7.5, Line 15), divided by disposable personal income (Table 2.1, Line 26) plus the statistical discrepancy (1.7.5, Line 15), available at http://www.bea.gov/national/nipaweb/SelectTable.asp?Selected=N.