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Housing problem was the bubble, not the bust

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As sales of new homes reach historic lows, there are increasingly strident calls for Washington to do something. These demands for action, however, fail to recognize that it was government, mostly Washington, which got us into this mess in the first place. Decades of subsidies for the housing industry have resulted in booms and busts that have repeatedly undermined the strength of our financial institutions while leaving the nation with a massive inventory of vacant homes.

The rental vacancy rate is just shy of 11 percent, while owner vacancy rate is approaching 3 percent, both close to double their historic average. In a nation of about 130 million homes, we have almost 19 million that are vacant. Almost 7 million of these are being "held off the market' awaiting better market conditions. Seven million is close to annual record for combined new and existing home sales. It should be painfully clear that our housing markets are facing a problem of way too much housing. Any increase in new housing starts should be a signal for tears, not optimism.

Basic economics teaches that holding prices above their market levels will decrease the quantity sold. The low homes sales numbers are the direct result of continued government efforts to boost prices. In addition to creating a wedge between supply and demand, housing stimulus efforts have created an expectation that prices will fall once these efforts are curtailed. Who would want to buy into a falling market?

With almost 2 million of the over 7 million job losses during this recession coming from the construction industry, Washington has latched onto believing that getting construction going will reduce unemployment. This is the rationale for infrastructure spending and incentives for homebuying, as well as Federal Reserve policies to prop up the mortgage market.

It is also the absolute wrong policy for job creation. Rather than encouraging the unemployed to go back into unsustainable sectors of the economy, such as construction, we should be creating and encouraging flexible labor markets that allow the private sector to create sustainable, non-bubble, job growth.

The housing market is especially sensitive to interest rate changes. The lower rates go, the more prices can be bid up while keep monthly payments constant. In addition, lower interest rates encourage builders to extend the construction process, building ever larger and luxurious homes. For this reason, at the center of almost every housing bubble you can find a central bank. The Federal Reserve's extremely loose policies earlier this decade resulted in a massive reallocation of resources from the rest of the economy into housing. With the help of Fannie Mae and Freddie Mac, foreign governments were also able to funnel their savings into the U.S. housing market. Once it became clear that production was being driven by speculation, rather than fundamentals, the bubble burst.

Ultimately home sales, and hence, home construction, will be determined by family incomes and basic demographics, such as population growth. Neither the level of subsidies or aggressive monetary policies will change that fundamental relationship. America's cycle of housing booms and busts is the result of government pretending these fundamentals don't matter. Every decade or so we are painfully reminded they do.

Washington must stop and re-learn basic economics. First, when you're in a hole, stop digging. In the case of housing, as a country, we built too much. The cure is to build less. Second recognize that for markets to clear, for supply to equal demand, prices must be allowed to adjust, or in the case of housing, fall. The solution is to get our government out of the housing markets; only then do we have any chance of achieving economic stability and avoiding financial crises.

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