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Statement by

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Governor

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before the

Committee on Banking, Housing, and Urban Affairs

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Chairman Johnson, Ranking Member Shelby, and members of the Committee, thank you for inviting me to talk about the current situation in housing markets.

The Federal Reserve has a keen interest in the state of housing and has been actively engaged in analyzing issues in the housing and mortgage markets. Issues related to the housing market and housing finance are important factors in the Federal Reserve's various roles in formulating monetary policy, regulating banks, and protecting consumers of financial services. In particular, the failure of the housing market to respond to lower interest rates as vigorously as it has in the past indicates that factors other than financial conditions may be restraining improvement in mortgage credit and housing market conditions and thus impeding the economic recovery. Federal Reserve staff have been actively working to understand the reasons behind the impairment in housing and mortgage markets and the tradeoffs involved in designing policies that would remove obstacles to normal market functioning.

On January 4, 2012, the Federal Reserve released a staff paper titled "The U.S. Housing Market: Current Conditions and Policy Considerations," which is attached at the end of my written statement. The paper provides information on current conditions in the housing market and analytic background on some housing market issues. Although the paper does not include recommendations for any specific policy actions, it does lay out a framework for discussion by outlining some options and tradeoffs for policymakers to consider. My testimony today will be drawn from this paper.

Six years after aggregate house prices first began to decline, and more than two years after the start of the economic recovery, the housing market remains a significant drag on the U.S. economy. In a typical economic cycle, as the economy turns down households postpone purchases of durable goods such as housing. Once the cycle bottoms out, improving economic prospects and diminishing uncertainty usually help unleash this pent-up demand. This upward demand pressure is often augmented by lower interest rates, to which housing demand is typically quite responsive.

The current economic recovery has not followed this script, in part because the problems in the housing market are a cause of the downturn as well as a consequence of it. The extraordinary fall in national house prices has resulted in $7 trillion in lost home equity, more than half the amount that prevailed in early 2006. This substantial blow to household wealth has significantly weakened household spending and consumer confidence. Another result of the fall in house prices is that around 12 million households are now underwater on their mortgages -- that is, they owe more on their mortgages than their homes are worth. Without equity in their homes, many households who have experienced hardships, such as unemployment or unexpected illness, have been unable to resolve mortgage payment problems through refinancing their mortgages or selling their homes. The resulting mortgage delinquencies have ended in all too many cases in foreclosure, dislocation, and personal adversity. Neighborhoods and communities have also suffered profoundly from the onslaught of foreclosures, as the neglect and deterioration that may accompany vacant properties makes neighborhoods less desirable places to live and may put further downward pressure on house prices.

An ongoing imbalance between supply and demand exacerbates these problems in the housing market. For the past few years, the actual and potential supply of single-family homes for purchase has greatly exceeded the effective demand, in part because of the large number of homes that have come back onto the market after moving through the foreclosure process. The elevated pace of foreclosures, unfortunately, is likely to be sustained for quite a while and therefore will continue to put downward pressure on home prices.

At the same time, a host of factors have been weighing on housing demand. Many households have been reluctant or unable to purchase homes because of concerns about their income, employment prospects, and the future path of home prices. Tight mortgage credit conditions have also prevented many households from purchasing homes. Although some retrenchment in lending standards was necessary and appropriate given the lax standards that prevailed before the crisis, current lending practices appear to be limiting or preventing lending even to creditworthy households.

In the paper, we discussed the benefits and costs of a variety of policy options that have been proposed to respond to these difficult housing issues, including increasing credit availability for households seeking to purchase a home or to refinance an existing mortgage; exploring the scope for further mortgage modifications, including encouraging short sales and deeds-in-lieu of foreclosure in cases where foreclosure cannot be avoided; and expanding the options available for holders of foreclosed properties to dispose of their inventory responsibly. Any policy proposals, though, will require wrestling with difficult choices and tradeoffs, as initiatives to benefit the housing market will likely involve shifting some of the burden of adjustment from some parties to others.

I greatly appreciate the leadership that the Senate Banking Committee has shown on the profound challenges facing the housing market. For its part, the Federal Reserve will continue to use its policy tools to support the economic recovery and carry out its dual mandate to foster maximum employment in the context of price stability. In its supervisory capacity, the Federal Reserve will continue to encourage lenders to find ways to maintain prudent lending standards while serving creditworthy borrowers.

Thank you again for inviting me to appear before you today. I would be happy to answer any questions you may have.