OP-ED CONTRIBUTOR

How to Stop the Drop in Home Values

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Wesley Bedrosian

HOMES are the primary form of wealth for most Americans. Since the housing bubble burst in 2006, the wealth of American homeowners has fallen by some $9 trillion, or nearly 40 percent. In the 12 months ending in June, house values fell by more than $1 trillion, or 8 percent. That sharp fall in wealth means less consumer spending, leading to less business production and fewer jobs.

But for political reasons, both the Obama administration and Republican leaders in Congress have resisted the only real solution: permanently reducing the mortgage debt hanging over America. The resistance is understandable. Voters don't want their tax dollars used to help some homeowners who could afford to pay their mortgages but choose not to because they can default instead, and simply walk away. And voters don't want to provide any more help to the banks that made loans that have gone sour.

But failure to act means that further declines in home prices will continue, preventing the rise in consumer spending needed for recovery. As costly as it will be to permanently write down mortgages, it will be even costlier to do nothing and run the risk of another recession.

House prices are falling because millions of homeowners are defaulting on their mortgages, and the sale of their foreclosed properties is driving down the prices of all homes. Nearly 15 million homeowners owe more than their homes are worth; in this group, about half the mortgages exceed the home value by more than 30 percent.

Most residential mortgages are effectively nonrecourse loans, meaning creditors can eventually take the house if the homeowner defaults, but cannot take other assets or earnings. Individuals with substantial excess mortgage debt therefore have a strong incentive to stop paying; they can often stay in their homes for a year or more before the property is foreclosed and they are forced to move.

The overhang of mortgage debt prevents homeowners from moving to areas where there are better job prospects and from using home equity to finance small business start-ups and expansions. And because their current mortgages exceed the value of their homes, they cannot free up cash by refinancing at low interest rates.

The Obama administration has tried a variety of programs to reduce monthly interest payments. Those programs failed because they didn't address the real problem: the size of the mortgage exceeds the value of the home.

To halt the fall in house prices, the government should reduce mortgage principal when it exceeds 110 percent of the home value. About 11 million of the nearly 15 million homes that are "underwater" are in this category. If everyone eligible participated, the one-time cost would be under $350 billion. Here's how such a policy might work:

If the bank or other mortgage holder agrees, the value of the mortgage would be reduced to 110 percent of the home value, with the government absorbing half of the cost of the reduction and the bank absorbing the other half. For the millions of underwater mortgages that are held by Fannie Mae and Freddie Mac, the government would just be paying itself. And in exchange for this reduction in principal, the borrower would have to accept that the new mortgage had full recourse — in other words, the government could go after the borrower's other assets if he defaulted on the home. This would all be voluntary.

This plan is fair because both borrowers and creditors would make sacrifices. The bank would accept the cost of the principal write-down because the resulting loan — with its lower loan-to-value ratio and its full recourse feature — would be much less likely to result in default. The borrowers would accept full recourse to get the mortgage reduction.

Without a program to stop mortgage defaults, there is no way to know how much further house prices might fall. Although house prices in some areas are already very low, potential buyers continue to wait because they anticipate even lower prices in the future.

Before the housing bubble burst in 2006, the level of house prices had risen nearly 60 percent above the long-term price path. So there is no knowing how far prices may fall below the long-term path before they begin to recover.

I cannot agree with those who say we should just let house prices continue to fall until they stop by themselves. Although some forest fires are allowed to burn out naturally, no one lets those fires continue to burn when they threaten residential neighborhoods. The fall in house prices is not just a decline in wealth but a decline that depresses consumer spending, making the economy weaker and the loss of jobs much greater. We all have a stake in preventing that.

Martin S. Feldstein, a professor of economics at Harvard, was the chairman of the Council of Economic Advisers from 1982 to 1984 under President Ronald Reagan.

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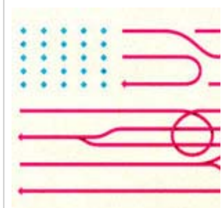

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