

The Economy and the Housing Glut

On the community access TV show "Winsted Reviews" last week, Dr. Norman Douglas was Barbara Wilkes' guest. An economist for more than 40 years, Douglas holds a doctorate and an MBA in finance from the Stern School at New York University. Having begun his professional career on Wall Street and now retired from 30 years as a university professor, he knows his stuff.

Douglas suggested that the economy is already in a recession. He noted that Martin Feldstein, the conservative economist who recently stepped down as head of the prestigious National Bureau of Economic Research, has made the same observation.

The proximate cause of this recession is the housing bubble financed by the Federal Reserve with low interest rates and fueled by the unrelenting greed of mortgage companies and banks that made subprime mortgage loans with no requirement that the borrower have the ability to repay the loans. Wall Street then upped the ante on this house of cards by buying bundles of these low quality mortgages and then selling bonds backed by these mortgages.

This entire scam was built on the irrational belief that housing prices would continue to increase, forever. When housing prices began to slide in mid-2005, the jig was up.

Homeowners who foolishly committed to mortgage loans beyond their means, or were led to believe through predatory practices and outright fraud that they could manage the payments, saw the value of their houses fall below the value of the mortgages they owed. They cannot refinance those mortgages without coming up with a cash payment equal to the difference between

the market value of the house and the value of the mortgage loan.

Banks and other institutions that bought the mortgage-backed bonds for investment suddenly saw the market for these bonds dry up. They could not sell them and thus sustained huge losses. The banking system subsequently lost liquidity — the ability to turn an asset

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into cash quickly and without loss.

The Federal Reserve Bank stepped in and dropped interest rates 5 times from 5.25 percent to the present 3 percent in order to encourage banks to borrow from the Federal Reserve Bank to maintain their liquidity. Those moves should have caused all market interest rates to fall, but it did not.

Banks pulled back on lending to all borrowers, mortgages, student loans, credit cards, etc. and raised the interest cost on those loans. It is more difficult for home buyers to get mortgages as rates have risen and banks have become more conservative in demanding bigger down payments and more proof of income than they did during the housing boom.

Meanwhile, in the real economy, the housing market tanked, throwing large numbers of people out of work, while economic indicators show a slowing economy in the midst of rising prices. It is unlikely that housing prices will stabilize for several years.

Dr. Douglas was most concerned, however, about a period of "stagflation" — a stagnant economy combined with inflation. He said the latest data show a strong rise in prices across the board.

The next day in The New York Times, an op-ed by economist Paul Krugman echoed this concern ("Don't Rerun That '70s Show," Feb. 22). Tuesday's New York Times reported essentially the same thing: It is bad news for the economy as house values decrease and the cost of everything else increases ("As Inflation Rises, Home Values Slump, Data Show," Feb. 26).

The author suggests that if federal officials act aggressively, cutting interest rates to stimulate the economy, inflation is likely to increase. This is not good news, given higher prices for fuel, energy and food.

Here in Connecticut the slide in housing prices is just beginning. Housing starts are down and it is likely, if the national picture is any indication, that the slide in the prices of houses still has a long way to go, perhaps a matter of years before it bottoms out.

Winsted has at least five housing developments in the works: the proposed 44 condominiums on Wallens Street; the 24 homes (Tradewinds Farm) on Platt Hill Road; the 108 homes (Ridge at Winchester) on Wallens Hill; the 470 homes (Aurora Estates) on Torrington Road; and the 160 condominiums (Aurora Estates II) on Torrington Road. Some of these projects have been in the works for more than 10 years. They total more than 800 new homes in Winsted. Fortunately, none of these projects is complete. Most have never gotten underway.

This situation painfully demonstrates the haphazard and ill-conceived manner in which Winsted perceives itself, ignores the larger economic context and fails to appropriately plan for its future.

Charlene LaVoie is the community lawyer in Winsted. Her office is funded by the Shafeek Nader Trust for the Community Interest.