A Schumpeterian View of the U.S. Housing Crisis

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Joseph A. Schumpeter explains the institutional conditions that expand sectors of the economy, over expand those sectors and then cause the collapse to the market. He used as an example the stock market expansion, the overexpansion and then the collapse associated with the stock market crash of 1929. That analysis can be applied to the real estate market expansion into the 1990s; and the collapse of the real estate market of the fall of 2006. There are a great many similarities between the events leading to the 1929 stock market crash and the 2006 real estate market collapse.

There are three institutional factors that combined to create the largest real estate price decrease in U.S. history. Participation by individual buyers with no regard toward the quality of the investment; government encouragement of real estate purchases through expansion of the Community Reinvestment Act; as well as the banking institutions competing for increasingly bad loans sold in the secondary market all helped bring about the collapse in the real estate market and the resulting "Great Recession" of 2007.

SCHUMPETER'S THEORY OF THE ECONOMIC CRISIS

In the late 1990s and early 2000s the United States residential housing market experienced very rapid price appreciation; in many cases annual double digit percentage increases. These rapid price increases peaked in early 2006 and decreases in prices followed with very rapid price declines starting in late 2006. On December 30, 2006, the Case Shiller Home Price Index reported the largest real estate price decline in U.S. history. (Case Shiller)

The importance of the residential housing market and real estate in general, is that it is a leading indicator of the general economy. In most recessions in the U.S. economy since the great depression, each recession was preceded by a decline in the real estate market. Also, in most recoveries since the great depression, the recovery was preceded by a recovery in the real estate market. (McKinsey and Betts). It seems obvious that what has been termed the 'Great Recession' of 2007 (National Bureau of Economic Research) was caused by the rapid deterioration in the U.S. real estate market. Also, what can be hypothesized is that a full recovery in the U.S. economy will not occur until there is a recovery the U.S. real estate market.

In the 1930s, Joseph A. Schumpeter outlined the scenario by which sectors of the economy over expand collapse, and recover. In general, he described how a market would expand, drawing new entrants into this particular area of the market. These individuals would not understand the particular area of the economy but rather would usually have a 'get rich quick' philosophy as prices, returns and profits were rapidly increasing. Schumpeter further elaborated that at some point when participants cared little about the particular market but rather were more concerned with quick profits, the market in that area would then over expand and the weight of all the new investors would collapse that particular market. The get rich quick investors would lose their investments and only those who fully understood that area of the market and were prudent in their economic activities would be able to 'hold on' and endure the economic collapse (Schumpeter, 1949). As a result, after the 'weeding out' process was complete and the market started to rebound, those left in the market would experience 'temporary monopoly profits' (Schumpeter, 1934).

Although Schumpeter used the rapid price increases in the stock market as the basis for the analysis of the overexpansion and collapse of the stock market leading up to the 1929 stock market crash and the resulting Great Depression, it is easy to apply the same analysis to the events leading up to the collapse in the real estate market in the fall of 2006. The history preceding each of these two events has a great deal of similarities. First, the lack of economic knowledge of individuals in the particular area of investments was similar. The over investment for the sole purpose of 'get rich quick' attempts to gain profits were similar. Second, the lack of government action to help regulate the out of control segment of the economy and even governmental encouragement of uninformed individuals was quite similar. And third, the banking industry with small margin requirement in the 1920s and the industries loans to marginally or unqualified borrowers in the 1990s and early 2000s was quite similar. Furthermore, the over expansion and eventual collapse of each market is quite similar.

This paper will use Schumpeter's analysis to describe the three institutional areas where participants can be identified as those who contributed to the over expansion in market causing its collapse. These participants include not only individual home buyers but also participation from the banking industry as well as the federal government.

CONSUMER SPECULATION AND INDIVIDUAL GREED

In 1929 the U.S. stock market was fueled by participants who purchased stock with little knowledge or concern about the company that issued the stock. The purchaser's attitude was that since all stock would continue to rise, the particular stock was of little concern. This frenzy was fed by individuals who had no knowledge of the stock market. From the local shoeshine attendant, the grocery store clerk, the house cleaning maid to anyone who had a few dollars to spare, all were buying random stock with little or no regard to the quality of the investment.

Likewise, consumer speculation began to appear in U.S. real estate by the mid to late 1990s. Individuals assumed that any real estate purchased would reap great returns in very short time periods. This "irrational exuberance" (Schiller) was fueled by the belief that all who applied could qualify for a home mortgage. As a result of this irrational economic behavior on behalf of many individuals, increasing number of individuals began applying and qualifying for home loans that were far beyond their respective income flows. Individuals could qualify for a much more expensive home when the interest rate was low or even zero for two or three years; when little or no down payment was required; and when sometimes the individual home buyer even received cash back at the closing of the mortgage.

The 1990s and early 2000s was a time of substantial economic prosperity. Most sectors of the economy were swept up in an almost universal thinking that the new millennium would always be prosperous. Although California had a real estate crash, it was rebounding and therefore the thought was that all real estate would reap large financial gains. Factors adding to this almost universal thinking included ready access to all real estate markets through the internet; the capitalist explosion in many parts of the world including wealth generation through private property ownership; the growth of wealth from successful entrepreneurs; the "Baby Boom" generation buying second homes in preparation for retirement; as well as a general optimistic economic forecast by almost all media outlets.

This consumer speculation and individual greed allowed home buyers to falsely believe that they could buy a home far beyond their long term ability to own. However, the common perception was that in two or three years the price appreciation for the real estate property would allow the owner to sell the property at a large financial gain. This belief even worked at the beginning of the real estate boom. However, this approach is like a pyramid that works only so long as there are continuously more buyers than sellers. Once the steady stream of new buyers evaporated, sellers had no one to purchase their over inflated properties and real estate foreclosures followed leading to the real estate market collapsed. This set of events is strikingly similar to the events and conditions that led to the collapse in the stock market in 1929. Over speculation and greed were major factors in both economic events.

GOVERNMENT OVERSTIMULATION

During President Carter's administration, he pushed through congress a bill which would help reverse the increasing urban blight in large metropolitan cities. The Community Reinvestment Act provided for subsidized home mortgage interest and small or sometimes zero down payments for houses identified in areas termed 'urban blight'. This act allowed for ownership of residential dwellings to be transferred from landlords of tenement dwellings to owners who resided in those houses. This act successfully transformed many rundown tenement houses into homes that were better cared for with grass, paint, repairs and home pride.

The community Reinvestment act was a huge success by almost any standard. This act was a way to allow individuals with modest incomes to become home owners and begin to acquire wealth and achieve part of what has been termed the American Dream (home ownership). The overall success for the Community Reinvestment Act (1977) encouraged the U.S. Congress to extend the Acts boundaries outside urban blighted areas. Herein lies the problem of the federal government actually contributing to the over expansion in the real estate market. At least six times after the Act became law, (1989, 1991, 1992, 1994, 1995, 19999 and even as late as 2005) congress continues to push the Act into broader and broader applications. Eventually, any prospective home buyer in any location could purchase a home with little or no down payment, at in interest rate that was very low or sometimes zero for up to three years and often the home buyer received a cash refund at the closing of the mortgage for the property.

Congress encouraged banks to make more residential property loans and chastised banks that were not lending money for residential property to marginally or under qualified borrowers. The Community Reinvestment Act had marginally qualified or under qualified borrowers become an avenue for a massive increase in residential property loans for second homes in recreation and resort areas, in upscale and high end neighborhoods and in virtually all areas in the U.S. This governmental encouragement of home ownership regardless of financial ability, obviously led to the drastic over expansion in the real estate market where many regions of the U.S. experienced double digit percentage annual appreciation values. This governmental encouragement, direct involvement and pressure toward the banking industry to continue marginally qualified loan approvals was a direct cause of the over expansion and then collapse in the real estate market in the fall of 2006.

The institutional rigidity of congress has allowed it to never acknowledge nor accept any responsibility for this over expansion and subsequent collapse of the real estate market. Instead, blame has continuously been pushed on various parts of the economy, even though there were those who expressed warnings to congress about their actions. On July 16, 2002, it was Ron Paul who saw the actions of congress as detrimental to the real estate market. Regarding the eventual collapse of the real estate market, Ron Paul stated "These losses will be greater than they would have been had government policy not actively encouraged over investing in housing (Paul)."

Belatedly, congressional attempts to control the banking industry in regard to real estate with legislation such as the (Dodd-Frank Act) that came after the collapse in the real estate market did not help eliminate the "Great Recession". In fact, this bill as well as a general government tightening of lending regulations is hindering economic recovery by making it more difficult for qualified borrowers to attain loans in all areas of the economy.

The collapse of the real estate market and the resulting "Great Recession" was not a market failure but rather in great part a failure of government to regulate the banking industry BEFORE the collapse in the real estate industry; a failure of government to self-regulate the over expansion in its Community Reinvestment Act; and by the failure of government to promote the tried and true criteria for a real estate loan of twenty percent down and proof of financial ability to meet the monthly mortgage payments.

BANKING INDUSTRY COMPETITION FOR BAD LOANS

As the residential real estate market continued to expand there was increased pressure in the banking industry to secure a greater number but less qualified loans. These loans were bundled with even more marginal credit card debt and sold in the secondary loan market. Banks paid little attention to the quality of the loans knowing that ownership would immediately be passed on in the secondary market. Buyers of these bundled loans assumed that real estate would continuously appreciate and therefore the loan value would always exceed the loan amount.

The banking institution continuously competed for more residential real estate loans and this competition placed increasing pressure on banks to offer lower interest rates to attract potential home buyers. The end result of this increased competitive pressure was a zero interest rate for several years with future increases in interest rates to a more normal long run rate. Banks began to view themselves less as lending institutions and more as real estate closing agents. The theory was that banks could profit more from increasing their weekly closing numbers and collecting closing costs than from the low interest charges on the loan. Banks more and more became closing agents and less and less financial institutions collecting interest on loans.

The banking industry increasingly became transfer agents, closing residential home loans, transferring those mortgages to national financial institutions including Fannie May, Freddie Mac, Enron and others. The risk was transferred with the mortgage as local banks profited from increasing numbers of real estate closings and the related charges. Local banks could close several mortgage loans each day, dozens per week and reap tens of thousands of dollars each week without regard to the quality of real estate loans that they were approving. Obviously, this disregard for the quality of the real estate loans would ultimately add to the collapse of the real estate market and ultimately bring about the 'Great Recession.'

Unintended Economic Consequences (The Forgotten Analysis)

The economic analysis of an economic catastrophe like the collapse of the real estate market and the resulting 'Great Recession' usually ends with the above analysis. The bad guys, like risk taking individuals taking on excessive leverage and over investing by financial institutions are financially punished by incurring economic losses and the economy moves on. However, there are several economic consequences that hurt individuals who were in no way excessive risk takers, gamblers leveraging economic future or individuals making bad economic decisions.

A typical example of economic impact on non-participants in the economic frenzy leading to economic collapse would be the millions of homeowners who, in an attempt to provide the American Dream for their family, saved twenty percent of the purchase price of a home as a down payment and had provided proof of the ability to meet the monthly mortgage obligations. This group included a typical family of four with both adults gainfully employed, providing adequate housing for the family. Because the collapse of the real estate market led to the "Great Recession' and the resulting double digit unemployment, many of these 'responsible' households became part of the unemployed. As a result, these families had their homes foreclosed, were forced to move out of their residences and lost most if not all of their wealth. This is but one example of the many economic impacts of unregulated over expansion.

In addition to the millions of home owners negatively impacted by the 'Great Recession' which was a direct result of the crash in real estate prices, the impact has been felt by tens of millions of people throughout the entire economic system. Examples include not only the direct impacts to homeowners and financial institutions mentioned above but include all types of commerce. To mention a few, furniture stores, grocery stores, automobile dealerships, and service centers supporting all of the above areas of commerce were negatively impacted by the over expansion and subsequent collapse of real estate prices. Many of these individuals lost wealth; often their homes and many were forced into bankruptcy as a result. This is but one example of the many institutional impacts of unregulated over expansion.

This example of the economic results of unregulated over expansion in the real estate market is most often overlooked and not taken into account when the economic causes and consequences are discussed.

However, it is one of the most important part of the analysis. These institutional impacts clearly affect the entire economy and cause major economic and social consequences through the economic system.

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