Recession Time! The Housing Bubble Bursts the Economy

By Dean Baker

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The downturn in jobs reported last month by the Labor Department provided evidence of an economic downturn that even the economy's greatest cheerleaders could not ignore. Healthy economies do not shed jobs.

During the core periods of the upturns in the eighties and nineties, there were three months in which the economy lost jobs. In two of these, the loss was attributable to major strikes. (The jobs of striking workers are not counted in the survey.) That leaves a grand total of one month in more than twelve years of recovery in which the economy lost jobs. In other words, the August job loss leaves the economic optimists somewhat less credible than the deniers of global warming.

The backdrop for the August job loss is the collapse of the subprime mortgage market. Millions of low- and moderate-income homeowners are now looking at the resetting of interest rates on adjustable rate mortgages to levels that they cannot afford. While the Fed chairman and other leading economists assured the public that the problems would be restricted to the subprime segment of the housing market, this assertion was always ridiculous on its face.

Subprime mortgages accounted for one-fourth of all mortgages issued in 2006. The equally troubled Alt-A mortgage category accounted for another 15 percent. With segments that account for 40 percent of the mortgage market going into convulsion, there was no way that the housing market as a whole would not be affected. Of course, record supplies of unsold new homes and vacant homes also ensured that there would be substantial downward pressure on house prices.

The excess supply and constriction of mortgage credit is now affecting prices. Prices in the cities that had been the hottest bubble markets, such as San Diego, Las Vegas, Phoenix, and Miami, are declining at double-

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digit rates. Prices in slightly less bubbly markets, such as New York City, Washington, DC, and Boston, are falling at single-digit rates. These declines are likely to continue and quite possibly accelerate as the turmoil in the mortgage market further constrains demand.

This process will set in motion a downward spiral, as declines in house prices lead to more mortgage defaults. This will both place more foreclosed homes on the market and further constrain mortgage credit as the risk of default rises. The weakness in the housing market will be further reinforced by the weakening of the job market.

The job loss will first show up in the housing-related sectors. More than 50,000 layoffs have already been announced in the mortgage banking industry. This job loss has not shown up yet in the jobs data, since these workers were still employed when the August survey was taken. Construction and real estate will also see sharp declines in employment in the months ahead.

However, the direct impact on the housing sector is just the tip of the iceberg. The housing bubble created more than $7 trillion in housing wealth. Homeowners have used this bubble wealth to support a surge in consumption over the last five years, pushing the saving rate to near zero. They borrowed against their home equity to pay for vacations, new cars, or just to meet necessary expenses. As this bubble wealth disappears, consumption of all forms will be cut back, slowing growth and leading to more job losses.

In addition, declining construction-related fees and property tax revenue will constrict state and local budgets. This will lead to pressure for tax increases, just as the economy is going into a downturn, and to cutbacks in government spending and employment. This will further reinforce the downward spiral.

The growth of the housing bubble made this sort of collapse inevitable, just as the crash of the stock bubble was inevitable. The only question was when the bubble would finally burst and the exact form that the collapse would take.

It was incredibly negligent for the Federal Reserve Board and the Bush administration to allow the housing bubble to grow unchecked, and especially to allow the sort of mass fraud perpetrated against moderate-income homebuyers in the subprime market. At this point, there is probably no way to avoid a recession. If those making economic policy show no better judgment going forward than they have in the recent past, it is likely to be a long and painful recession.

Dean Baker is the co-director of the Center for Economic and Policy Research (CEPR). He is the author of The Conservative Nanny State: How the Wealthy Use the Government to Stay Rich and Get Richer *(www.conservativenannystate.org). He also has a blog, "Beat the Press," where he discusses the media's coverage of economic issues. You can find it at the American Prospect's web site.*

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