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STATEMENT OF

GARY THOMAS
2013 PRESIDENT
NATIONAL ASSOCIATION OF REALTORS®

TO THE

UNITED STATES SENATE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

HEARING TITLED

IMPACT OF A DEFAULT ON FINANCIAL STABILITY AND ECONOMIC GROWTH

OCTOBER 10, 2013

Introduction

Chairman Johnson, Ranking Member Crapo, and members of the Committee; my name is Gary Thomas. I am a second generation real estate professional in Villa Park, California. I have been in the business for more than 35 years and have served the industry in countless roles. I currently serve as the 2013 President of the National Association of REALTORS® (NAR).

I am here to testify on behalf of the 1 million members of the National Association of REALTORS®. We thank you for the opportunity to present our views on the potential economic consequences if Congress fails to raise the statutory limit on our nation's debt before the limit is breached.

State of Housing

It is no secret that real estate is a cornerstone of our nation's economy. The housing sector accounts for roughly 18 percent of GDP and research has shown the social and financial benefits to all Americans. As our economy slowly improves from the Great Recession, the U.S. housing market will be key to this recovery. Our nation will not return to full employment and robust economic health unless the real estate market makes a broad-based and lasting comeback. Fortunately, the U.S. housing market recently has shown some hopeful signs.

Housing has been instrumental in pulling the economy out of the Great Recession, substantially contributing to our nation's economic growth since 2011. Home sales, housing prices, and residential construction have increased during this time, supported by low mortgage rates and improved consumer confidence in both the housing market and overall economy. In the past two years, home prices have gone up 15 percent, pushing up the value of household real estate to $18.6 trillion at the end of the 2nd quarter of this year. Additionally, home sales were 13.2 percent higher in August 2013 than a year earlier with 5.48 million homes sold, but were well below the 7.23 million homes sold in August 2005. Also, the residential construction industry has recovered almost half a million jobs of the 2.3 million lost during the recession; however, it still lags behind as a job creation engine.

Impact of a Default

While these figures are promising, the housing market clearly remains far from healthy. Maintaining momentum in the housing market is particularly crucial right now. Sustaining the housing market rebound will increase economic and job growth, as it has in past U.S. economic recoveries. However, the momentum of the housing recovery will be in serious jeopardy if Congress is unable to move passed unnecessary political brinkmanship over raising the debt limit. A default, or even the perceived threat of a default, could result in a harsh and long-lasting recession, which may be even more severe than the previous economic downturn.

Congress must raise the $16.7 trillion Treasury debt limit before the middle of October 2013, which is when the Treasury will exhaust all its extraordinary measures to stay under the limit. At that point, incoming revenue would be the only way for the U.S. to finance its debt obligations. However, the government is expected to experience a monthly deficit of $50 billion in FY2014, which will rapidly diminish any remaining cash the Treasury has on hand. If this occurs, the U.S. would be unable to meet its financial commitments and be in default on some or all of its obligations. Investor confidence along with consumer and business sentiment will likely fall sharply, placing both domestic and global financial markets into turmoil.

2011 Debt Ceiling Impasse

Given that the United States has never defaulted on its debt obligations, it is impossible to predict the exact economic impact in the event our nation is unable to pay its creditors. However, economic theory and evidence of significant economic disruptions resulting from the 2011 debt ceiling impasse, when Congress delayed raising the debt limit until the very last minute, can help illustrate the severity of an actual default.

According to the U.S. Department of the Treasury, the political brinkmanship during the 2011 debt ceiling was responsible for financial market disruptions, reduced consumer and business confidence, and slower job growth. The debt ceiling stalemate ultimately led Standard & Poor's to downgrade our nation's credit rating. Even though lawmakers were able to raise the debt limit before the Treasury expended its remaining cash on hand, political gridlock nearly caused our economic recovery to freeze. Furthermore, the Bipartisan Policy Center estimates that delays in raising the debt limit during 2011 led to higher borrowing costs for the federal government, which the Bipartisan Policy Center estimates will cost taxpayers an estimated $19 billion over the next 10 years.[1]

Higher Treasury Rates Mean Higher Mortgage Rates

Long-term mortgage rates are closely linked to U.S. Treasury rates. As a result, an increase in U.S. Treasury rates would result in higher mortgage rates. In the event of a default, U.S. Treasury prices would fall and yields, which move inversely to prices, would rise. Both banks and borrowers would be sensitive to this change.

Banks, which face requirements regarding the amount of capital they hold, would see declines in the value of one of their core capital assets—U.S. Treasury securities. Banks would likely restrict new lending in order to shore up capital and charge more for mortgages they originate. Borrowers would be impacted by both tighter credit standards and the compounding of higher rates.

Historically, an increase in mortgage rates of 1 percentage point reduces home sales by roughly 350,000 to 450,000 units. That relationship might prove more robust in an environment of rising mortgage rates and bank tightening. For a borrower earning $60,000 and taking out a $200,000 mortgage, that 1 percentage point increase would raise the monthly payment by roughly $120 and could raise the borrower debt-to-income ratio (principle and interest only) from 27 percent to 29 percent, enough to disqualify them from many lending programs and potentially under the terms of the qualified mortgage (QM) rule.[2]

Researchers at the Federal Reserve Bank of St. Louis found similar results in their analysis of trends in mortgage finance from 1940 through 1960.[3] According to the study's authors, 8.5 percent of the increase in homeownership from 45.5 percent to 62.5 percent was due to the 85 basis point decline in cost of mortgage credit during this period. African American, Latino Americans and first-time buyers who utilized low down payment loans are more susceptible to a tightening of credit and a resulting decline in ownership. Current home owners seeking to trade up and baby boomers looking to trade

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[1] Bipartisan Policy Center. *Debt Limit Analysis*. By Steve Bell, Shai Akabas and Brian Collins. Available at: http://bipartisanpolicy.org/sites/default/files/Debt%20Limit%20Analysis%20Sept%202013.pdf.

[2] For this example a 30-year fixed rate of 4.25% is assumed as well as a 5% down payment, 0.67% primary mortgage insurance, $70 monthly homeowner's insurance, and 1% real estate taxes.

[3] Federal Reserve Bank of St. Louis. *Did Housing Policies Cause the Postwar Boom in Homeownership?* By Matthew Chambers, Carlos Garriga and Don Schlagenhauf. Available at: http://research.stlouisfed.org/wp/2012/2012-021.pdf.

down also would not be immune to the disruption as fewer qualified first-time buyers result in reduced demand for the homes they would sell before purchasing again.

A significant loss of home sales would have ramifications for the economy. Roughly 700,000 to 900,000 fewer jobs would be created as a result of a 1 percentage point increase in mortgage rates. This decline in industry and construction incomes along with fewer expenditures on services, renovations, appliances and other goods associated with home purchases that would weigh on ancillary businesses and their decisions to create jobs. Higher mortgage rates also hamper refinance activity, which would hold back additional consumption spending.

As noted by the U.S. Department of the Treasury, it is important to recognize the sovereign debt concerns in Europe, as well the sharp downward revision to 1st quarter GDP in the United States, had an impact on U.S. financial markets during the 2011 debt limit episode.[4] Thus, the widening of mortgage spreads in 2011 was due in part to these issues. However, those same concerns dropped Treasury yields, so on balance, mortgage rates decreased even as the spreads widened. If mortgage spreads widened today as a result of a debt ceiling impasse, with Treasury yields rising, the negative consequence for borrowers would be higher mortgage rates, which would curtail household spending and prevent the housing market from contributing to our economic recovery.

The Federal Reserve's ability to support the housing market could be affected as well. The Federal Reserve has been purchasing $40 billion of mortgage backed securities and $45 billion in Treasuries per month since the fall of 2012, but has indicated its intent to wind down this program. A decline in Treasury prices could undermine the Federal Reserve's ability to wind down its purchases in an orderly fashion, potentially creating volatile movements in mortgage rates. In the long term, lower Treasury and mortgage-backed security (MBS) prices could hamper the Federal Reserve's ability to manage its significant holdings of Treasuries and MBS. What's more, if weaker confidence in the Treasury results in less and more erratic demand for it, the Federal Reserve's open market operations would become more difficult, limiting the Federal Reserve's ability to respond to the next crisis.

The impact of an actual default would have far greater and long-lasting impact on interest rates on Treasuries than concerns about a potential default during a temporary standoff.

<u>High Mortgage Rates & Lower Consumer Confidence</u>

Consumer spending is a key driver of our nation's housing market and overall economy. The consumer confidence index measures the degree of optimism that consumers feel about the overall state of the economy and their personal financial situation. Confidence in the stability of their incomes affects consumer economic decisions, such as spending activity, and therefore serves as one of the key indicators for the overall shape of the economy.

In essence, if consumer confidence is high, consumers likely purchase more goods and services. Conversely, if confidence is lower, consumers tend to save more and spend less on goods and services. A month-to-month trend in consumer confidence suggests the outlook of consumers on their ability to find and retain good jobs according to their perception of the current state of the economy and their personal financial situation.

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[4] U.S. Department of the Treasury. *The Potential Macroeconomic Effect of Debt Ceiling Brinkmanship*. By Sabrina Siddiqui. Available at: http://www.treasury.gov/connect/blog/Pages/Report-on-Macroeconomic-Effect-of-Debt-Ceiling-Brinkmanship.aspx. Accessed: 10/4/13.

Falling stock values, weak employment numbers, and higher mortgage rates can weigh on consumer confidence. This was evident during the debt ceiling stalemate between June and August 2011. According to the U.S. Department of the Treasury, consumer confidence eased in the spring of 2011 over employment concerns before it plummeted 22 percent in response to the impasse; it took several months after the debt limit stalemate was resolved before consumer sentiment recovered.[5] A home is the largest and most complicated purchase of most consumers' lives. A general decline in confidence would weigh on consumers.

Just as with interest rates, the impact of an actual default would have far greater and long-lasting impact on consumer confidence than concerns about a potential default during a temporary standoff.

Mortgage Rates & Consumer Confidence Impact on Housing & Economy

Higher mortgage rates and lower consumer confidence are associated with fewer home sales because the cost of borrowing goes up for consumers. This mechanism is more relevant today given today's tighter underwriting and debt to income requirements, as well as regulatory requirements from the qualified mortgage (QM) rule. Home sales decline when interest rates go up, and housing prices moderate as a result. As seen in recent years, stagnant or falling prices weigh on sales growth as buyers fear the value of their purchase may decline. Slow price growth slows equity accumulation, forcing some consumers to pay mortgage insurance longer, hampering refinancing during recessions, and making owners more susceptible to default as a result of unemployment or loss of income.

Interest rates tend to fall during recessions and eventually, demand for housing and new construction increases as a result. This pattern has been an important driver of U.S. economic expansions in recent decades with the notable exception of the most recent episode. Furthermore, the U.S. Treasury securities status as a safe or risk-free store of wealth attracts capital especially during an economic and fiscal crisis when investors shy away from riskier activities which augments this pattern resulting in shallower recessions. A decline in the Treasury securities low-risk of default status could reverse this pattern.

Fewer home sales means less construction, less income from transactions, and fewer purchase of appliances, renovations and the services that accompany a purchase. As discussed earlier, this pattern is circular as it weighs on the economy, job growth, and future homeownership.

As previously noted, the impact of an actual default would have a much more severe and drawn out effect on home prices and sales than concerns about a potential default during a temporary standoff.

Challenges Facing the Housing Recovery

Luckily, our economy has been able to bounce back from the 2011 debt ceiling debate and home prices have increased 14.7 percent over the 12-month period ending in August. However, they are still 7.6 percent lower than in August of 2006. Today, home prices have led to positive gains in the net worth of homeowners, $18.6 trillion of which is saved up in residential real estate. Rising home prices have also cut the number of underwater homeowners by nearly half, but have put pressure on potential home buyers who have not yet completed their home purchase. Home sales rose 13.2 percent from August of 2012 to August of 2013, but are 24.2 percent below the level from August of 2006.

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[5] U.S. Department of the Treasury. *The Potential Macroeconomic Effect of Debt Ceiling Brinkmanship*. By Sabrina Siddiqui. Available at: http://www.treasury.gov/connect/blog/Pages/Report-on-Macroeconomic-Effect-of-Debt-Ceiling-Brinkmanship.aspx. Accessed: 10/4/13.

In addition to increases in home prices, mortgage rates have begun their ascent from historically unprecedented lows. While mortgage rates have stabilized recently due to the Federal Reserve's delay in the tapering of asset purchases, all expectations of a healing housing market and recovering economy point to higher mortgage rates ahead. These two factors combined with meager increases in family income are squeezing the affordability of homes. Affordability has plunged 18 percent to the lowest level since 2006. While affordability remains above historic levels, a swift reduction will undoubtedly have an impact on buyer options and psychology.

Consumer sentiment is already facing headwinds from rising interest rates and the recent government shutdown will likely be an additional blow to consumer confidence and our economic recovery. Some economists have predicted that a weeklong government shutdown could slow GDP growth by a quarter of a percent. Any longer shut down could result in a more significant effect. In either case, U.S. economic expansion will be more susceptible to the adverse effects from a debt limit impasse than prior to the shutdown.

Conclusion

The U.S. housing sector is in the midst of recovering from the worst economic downturn since the Great Depression. Home prices and sales, as well as household wealth, are all up from a year ago. While this industry continues to face many headwinds such as higher interest rates and affordability challenges, maintaining the housing recovery will be key to boosting economic and job growth, as it has in past recoveries. This will only be possible if Congress has the willingness to raise the debt limit in a timely manner.

We have already experienced the negative economic consequences from even the prospect of a default during the debt ceiling impasse in 2011. Let's not repeat this mistake again. More importantly, let's not allow a debt limit impasse lead to the Unites States defaulting on its debt. An actual default by the federal government along with a protracted government shutdown could have serious implications on the U.S. economy and may result in a recession even more severe than any since the Great Depression. This scenario may include higher interest rates, reduced consumer spending and business investment, diminished household wealth, and high unemployment levels that could last more than a generation.