Housing Bubble 2.0 Courtesy of Lenders and the FED

May 6, 2011 - As bad as real estate markets have been across the country for the past four years, there were improvements last year in a good many markets. But over the past few months prices have dipped again. There is growing reason to believe that another housing bubble has formed and it may be about to collapse. And once again, that bubble appears to have been formed by misguided government and FED policies.

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Throughout last year, there was evidence that housing prices were improving. Many who follow real estate markets attributed that improvement more to government tax credits than to any real improvement in markets. And most people would agree that by that time lenders had tightened their loan criteria so much that any improvement can't be attributable to them.

With the expiration of tax credits for home purchases, housing prices did start to slide and now they have been dropping for four straight months. And there is growing pressure on home prices. Banks have stepped up the speed at which they are approving short sales. They have also increased the number of bank owned properties they are placing on the market. Those two categories of homes available now account for 40% of the market nationally; significantly higher in some areas. That combination has led to increased housing inventory and decreased prices.

Even with these issues, the news hasn't been all bad for homeowners or buyers. One of the primary things that has kept real estate markets afloat in many areas has been low interest rates. Despite growing evidence that inflation is on the rise, the FED has continued to hold interest rates down. They have used a number of techniques to manipulate rates but, at the same time, they are facing growing criticism for their policies.

If the inflation rate today was determined using the same methodology used during the Carter administration, it would be above 9.5%. But today, the FED backs out food and energy prices from its inflation equation. Doing this has allowed them to perpetuate the fantasy that inflation is low.

The FED has also been pumping hundreds of billions of dollars into the economy by purchasing US Treasury bonds. The FED calls this "quantitative easing", and because this is the second time they are doing it, the acronym "QE2" is often used. Economists call this policy "monetizing the debt"; something that FED Chairman Ben Bernanke promised congress that he wouldn't do as late as June, 2009. The truth is that whatever you call it, the policy is akin to turning on the money printing presses. It floods the economy that the FED has made out of thin air, devalues the purchasing price of every dollar, and saddled taxpayers with even more national debt.

The policy has also allowed flooded mortgage lenders with easy money. Again, that has helped housing markets because even though lending policies remain much tighter than they were a few years ago, borrowing money remains cheap. That may be about to change though.

Bernanke has said that he will end the policy of QE2 in June. As soon as that happens, borrowing money is likely to become more expensive as interest rates rise; and they are likely to rise sharply. In turn, this will impact both housing markets and all other forms of consumer and business borrowing.

The effects of this are going to be felt throughout the economy. When borrowing money becomes more expensive, businesses choose not to expand. This holds down job growth and, if interest rates become too high, contributes to growing unemployment. Consumers who use credit are likely to see the prices for the money they borrow rise sharply too. This means that that consumer spending will slow, further negatively impacting businesses. It is a vicious cycle.

With regard to housing, when interest rates on home loans go up, people in the market can't afford to buy as big a home as they want. Or they can't afford the neighborhood that they like. This causes many people to drop out of the market completely. Given the large numbers of homes already on the market, a precipitous drop in housing prices is going to be the likely result. That's "housing bubble 2.0".

If you look back at the bad old days of Jimmy Carter, the situation wasn't much different. High unemployment, low business growth, high interest rates, tough housing market. It was called "stagflation" and it is looking more and more like it is about to return.

The sad thing is that had the government and the FED simply allowed the market to correct, we'd be through most of this pain by now. The federal government's direct intervention in housing markets has created an artificial floor on prices by bringing more buyers into the market and by encouraging banks to adopt foreclosure and short sale policies that wouldn't work without the government's help. In the process, they have left taxpayers on the hook for trillions of dollars in what are apparently failed policy decisions. That floor looks like it is about to fall out. And the FED's policy of printing money has created an environment where the choices we're left with may be both inflation and collapse of the dollar or a protracted period of stagflation.

Hold onto your seat. It looks like it's going to be a bumpy ride.

byJim Malmberg
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