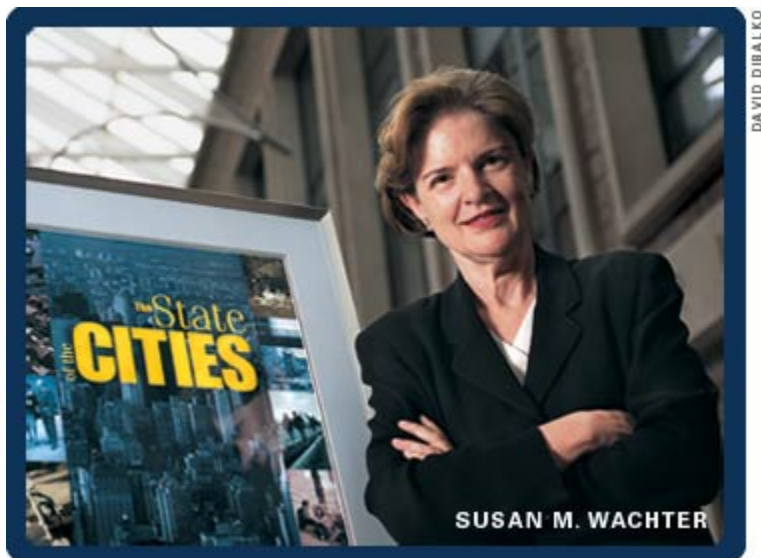




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When it comes to real estate, Wachter both sets and follows trends. She founded and directs the Wharton GIS Lab, which specializes in Geographic Information Systems, a technology that combines geographic, economic, and other data to study everything from land use to foreclosure rates in various neighborhoods.

Her GIS work led President Clinton to choose her to be his assistant secretary for policy development and research at the U.S. Department of Housing and Urban Development, a position she held for two years until President Bush took office in 2001.

Most people take the rebirth of urban America as a given now, but Wachter never stopped believing, even when the words urban and decay were frequently partnered. As policymaker, researcher, and professor, she pushed for reinvestment in urban areas. Now that the housing boom has turned into a bust in some areas, Wachter can often be found discussing these ups and downs on ABC News and in the *New York Times*.

Q. How big is the housing problem?

A. Estimates have been that it will reduce GDP by about 1 percent, but the key question is whether we're going to get out of the subprime crisis without a recession. We don't know. The next six months will be very telling.

Q. The housing market has been in decline for more than a year. Why does so much uncertainty remain?

A. In some ways, we are in very, very uncharted territory. In fact, we have to go back to the Great Depression to find a period of decline in housing prices as great as we have now.

Here are the two big questions: As prices decline, will homeowners and potential buyers react by going on a buyers' strike in the expectation that prices will fall further? If so, will this have a self-reinforcing impact? One thing we do know is that on the upside, rising prices are self-reinforcing, and that is what gives rise to bubbles.

Secondly, as prices decline in the normal housing market, demand increases and you get to a point where demand absorbs excess supply. But what we are in is a situation where as prices decline, supply increases. New housing starts are down, but our current situation generates supply increases through increases in foreclosures. No one really has good estimates of the impact of this.

Moreover, there's a possibility for the overall economic slowdown to feed into the housing decline and for housing decline to feed back into the overall economic decline.

As prices fall, if you're not forced to sell, you may simply wait it out. We've already had a 15 percent price decline, according to (Standard & Poor's) Case-Shiller National Home Price Index. Foreclosure sales have been an unusually large percentage of the last quarter's sales; there will be more sales generated from the usual market forces from springtime and this may lead to a moderating of the price decline. Whether owners will hold on and prices will moderate or whether we will continue to see the disproportionate impact of foreclosure sales depends on lender behavior as well as policy inducements to encourage loan work-outs.

There are more than 10 million homes in the United States where the value, based on current mark to market, is less than what is owed. It's a stunning number, but its economic impact depends on how these homeowners respond, and whether they act on knowledge that their home value is beneath their mortgage amount.

We do know that typically homeowners do not monitor the value of their homes, nor do they typically get up and walk away. People are invested in their homes, invested in their neighborhoods. Nonetheless, there is the potential of a downward spiral, which is why the Federal Reserve eased credit — to minimize the danger of the resetting of so-called teaser rates. By getting short-term interest rates down substantially that particular bullet has been avoided.

Q. You mentioned earlier that we have to go back to the Great Depression to find comparable declines in the housing market. But how well does the current period compare? Haven't the housing market and the overall economy changed dramatically?

A. We're only using that as a way to say we're in uncharted territory. Fed Chairman Ben Bernanke is an expert on the Great Depression, which explains his very quick reaction to the credit crisis.

In some ways the markets do compare. Then, too, we had loans that could not be refinanced when they came due, so-called bullet loans. The major difference is that upwards of 25 percent of mortgages were in default. Today, we see defaults at 6 percent.

Also, this is a regionally based housing recession. What were the drivers of the subprime crisis? One was lower middle- income and working-class borrowers who had a hard time affording a house, including the Midwest where the job market is weak. So wherever credit was imperfect, where people had low credit scores, subprime expanded, sometimes with these toxic, aggressive loans.

And in coastal states, where housing was not affordable, subprime loans offered a way to get people into houses. Much will depend on the course of the regions as well as the national economy.

Q. So are there solutions to the housing crisis?

A. Bernanke has eased monetary policy and stabilized financial markets to some degree. Going forward, inflation is a real issue, so there are limits to what can be done. At some point inflation expectations start to drive up interest rates. There's not a lot of room here for getting it wrong.

There are targeted responses as well, such as those that were put into place after the Savings and Loan crisis and the Great Depression. In the latter case, the government stepped in to put a floor on the decline on housing prices. Congress is currently considering legislation that would work in this direction, but issues of who pays and consequences for future risk taking are also being weighed.

Q. Some experts say lenders should be working harder to negotiate with borrowers who are behind in their loans. These people say it's often cheaper to modify a loan than to go through foreclosure and sell a house at a loss.

A. A real problem is borrowers making the connection with the lender. This problem can grow if you don't get it early, so that first connection is crucial. If you can make the connection and modify the loan then often that is best for the borrower and the lender. But if in the end, foreclosure is going to happen, if the economics will not allow them to be in the house long-term, it doesn't do a favor to the borrower to prolong the process. There is also an issue of conflicting interests on the parts of the multiple holders of mortgage securities that needs to be resolved for fast action to be taken. Moreover, from a production perspective, this is a difficult time. Mortgage servicers are overwhelmed and simply lack staff to get borrowers to the table and negotiate solutions.

But, if this is a self-reinforcing process, what do you do? What will it do to cities? What will it do to neighborhoods? This is at the heart of the current policy discussions.

Q. The last time we experienced a downturn in the housing market was in the 1980s. Many experts have said that markets hardest hit during that period — Boston, California — recovered. Does that offer any comparisons to today?

A. Cyclic markets like Boston and California recovered. They were down 30 percent in nominal terms and they came back. So in this run-up, prices exceeded previous highs of the mid-1980s substantially. These are very volatile markets because supply is constrained and once prices start to rise there's an expectational component that itself drives demand, which can quickly reverse.

The price dynamics are different in what I call the flat-liners — the markets where housing prices just keep pace with inflation — places like Texas where despite tremendous increases in demand, prices did not increase. Supply did. The problem is that much of the United States has become more volatile. Texas is the exception — supply constraints add to price volatility.

Markets will be weighed down by inventory of new production and foreclosed homes now on the market. Before recovery can begin, we need to stanch the increase in inventory. We are not there yet. This crisis is the inevitable result of financial markets flooding the housing sector with capital without regard to underwriting standards and then withdrawing funding after unsustainable price run-ups. Mortgage-market cyclicalities are now a key to the problem and the part that we need to resolve longer term.

For more from Wachter on the subprime mess, see additional coverage in Knowledge@Wharton at <http://knowledge.wharton.upenn.edu/article.cfm?articleid=1812>