Four years after a deflating U.S. housing bubble sparked a global financial crisis, housing worries in the U.S. and other countries are weighing on the world economy.

In Spain, the latest euro-zone nation to trigger tremors in global markets, households and banks are struggling with the fallout from the bursting of their own property bubble. Chinese policy makers are trying to cool their country’s housing boom so it doesn’t damage the world’s second-largest economy. And in the U.S., the hobbled housing market continues to hold back the economic recovery.

The International Monetary Fund this week will urge the world’s top finance ministers meeting in Washington to take more aggressive action to help households burdened by mortgage debt. Doing so, fund officials argue, would help boost consumer spending and global growth.

For the U.S., the IMF ranks housing alongside the federal budget deficit as the top areas needing urgent attention from policy makers. U.S. home prices have dropped 34% since a 2006 peak, and more than two million properties are in foreclosure. Almost one in four homeowners is “underwater,” meaning they owe more on their mortgages than their homes are worth.

Specifically, the IMF waded into a politically charged debate by backing the Obama administration’s proposal to use taxpayer money to reduce mortgage-loan balances for some underwater homeowners. A key housing regulator has expressed skepticism about the plan, and many Republicans oppose it, worried it could encourage borrowers to default on their mortgages in hopes of having their debt reduced.

IMF Managing Director Christine Lagarde last week publicly endorsed the idea of reducing U.S. mortgage balances. "American households have to be able to unload a bit," she said.

The IMF’s new analysis of 99 housing busts across 25 advanced economies over the past three decades found that housing crises preceded by large surges in household debt tend to be more severe, with an economic slump persisting at least five years.

The pattern has played out around the world. At the end of a housing boom, indebted households cut spending, pushing down overall economic demand, employment and incomes. "That sets off a negative chain reaction with more defaults, banks being more worried about lending, and there can be long-term damage to the economy," said IMF economist Daniel Leigh.

Spain, which is well into that cycle, faces severe economic turmoil. In 2007, the end of a decadelong boom in home construction pushed Spanish employment and spending down. The resulting budget woes are fanning fears the country will need a bailout, worsening the European debt crisis. Home prices in Spain have dropped more than 20% since 2007, but many analysts believe they need to drop at least 20% more. Spanish banks are still sitting on a pile of troubled loans.
China, on the other hand, didn’t fuel its housing boom with household debt. But a large run-up in home prices hangs over its economy. Prices have dropped a bit, and Chinese officials worry that a steeper fall could hurt an already slowing economy.

By one measure, China had a bigger housing boom than many others. China’s investment in residential housing reached about 9% of its economy last year, a threshold matched only by Spain in 2007, according to Nicholas Lardy, a China expert at the Peterson Institute for International Economics. The peak for the U.S. was 6% in 2005.

China’s real-estate boom started in 2004 as inflation-adjusted interest rates for bank deposits turned negative, a government policy that pushed savers to shun banks. “People have piled into property because you can’t put your money abroad and the stock market is rigged,” Mr. Lardy said. China’s government has tried to let air out of the bubble, for instance by requiring higher down-payments. But incentives remain for households to pour money into real estate.

Because China’s bubble was so big, experts say its housing problems could hang over the country for years, slowing growth. As home prices decline, sales in the broader economy—such as steel used in home construction and the household goods that go inside—also will fall.

Government actions can help ease the pain of a burst housing bubble, the IMF concluded in its analysis, which is part of its semiannual economic outlook being released Tuesday.

The IMF points to the U.S. during the Great Depression, when the government-created Home Owners’ Loan Corp. bought distressed mortgages from lenders and restructured them, freeing up cash for households to spend. “By making mortgage payments more affordable, it effectively transferred funds to households with distressed mortgages that had a higher marginal propensity to consume,” the IMF said.

That intervention started in 1933, four years after a stock-market crash and eight years after home prices peaked.

One lesson, according to the IMF: Delaying action prolongs the pain.

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