California housing bubble: an impending disaster for working people

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Over the course of the past several months, reports by the California Association of Realtors (CAR) have tracked a dramatic rise in housing prices in the state. This is the latest stage in the development of a housing bubble that has placed tremendous pressure on the budgets of many working people and created enormous financial vulnerabilities for others.

The housing bubble in California has already caused a crisis for the many millions who are unable to find affordable housing. The eventual bursting of this bubble is an impending disaster for many California workers that have sought to shore up their living standards by borrowing against the rising value of their homes.

As of July, the median-price of a home in California was $540,900, CAR reported on their web site. This is slightly down from June's median-price of $542,720, but still dramatically higher than last year's $488,600. Over the course of the last five years home prices have increased by over 65 percent.

According to CAR, the minimum income needed to purchase a median-priced home in California in July was $125,670, while the median-household income in the state is $53,500. Only 16 percent of households can afford the median-priced home, a drop of 3 percentage points from one year ago.

In a May 4, 2005 article in the *Sacramento Business Journal* detailing a newly released report from CAR, the organization's president, Jim Hamilton says, "These numbers are particularly troubling for would-be first-time home buyers, who often are locked out of home ownership because of the lack of affordable homes for sale." Since Hamilton made this statement, the median price of a home in California has risen almost $60,000.

California does not have adequate housing to meet its growing population, which is expected to expand at a rate of 600,000 people annually over the course of the coming decade. The available housing stock is unaffordable for many.

According to a report entitled "California's Deepening Housing Crisis" issued by the Department of Housing and Community Development (DHCD), "Housing production has not kept pace with the State's housing needs, particularly in the coastal metropolitan areas and housing need has worsened, especially for renter households and low income owner households throughout the State."

The DHCD reports that in 2004 California's home ownership was the second lowest in the nation at 59.7 percent. In April 2005, only 17 percent of California households could afford to buy the median-priced single-family home, compared to 50 percent nationwide. In addition, overcrowding is an increasing problem among renters. Approximately 24 percent of renter households house more people than their dwellings are designed to accommodate.

In the face of these conditions, Californians have increasingly resorted to high-risk financial means to purchase a home, such as adjusted-rate (ARM) and interest-only (I/O) mortgages, or a combination thereof.

ARMs, like I/Os, are exactly what the names imply. They are mortgages whose interest rate adjusts to the prevailing market level. While interest rates are low, payments stay low; when interest rates rise, so do the monthly payments that a borrower has to make. ARMs are attractive to home buyers because, according to *Forbes.com*, "since loan amounts are often dependent upon the ratio of your current income to the cost of the loan's first year of payments, an adjustable rate mortgage may mean a larger total loan than a fixed rate mortgage."

I/Os allow the borrower to pay only the interest on a mortgage for the first five to ten years, thereby keeping monthly payments to a minimum. The problem with this type of mortgage is that the borrower does not pay on the principal; if the house does not appreciate, the borrower does not build up any equity. If the price falls, the borrower is still responsible for the original amount of the loan.

An article in the *Sacramento Bee* reported that 74 percent of all California mortgages issued in June were ARMs. According to the *Economist* magazine, 60 percent of all new mortgages in California over the last year have been ARMs or I/Os.

For example, in Orange County, one of the wealthiest regions in the state, $14 billion was lent last year for ARMS. According to the real-estate management corporation Ameriland Reality, this is four times the amount lent out for fixed-rate mortgages.

In an article from June 24, 2005, the on-line industry newspaper *Realty Times* states that "the Office of Federal Housing Enterprise Oversight's latest Home Price Index for the first quarter 2005 reveals California's home prices have risen 25 percent in one year, second only to Nevada, and 103 percent

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in the last five years, second to none.”

“UCLA economist Christopher Thornberg says buyers are gambling both their household budgets and the economy on spending habits based on home price appreciation and related equity. A housing slowdown would trigger a slump in consumer spending because home owners rely heavily on home equity to fund college education, business start-ups, cars, home improvements and furnishings, retirement and other purchases typically purchased with income, savings or other investments.”

“With consumers relying heavily upon continued equity gains, even prices flattening could squeeze them and, ultimately, the state’s economy,” the article notes.

According to the *Sacramento Business Journal,* “Some market participants estimate that these higher risk ARMs are increasingly being offered to borrowers seeking low—or no—documentation loans and to those with blemished credit histories. While financially savvy borrowers using these products are more likely to be prepared for the possibility that their monthly payments may jump sharply, marginal borrowers may face greater difficulties adjusting as their monthly payments inevitably rise.”

Workers who have bought homes with these “highly-creative” mortgage schemes will become—with a decrease in home prices and a rise in interest rates—very susceptible to foreclosures. Over the course of the past two years, interest rates have been steadily rising.

The recently enacted changes in US bankruptcy law, which will go into effect on October 17, increase the potential financial fallout from a future collapse of the housing bubble. The new laws passed by Congress make it much more difficult to erase debts and are expected to force thousands of people to enter into repayment plans that will leave them destitute for years. If there is a significant fall in home values that forces foreclosures, millions of people could still find themselves responsible for paying off the debt on homes they bought at incredibly overblown prices, whose value no longer covers the amount of the initial loan.

The housing bubble in California is being driven in large part by financial speculation. With interest rates at historic lows over the past several years and returns on investments in the stock market declining with the bursting of the dot-com bubble, both large and small investors have been pouring money into the real estate market.

Over the course of the past few months, experts have voiced increasing concern about the housing bubble in California, and there are already signs that the housing market pendulum is beginning to swing in the other direction.. According to the chief economist at CAR, Leslie Appleton-Young, “Things are getting worse by the day.”

Recently, Broderick Perkiness of *Realty Times* noted, “With nearly a decade of dropping foreclosure activity leveling off, more buyers being priced out of the market and some pockets where home values are already unable to recover, California’s housing bubble is springing leaks.”

Most commentators agree that we will see massive amounts of foreclosures and a drastic drop in real-estate prices. The Federal Deposit Insurance Corporation (FDIC) has issued two reports in the last year on precisely this issue. But they maintain that the market will not collapse entirely, but rather go through a period of price stagnation that will continue until wages are able to catch up to the level of home prices. However, real wages have either been largely stagnating or declining over the past 30 years.

The FDIC is deeply concerned about the economic fallout associated with a collapse in the housing market. The FDIC insures banking institutions, which in turn finance mortgages. If there is a widespread default on the repayment of home loans, the FDIC could be brought to the brink of insolvency. The possibility of such an outcome is by no means remote, as this is similar to what happened during the savings and loan crisis of the 1980s. At that time, a wave of defaults by savings and loans customers drove the institutions that held those debts into bankruptcy, forcing the government body that insured those institutions, the Federal Savings and Loan Insurance Corporation, to the brink of collapse.

Over the course of the past several years, working people in California have confronted ever growing attacks on their living standards. The ongoing multibillion-dollar fiscal crisis in the state has served as a pretext for the Republicans and Democrats to implement a wide range of austerity measures, ranging from cuts in funding for public education, health care, and a wide range of social programs, to the effective dismantling of workers compensation.

At the same time, workers face increasing economic pressures as a result of the elimination of jobs that provide decent salaries, and health and retirement benefits. In this context, the bursting of the California housing bubble will have devastating consequences for masses of people. It could touch off an economic crisis throughout the state with widespread reverberations, such that even those who do not own homes or who have not relied upon high-risk mortgages would be affected.

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