Example of term paper on housing bubble and burst in us

Business, Marketing

The housing bubble and its subsequent burst in late 2006-07, were cited as one of the primary reasons for the financial crisis of 2007-08 that left the whole global economy in tense situations. In the US alone, millions of people went homeless, and thousand of real estate companies were having unsold homes and commercial properties. The financial pundits and researchers blamed the easy financing and relaxed regulation on the financial sectors that fed into the bubble, allowing it to grow to proportions and such level, from where it was not possible for the federal system to save the economy from the financial crisis.

This research paper will go back to the time period of mid 1990’s when the foundation of the housing bubble was laid by the stock market capital appreciation and will finally conclude as how the relaxed credit policies, aggressive sub-prime lending and financial innovations allowed the housing bubble to grow to dangerous levels that resulted in a financial crash that shook the country’s financial system.

Origin of the Housing Bubble:

The origin of the housing bubble in the United States is attributed to the stock bubble during the mid 1990’s. This was a time when blue-chip stocks like Microsoft were heading high and so do other companies in US. Thus, individuals whose capital money has grown manifold courtesy extraordinary run of the stock prices were now spending their money with high purchasing power. As a result, the late 1990’s saw a tremendous increase in consumer spending while the saving rate fell from 5% during 1996 to 2% during 2000. One integral portion of this increased spending was channelized into bigger and better homes. With increasing stock prices and increasing wealth, Americans had grown their spending tendency with a higher proportion being spent on purchasing new homes. Thus, on the macro effect, this increased the demand level in the economy and soon this triggered the housing bubble in US as in the short run, the supply of the housing properties was fixed. Thus, it lead to the first phase of housing bubble where because of low supply and increasing demand; prices for homes started increasing. As the price continued to rise consistently, the increase got incorporated into expectations. US individuals and investors because of expectation of a continuous rise in price levels started to pay higher amount for homes in the expectation of substantial profits.

In a data issued by US Government, the inflation adjusted housing process across the country was not changed on the average from 1953 to 1995. Another researcher, Robert Sheller, constructed a data series for 100 years from 1895 to 1995 and again proved that, on an average, the inflation adjusted prices for homes were unchanged in US. However, it was interesting to know that, by the end of 2002, the prices of houses in the United States have increased by nearly 30 percent after adjusting for inflation. Furthermore, comparing the 30% increase in housing prices with the long history of stable house prices shown in the government data, and the even longer history in the data series constructed by Sheller, it can be concluded that the increase in housing prices were driven by the speculative and expectation bubble and not by the fundamental pricing of the housing market. Furthermore, this fact was confirmed when the rental charges in US had increased by around 10% in real terms. Thus, this was concrete evidence that the nation was experiencing a speculative housing bubble.

This was because if there were fundamental price rise in US then both house prices and rental prices should have increased. However, there were speculative increase only in the housing prices and finally, the housing bubble had arrived in the Unites States.

The second phase of the housing bubble:

After the demand side effect, now with high prices in the housing market, the supply side finally started showing its effect. Soon, the housing supply started increasing. By the end of 2002, housing starts were almost 25 percent above the average rate over the three years immediately preceding the start of the bubble (1993-95). The increasing supply of buildings first showed its effect in the rental market where the vacancy rate increased to 9 percent in 2002 compared to the rate of 7. 5% in the mid 90’s.

Interestingly, after the collapse of the stock market in 2001-2002, the housing market started reaching new heights as the loss of faith in stock market, led million of US investors and individuals to channelize their investment in the real estate sector as they considered this sector of investment as safe when compared to stock market. Soon the word of investment in Housing Market was spread around the US Economy.

Then came the role of Federal Reserve, the policy of which is still criticized for feeding the housing bubble. Soon after the stock market crash during late 2001, the US economy was very slow on its recovery path and people were losing their jobs and the economic growth was on the standstill. Thus, the weakness of the US economy led the Federal Reserve to allow further cut in the interest rates and during the summer of 2003, the federal fund rates reached 1 percent, a 50 year low. Thus, with low Federal Funds Rate, the average interest rates on 30-year fixed rate mortgages fell to 5. 25 percent in the summer of 2003; also a 50-year low and low interest rates on mortgages once again boosted the housing bubble.

Final Phase of Housing Bubble:

Finally, the policies of the Federal Reserve are to be blamed for inflating the bubble. In an official statement of the Federal Reserve Board Chairman, Alan Greenspan officially suggested that the US individuals are wasting their money by purchasing fixed rate mortgages instead of adjustable rate mortgages (ARM). This once again motivated the home buyers to take mortgage loans of the large amount. Overall, the low interest rates have finally started playing its role during 2003.

The substantially low interest rates accelerated the run-up in house prices. By the end of 2006, US housing prices had increased by 31. 6 percent since late2002, recording an increase of 7. 1 percent. This motivated the builders to increase their supply to support the surging demand. By the end of 2005, 2070000 houses were built a record 50 percent above the rate in the pre-bubble years this also fueled the consumption in US

This fueled more construction, and while the consumption expenditure increased substantially during this period, the saving rate fell miserably low to 1 percent during 2005-07.

Other Catalyst of Housing Bubble: Non Standard Mortgages and Financial Innovations

As the housing prices grew further and that too on pure speculative basis, the financial industry turned up as a catalyst to the housing bubble. Soon after the cut in the interest rates by the Federal Reserve Board, the financial industry adopted more financial innovations to support this growth. One of the primary parts of this growth was the Sub-Prime Mortgages. Under this type of mortgage, individuals who were having poor credit history were also provided with mortgage loans but at the higher rate of interest.

Furthermore, during the late 1990's, most of the mortgage loans were fixed rate mortgages, but in the middle of 2000's majority of the loans were on adjustable mortgage rates and amounted to 35 percent of the total loans issued in 2004-06. Interesting, these mortgages did not provide the security of fixed rate mortgages; they were also issued at below the market rates. Finally, the sub-prime market exploded during this period and of the total mortgage loans, sub-prime loans amounted to 25 % in 2005 in comparison to 9 % during 2002. In addition to this explosion in subprime loans, there was also a boom in the intermediate " Alt-A" mortgage category. These were loans given to homebuyers who either had a mixed credit record (better than sub) The Alt-A loans were in many cases of more questionable quality than the subprime loans. Many (perhaps most) of these loans were for the purchase of investment properties.

Interestingly, the Alt-A loans were issued by the banks without proper documentation, and this prompted the issue of ''Liar Loans' in US. Another fact that came to know later on was high loan to value ratios in Alt-A loans where many buyers had borrowed full purchase price and in some cases, borrowers even borrowed a sum higher than the purchase price of the house. Also, many of the Alt-A mortgages issues in the years from 2005-2007 were interest only loans or option-ARMs, which required borrowers to just meet interest payments on their mortgage.

The Burst of the Bubble:

Finally, the day came: The Housing Bubble had busted. With excessive supply of housing units in the country, the bubble began to unravel after the house prices reached a record level during 2006. As soon as the bubble busted, the one which was expected took place: massive defaults, especially in the sub-prime markets. Thus, it was clear from the fact that the primary reason for collective default in the housing sector was the high amount of lending in sub-prime mortgages and Alt- A loans. Moreover, the sub-prime borrowers turned out to be the most vulnerable section of the society as these borrowers were not having any past savings, neither any retirement accounts from which they could withdraw. Finally, when the sub-prime and Alt-A borrowers found that they have no means of repayment of loans, a mass collective default by the borrowers was registered that shook the US financial system within few days.

It was also worth noting that most of the sub-prime loans that defaulted during 2007 were not the initial re-purchase mortgages, but refinance mortgages. This was the result of excessive allocation of loans by sub-prime lenders who marketed mortgages to refinance home loans even to defaulting borrowers. Further, loans were also provided to re-model the home. As a result of such a loose credit rationing, a major portion of the US economy was under debt and as a result of this, the world’s most strongest economy ultimately lead itself into financial crisis.

The news of the spread of defaults in the sub-prime market led to significant decline in valuation of housing properties, and there was a time when the value of the home of an average borrower was less than the amount he had borrowed from the bank. Millions of people left their homes and banks were left with no option than to file for bankruptcy. The fact that so many instruments and institutions were exposed to serious risk from the subprime market led to the series of credit squeezes that hit financial markets beginning in the winter of 2007 and it all started with a burst of the housing bubble.

Personal View: How the bubble burst has affected the US

It has been almost 6 years now when the US economy was significantly affected by the housing bubble burst. However, since Federal Reserve was equally responsible and played a major role in inflating the bubble, today, a number of steps has been taken to ensure that there exists no another housing bubble. However, on the hand, the federal government is trying to ensure that the real estate market gets back on the path of recovery.

In terms of existing housing sales, the numbers are down by 2 percent up from the normal levels. However, the biggest hurdle in the path of recovery is the low construction start ups which are down by 40 percent of the normal activity. Since, the hangover of bubble burst still exist, many people are still recovering from the losses. As a result, young adults are moving back in with their parents or living with roommates a lot longer before striking it out on their own.

As for the home prices, after the bubble burst in 2007, the US real estate market has seen a commendable recovery since 2011. Where the average housing prices fell to $166100 during 2007, currently the average price has increased to $213500. But still the amount of homeownership is on decline as after the bubble burst, investors are not considering real estate as a sound investment area.

How Fed is avoiding another Housing Bubble:

Gone are those days of Sub Prime lending which lead the US economy to the real estate disaster. In order to avoid another bubble, Federal Reserve Bank has asked all the banks to become more risk adverse. According to a report, around 55 percent of the homebuyers holding the mortgage loans have a FICO rate of 740 or above. This indicates that the Federal Reserve has raised the lending standards.

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