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ECONOMIC FORECASTS FROM CONGRESSIONAL BUDGET OFFICE DEPEND ON UNSUSTAINABLE PRIVATE SECTOR BORROWING

End of Housing and Refinance Booms Will Hurt GDP Growth as Highly Leveraged Households Pull Back on Borrowing, Levy Macro Team Says

ANNANDALE-ON-HUDSON, N.Y.—Despite evidence linking the housing and refinance booms with unprecedented and unsustainable levels of household debt, and the strong likelihood that home prices will decline in the near future, the Congressional Budget Office (CBO) continues to base its projections for U.S. economic growth on sustained household borrowing in excess of income. A new study from The Levy Economics Institute of Bard College shows that inflated housing prices, dubious lending standards, and unsustainable levels of personal debt are pushing the U.S. economy toward a strategic predicament in which maintaining growth and employment at current levels will require massive increases in the federal budget deficit.

In their Strategic Analysis, *Are Housing Prices, Household Debt, and Growth Sustainable?* the Levy Institute's Macro Modeling Team—President Dimitri B. Papadimitriou and Research Scholars Edward Chilcote and Gennaro Zezza—presents strong evidence suggesting that a correction to housing prices is overdue, and that, when prices drop, private borrowing, which has served as a major component of GDP, will return to historic levels, leaving a substantial shortfall in demand. “High prices, high vacancy rates, and low affordability suggest that it is unlikely home prices will continue to appreciate at recent rates,” the authors write, stressing that the surge of cash-out refinancings above original loan value, as well as adjustable rate and interest-only loans, make household spending all the more vulnerable to a housing drop. “The development and promotion of unconventional mortgages and the loosening of credit standards over the

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last few years has enabled unprecedented borrowing by households. . . . Given the highly leveraged position of households, even a modest drop in housing prices would reduce their wealth considerably.”

To estimate the impact that a fall in housing prices would have on the U.S. economy, the Macro Team explores several scenarios based on CBO assumptions regarding exchange and interest rates. When the authors factor in a drop in house prices, similar to the pattern that occurred during the early 1980s (about 8 percent over a three-year period), they find that the ensuing drop in household borrowing and household debt as a share of GDP results in a cumulative drop in GDP of 5 percent by 2010. Under this scenario, the U.S. current account balance stabilizes because lower private expenditure and GDP growth will lead to lower imports, but unemployment increases and growth slows substantially. To maintain the CBO’s growth and employment projections in the Levy Team scenario, the government deficit would have to grow to 10 percent by 2010.

The authors conclude that CBO projections for growth and employment are unrealistic, given the rapidly deteriorating financial position of American households and both recent and historic trends regarding housing prices. “Households are financially stretched, and falling or flat housing prices will reduce their capacity to borrow and spend,” write Papadimitriou, Chilcote, and Zezza. To further illuminate the potential consequences of a drop in housing prices, the authors look to evidence abroad, where housing prices have slipped in recent years, causing household consumption and growth to slow or stall in such countries as Britain, Australia, and the Netherlands.

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Strategic Analysis: *Are Housing Prices, Household Debt, and Growth Sustainable?*

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