U.S. housing market -- Bumping along the bottom, but not “Japanized”?  

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The recovery of the U.S. (and also European) economy from the financial crisis of 2008 has been very slow -- slow enough to raise questions about whether either or both are entering a lost decade. This scenario is being labeled “Japanization” or “Japanese disease,” in reference to Japan in the 1990’s. Deflation (or disinflation) and prolonged sluggish growth are regarded as key symptoms of “Japanization.”

Japan experienced a long period of stagnant growth after the bubble collapsed in 1990’s (so called the “lost decade”). There indeed are some troubling similarities to economic conditions today in the U.S. and/or in the euro-zone. In the U.S., households are more busy deleveraging (paying off old debt, cautious about new debt, and building up savings) than in spending money. Business, faced with a demand shortfall because consumer spending growth is so low, is pulling back on investment plans. And the public sector (federal, state, and local) is busy cutting spending to limit deficits and budget shortfalls. One consequence is the Fed is providing plenty of liquidity -- banks have money to lend at historically low rates (mortgages hit 4 percent in mid-September). But consumers, business, and the public sector aren’t interested in borrowing.

These conditions result in an economy growing very slowly (not more than 1 percent growth perhaps through the first half of 2012). If the economy is growing slowly, job growth is even slower. In turn, that makes it difficult for households to keep up with mortgage commitments. Therefore, foreclosures are not slowing down. Foreclosed homes being auctioned holds down new construction rates, and keeps downward pressure on home prices for a 4th straight year, and possibly a 5th straight year in 2012. Japan, after the bubble collapsed, experienced more than 10 years of falling home prices. Nobody in America hopes they are at least halfway through right now.

Rents are different (Fig. 1). Why are home prices continuing to fall but rents starting to rise? Basically two trends contribute to this result. First, a tax law was changed more than two decades ago, limiting the tax deduction on mortgage interest for secondary

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homes. It remains for the home the owner occupies but not any units the owner rents out. The result has been a low construction rate for rental units for almost twenty years (Fig. 2). Now, soft economic conditions are pushing new households into rental units and forcing former home owners into apartments. The result is falling vacancy rates and rising rents, even as home prices continue to fall.

The government has been for a long time encouraged homeownership as an “American dream” (entrepreneurial spirit or capital participation) as mentioned above. That is now changing, in the wake of the worst housing downturn in more than a century. What support remains for homeownership is now targeted to low- and moderate-income homeowners “and renters.” And the FHFA (Federal Housing Finance Agency) is now considering converting some of the foreclosed houses to rental units, which seems reasonable given these circumstances. In addition to opportunity costs, this is an attempt to limit repair costs that would otherwise occur if the unit remained vacant for a longer period of time. In the process, home buying and renting may improve sooner.

Still, the overall weak state of the economy, it is going to take more time for housing to recover, no matter what changes are made in programs to aid lenders or home buyers. The foreclosure process is still under way, weighing on the housing sales market. More than two million households have already lost their homes and potentially another three to five million could be forced into foreclosure. High levels of unemployment and very sluggish job gains are forcing some families closer to the brink of losing their homes, and the equity they have already paid into them. Meanwhile, it is impossible today for a potential home buyer to obtain a mortgage without a significant down payment, at least 10 percent down and as much as 25 percent. Again, without more job or income growth, it is difficult for a household to accumulate enough to make that down payment, especially for young families.

Demographics condition is one of the (encouraging) differences from Japan’s experience. The population is growing at about 0.9 percent every year in the United States. In Japan, the population grew at only 0.3 percent (annualized) during 1990-95 and now declining. This might be a part of the reasons housing rent is picking up unlike Japan. And it’s of course one of the important factors in the potential growth of the whole economy.

In conclusion, the housing market has already suffered a four year down turn. But it is unlikely to continue for another six years. Thus, the outlook is not for a lost decade, as occurred in Japan. Why? 1) home price depreciation has improved affordability; 2) Mortgage rates are very low (4 percent for well qualified buyers with a significant down
payment; 3) Preferential tax treatment of mortgage payments; 4) Favorable demographics; and 5) Still significant foreclosure rates but rates nonetheless that are slowing. Still, housing remains weak and will take more time to start to recover, just not another six years. How soon real recovery begins depends on recovery in the labor market, which in turn depends upon improvement in the overall economy.

Rogoff & Reinhart looked at many crises across the globe over the past centuries. Their principal finding from this important research is that financial crises have deeper and longer impacts than purely economic crises. 2008 saw the worst recession in almost a century. Second, at its core was a near financial meltdown. Third, the U.S. economy is also undergoing major fundamental restructuring. These factors help explain why the housing market is in such bad shape. They do not however, support the notion that a very prolonged period will necessarily precede recovery. The U.S. will not suffer a lost decade.

Last point: Could anything shorten the time frame? Yes and it does not necessary include action from the government. One proposal is that the banks, the mortgage lenders, forgive some of the loan allowing the distressed home owner to continue paying and not have to lose the home in foreclosure. Here is how this works. If the bank is forced to foreclose and throw the family out of the house, they have to put that house up for sale at a foreclosure auction. They might receive as little as 20 cents on the dollar, depending on the auction bidding.

The idea is that the bank would be better off getting 70 cents on the dollar from the homeowner. If they forgive a portion of the loan, the homeowner has a better chance of staying current on payments, staying in the home, and not losing equity. Homeowner wins. Banks win. And with fewer foreclosed homes on the market, supply would be more in line with demand, prices stabilize, and new construction could begin. Homeowners would jump at this kind of program. Banks are resisting. The Federal Reserve could use some capital to make the deal sweeter for banks. It could happen. It would have positive effects. And it doesn’t require any action from a deadlocked congress. So why haven’t they tried this? Some banks are as yet unwilling to accept less than 100 cents on the dollar, risking getting far less at an auction.

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Figure 1: Housing rents in Japan (left) and the United States (right)

![Graph showing housing rents comparison between Japan and the United States over time.](image)

Figure 2: Composition of housing started (left) and homeownership rate (right)

![Graph showing composition of housing started and homeownership rate over time.](image)

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