THE WALL STREET JOURNAL.
WSJ.com

OPINION | JULY 30, 2009, 11:21 P.M. ET

Signs of Life in the Housing Market

The good news is that government efforts to prop up prices didn't do much.

By GERALD P. O'DRISCOLL JR.

The economic crisis began with a housing downturn that spread to housing finance, and then to the entire economy in the form of a deep recession. Stability in the financial sector and growth in the economy will not resume until there is recovery in housing. But what will constitute a recovery in housing?

While the news this week about an uptick in home prices and sales in some markets is encouraging, those anticipating a return to pre-bubble price levels will find the wait to be a long one. In some markets it might not happen for a decade or more. Other markets may never return to pre-crisis prices—certainly not when adjusted for inflation.

Unfortunately, many public policy proposals have been aimed at propping up home prices, or at least cushioning their fall. Nothing could be more counterproductive.

The housing downturn was a classic bursting of an asset bubble. The suddenness of the collapse was frightening and, for a time, prices seemed to be in a free-fall, especially in over-heated areas in Arizona, California, Florida and Nevada. But the cure for falling prices in the aftermath of a speculative bubble is, paradoxically, to allow them to fall.

In housing, as with other assets, falling prices clear markets. They do so by making homes more affordable. During the bubble, homes had become out of reach for many people. In some areas—such as the San Francisco Bay area—households with a median income could not afford a median-priced home. This locked first-time buyers out of the market and made existing homes the currency for purchasing another home. To get around this, creative financing (such as "liar loans") sprang up to enable some to acquire a substitute currency. We know where that led—defaults and bankruptcies.

Another way falling prices clear markets is by raising future expected returns. This draws in speculative buyers. The very process that fueled an asset bubble can be harnessed to help stop a downward price spiral. When home prices fall sharply, banks and others help facilitate a process to sell homes more quickly than during normal conditions. That is what's happening in Phoenix and other cities right now as speculators scoop up homes on the brink of auctions. Often a buyer will allow a prior owner to remain in the home as a renter at a much reduced cost. The new buyers can cover some or all of their costs and hold the properties until such time as home prices actually turn up again.

First-time home buyers also contribute to the housing recovery process. People who thought that they were shut out forever discover that they can become homeowners. I know of a young woman and her fiancé who are now proud homeowners where heretofore they had been renters. They are helping restore a local housing market by restoring sales.

Government programs to prop up home prices have been half-hearted and ineffective overall, and mercifully so. A successful program to prop up home prices would have aborted the recovery process. It would have created an overhang of unsold, over-priced homes. Speculators would have held off buying and first-time buyers would have remained frozen out of the market.

That is what happened in the aftermath of the Savings & Loan crisis of the 1980s. Congress created the Resolution Trust Corporation (RTC), which took over the bad assets of failed S&Ls. Most of those assets comprised commercial, not residential, real estate. But the principle was the same. Prices needed to fall to revive sales.

The RTC has been hailed as a success, and it was, but not at first. Its original policy was to "warehouse" the assets so as not to push prices down further. But as those assets were set aside, the commercial real-estate market froze up. Only when the RTC decided to dump the assets did real-estate markets start functioning again. Texas was the epicenter of the S&L crisis and the collapse of commercial real-estate prices. When the RTC changed course, Texas recovered and the rest is history.

For all the talk of the failure of markets, what is actually working is markets. What failed were government policies of cheap credit and attempting to make housing affordable by stimulating demand. As amply demonstrated by Thomas Sowell in his new book, "The Housing Boom and Bust," land-use restrictions and "smart growth" (read no-growth) policies are the culprit for the lack of affordable housing. Stimulating demand through cheap credit only fuels unsustainable price bubbles. The way to avoid a future housing bust is to stay away from demand-stimulating and supply-restricting housing policies. Meanwhile, keep letting markets work.

Mr. O'Driscoll is a senior fellow at the Cato Institute. He was formerly a vice president at the Dallas Fed and a vice president at Citigroup.