

## Housing Stimulus Plan

### Why Housing?

Economic forecasters and financial futures markets suggest that, without action, house prices will continue falling into 2010 by an additional 20-25%. About two-thirds of Americans own houses, and for most of them their houses constitute a substantial portion of their net wealth. As house prices decline, homeowners consume less and save more to compensate. A further collapse of house prices will also cripple the balance sheets of financial institutions and may lead to nationalizing banks. The government has issued mortgage guarantees on about 70% of outstanding mortgages through Fannie, Freddie, and the FHA, leaving taxpayers on the hook for hundreds of billions of potential mortgage losses. Stabilizing house prices is therefore a critical component of an economic recovery plan.

Mortgage rates have historically hovered about 1.6 % above the 10-year Treasury bond rate, but that spread has recently grown, increasing the cost of owning a home by 10-17%. So although the government and banks can borrow at historically low rates, those rates haven't been passed along to borrowers, as they would normally be absent a credit crunch. Reducing rate spreads to their typical levels would bring down mortgage rates substantially, allowing 40 million Americans to refinance and save more than \$400 per month on average and bringing many new homebuyers into the market.

### What Is the Proposal?

- The GSEs (Fannie or Freddie) would offer to buy new mortgages at interest rates of 1.6% above 10-year Treasury bonds (currently that rate would be about 4.5%). These purchases would be funded with newly issued Treasury bonds.
- All borrowers with GSE mortgages would automatically be refinanced at the new rates. This would quickly reduce monthly mortgage payments for over 30 million people without clogging banks with refinancing paperwork.
- New homebuyers and non-GSE borrowers would be eligible to refinance provided that their current outstanding balance is below the highest conforming limit (\$729,750), they have good credit, and their outstanding mortgage is less than 95% of their property value. Borrowers with a loan-to-value between 80% and 95% will pay a somewhat higher spread than the 1.6%.

### What Are the Effects of the Plan?

- *Refinancings stimulate the economy.* This plan would allow an estimated 40.4 million homeowners to refinance into new more affordable mortgages, saving them an average of \$424 in monthly mortgage payments, depending on interest rates. About 30 million of these refinancings will be GSE borrowers. This change translates into a national savings of over \$200 billion annually, the equivalent of a large middle-income tax cut for 30 years.
- *New homeowners help stabilize house prices.* The plan would induce up to 2 million new homebuyers to enter. Demographics add about 1.4 million potential homeowners per year. Lack of credit has deterred these homeowners from buying a home in the last two years, so there is an appreciable pent-up demand.
- *Liquidity helps the banking system.* Banks' balance sheets would be flooded with liquidity. Up to \$2 trillion of second liens, jumbo mortgages, and non-conforming loans would pay off early. This helps in separating good mortgages from bad mortgages, a key part of any bank recovery plan. Absent this action, banks' balance sheets in the aggregate will continue to deteriorate.
- *Taxpayers save tens of billions of dollars.* Taxpayers now have issued mortgage guarantees on nearly \$6 trillion of mortgages and are on the hook for additional losses in the banking system. Lower payments reduce mortgage defaults.

- *Stabilized house prices prevent foreclosures.* Lower rates would help put a floor on house price declines and lower mortgage payments, helping to stem the rising tide of foreclosures. Growing foreclosures increase the risk of dangerous policy solutions like bankruptcy cramdowns.

### What are critics' concerns?

*Hasn't government involvement in the housing market caused this crisis?* Government sponsored agencies (Fannie Mae, Freddie Mac, and FHA) originated about 70% of outstanding mortgages and are now originating more than nine in ten mortgages. As a consequence of the "conservatorship," the government now dominates mortgage originations and is already setting mortgage rates. The government should not use broken credit markets to set mortgage rates. The most severe credit crunch is not the time to get the government out of the mortgage market. A temporary stabilization is required, with a plan to allow private markets to take over as the credit crunch abates.

*Will this plan re-inflate the housing bubble?* Analyses by Hubbard and Mayer, Morgan Stanley, and Goldman Sachs shows that the cost of owning a home has already fallen below rents, and house price are still spiraling down. This plan would stabilize house prices, not re-inflate them. Even with this intervention, house prices would surely keep falling in overbuilt markets like Las Vegas and Phoenix, but stabilization would come sooner. Other markets might see house prices bottom out more quickly. As the economy recovers and interest rates rise, mortgage rates will also increase, stemming any excess appreciation. This is the normal process through which an economy recovers from a recession, but the process is being hampered by the credit crunch.

*Will the government have to borrow too much for this plan?* Although the government would issue new Treasury bonds to fund these mortgage purchases, this would simply convert private debt (current mortgages) to government debt, with no net change in the national balance sheet. As well, the government would have hard assets backing the government bonds.

*Is this a subsidy?* Absolutely not! The government is simply passing along lower borrowing costs to consumers. Without a credit crunch, this would happen without government intervention. In refinancing the \$5 trillion of GSE debt, the government would earn a spread of 1.6 percent above the 10-year U.S. Treasury rate. Far from a subsidy, this is a profitable transaction for taxpayers – *who are already saddled with mortgage guarantees issued in previous years*. For the estimated additional \$2 trillion of additional refinancings and purchase mortgages, the government should charge an appropriate spread to ensure no taxpayer losses. Again, it is important to note that the government is already issuing mortgages at higher rates; we believe that the right spread is much lower than is now being charged.

*Doesn't this lock-in government involvement in housing for years to come?* The government is the mortgage market and will be so for the foreseeable future. A time-limited, two-year plan will help stabilize the housing market and the economy. This plan uses the existing GSE structure, presenting a future opportunity to privatize the GSEs.