Abroad

An interview with David Berson, vice president of Fannie Mae

The US housing market is set to slow down

A 10% home sales drop this year is likely. Prices ought to rise below trend. Unfortunately, some areas are going to suffer from a combination of contracting sales and prices. Florida, California, Arizona and Nevada may include some of these vulnerable areas.

TheEuropeanSide was both reluctant and happy to discuss the outlook of the American housing market with David Berson. Reluctant, because one may sound candid and silly asking the US mortgage giant whether the American housing industry is in trouble; happy, because few people grasp the sector better than Mr. Berson. All in all, we found a well-balanced person who expected real estate sales to suffer a 10% drop. Prices ought to rise below trend for a couple of years and the economy ought to slow down and experience a 2-2.5% growth rate. Of course, if you have any shocks such as oil at $100 per barrel or a human bird flue contagion then the impact on the mortgage market is likely to be much more severe.

***David Berson** is vice president and chief economist at Fannie Mae, the US mortgage giant. In this capacity, he is responsible for managing the economics department, forecasting and analyzing the economy, interest rates, and the housing and mortgage finance markets. He also advices Fannie Mae's senior management team on finance, economic, tax, and housing policy issues. Prior to joining Fannie Mae, Dr. Berson was chief financial economist at Wharton Econometrics and visiting scholar at the Federal Reserve bank of Kansas City. He has a doctorate in economics and a master's degree in public policy.*

Let's start with the overall picture: what's your diagnosis?

"On a national basis, we expect the housing market to slow."

Can you quantify the phenomenon?

"*Moderately* is probably too little, but *significantly* is too much. We are looking for nearly a 10% drop in home sales and housing starts in the United States this year. That's big for a non-recessionary year."

What are your arguments?

"There are several reasons why I envision the possibility of a deceleration. Number one, affordability is down in part because mortgage rates are up, but mostly because home prices have risen so much. Number two, although we are not leaning toward a recessionary scenario, the economy is less favourable and therefore job growth is not as strong and consumer confidence is deteriorating. And number three, the demand emanating from investors in second homes has been at record levels recently. We expect that to fall off."

The United States is a huge country, so I assume there are some regional differences…

"Of course. There may well be some parts that have significant downturns on account of a weakening local economy and in response to a declining demand from investors."

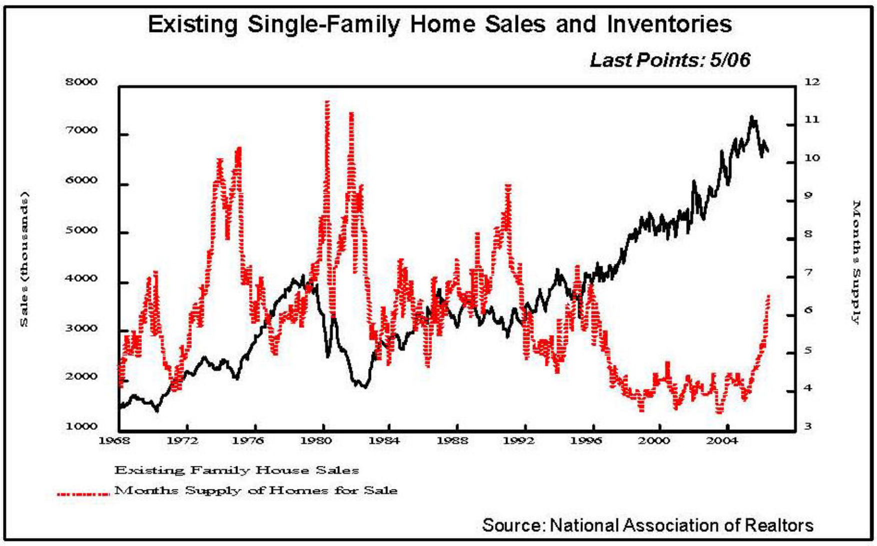
Could you mention any areas?

"Well, the parts of the nation which have seen the largest investor activity. Many cities in Florida, some in California, Arizona, Nevada."

You argue that a 10% drop in home sales is likely to happen this year. What about home prices?

"Home prices have risen in the last two years at double digit rates, which, in an economy where inflation is running at 2-3%, is unsustainable. And unsustainable trends eventually end. We think this is the year that the unsustainable trend ends. Nationally, the historical experience is that when we have a period of unsustainable price gains, we get a following period of below trend gains, but not a national decline. In the US we probably haven't seen a decline in home prices nationally since the Great Depression and I think we will not see a decline in this case; instead, a couple of years of below-trend growth is in the making."

What is in your opinion the



Inventories in the real estate sector are high compared to the last 10 years, but not historically.

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trend?

"It's around 4-5% per year. Thus, perhaps 2 to 3% is the range for the next few years."

Again, is it appropriate to say that some areas are going to endure a downward spiral in prices while others remain firm?

"It is almost certain that some cities will witness a contraction because the overall level of price appreciation is slowing. Some metropolises may suffer from a combination of weakening investor demand and overbuilding. In those cases, large declines are possible, but not nationally."

What do you mean by "large declines"?

"Large declines could mean, over the next couple of years, declines anywhere from 5 to 15%. In some sense they would be similar to those experienced in the early 1990s period."

Analysts have noted that inventories are on their way up, confirming the suspicion that the housing industry is in bad shape.

"We can look at the unsold inventories for new and existing houses. Let's look at new homes first. The inventories sales ratio for new homes is 5.5 months. It has been actually falling for 3 months in a row as the sales have risen, although, I am not sure they will continue to rise. The 5.5 months is still historically a little below average, but clearly up compared to the last 10 years."

Thus, you are not worried?

"I am not saying this, because if we look at the absolute number of homes for sale, the picture is different. In May, there were more homes for sale than in any other period and that is concerning and is one of the reasons why we do expect a nearly 10% fall in sales. Surely there has been a fall off in housing demand relative to the pace of new constructions. The longer the imbalance continues, the greater the potential for a more serious adjustment when it occurs."

Now the figures for the existing home sales…

"The inventory ratio is 6.5 months. Again, the figure is high for the last 10 years, but not historically. The big jump is in condominium inventories and we know that investors are highly concentrated in condominiums. Here is the problem."

Some experts claim that consumers are overextended; that they rely on continuous asset appreciations to sustain their spending. If home prices are beginning to stagnate, the slowdown in the economy may deteriorate into a recession. What do you think about that?

"Most spending growth has come from income growth. Clearly there has been some additional impetus from mortgage equity and that will slow in the future. Still, equity outstanding is at record levels. But, please, do not misunderstand my words, I expect consumer spending to slow. It's one of the reasons why our overall forecast for real GDP growth is only 2.5 to 3%, while its trend is at 3.5%."

In the past, the Federal Reserve often pushed the economy into recession at the end of a tightening cycle. And this time?

"Nobody knows and the Fed does not know either. Is it possible? Yes. Does it always happen? No. We don't know. And the reason is that nobody really knows, nobody has a good estimate of how high Fed funds have to go in order to finally cause a recession. The models are not enough precise to tell."

Ok, let me put my question this way: if there is a recession in 2007, how much would the mortgage market suffer?

"I can't answer without knowing the kind of recession. If it is a modest one, similar for example to 2001, then perhaps not very much and for a couple of reasons: first, the loss of jobs was mild and second, interest rates went down. Accordingly, there was an opportunity for people to refinance their mortgages and to buy homes."

Does the recession of 2001 offer a conceptual framework for understanding the course of events if a new economic contraction materializes?

"Remember, the recession is not my basic scenario. We are speaking of hypotheses. If a mild recession occurs, in my opinion, the Fed would ease very rapidly again, counterbalancing the negative effects. Some people would lose their jobs. Therefore, I am not saying we would not see any impact, but overall, if the situation is similar to 2001, it would be manageable."

What if the recession is deep?

"It is possible that we have a more serious downturn. For example, if oil prices go to $100 at the same time the Fed is tightening, or perhaps there's a bird flue pandemic which causes the economy to crash. In those shock situations, the impact on the mortgage market would be far more severe."

Let's hope for the best. Thank you for your time, Dr. Berson.

V.S.