Print Edition : Opinion

The bubble's necessary correction

With so much of our economic growth riding on a real estate boom, a downturn was inevitable.

By Joel Kotkin
November 4, 2007

Downtown's boosters hailed the cranes dotting the skies over Los Angeles as sure signs that the city's building boom and economic good fortune were continuing. At the same time, ever-rising housing prices convinced homeowners across the region that their bet on Southern California was a prudent -- maybe brilliant -- one.

But now, as the housing market undergoes a painful correction -- home sales in Southern California last month plummeted to a 20-year low, and foreclosures set a high last quarter -- it's time to look beyond the real estate hype and wishful thinking. On closer inspection, much of the "boom" has turned out to be a "bubble," built not on rapid growth in personal income and new jobs in many industries, as in past regional booms, but mostly on a housing market gone mad. From 2001 to 2005, home prices in Southern California grew at roughly eight times that of people's median income, among the highest ratios in the country. By contrast, in Seattle, housing prices rose four times the rate of personal income, while in Denver, the ratio was 2 to 1.

So how could people in Southern California afford to buy a new or existing house whose price kept rising while their income didn't go up much?

The answer is that the mortgage industry, with Calabasas-based Countrywide Financial Corp. taking the lead, covered the difference between income and the cost of a home with such innovations as loans that didn't require down payments or whose initial interest rates were extremely low. Meanwhile, rising housing prices allowed homeowners to cash in some of their equity to buy boats, cars or take vacations in Europe. This boosted retail sales and generated a feeling of prosperity, particularly among the home-owning middle class.

The resulting boom was hard to deny because you could actually see the tall buildings going up downtown and the seemingly endless tracts of new houses fanning out across San Bernardino and Riverside counties and up hillsides in San Diego County.

But with home sales now falling, foreclosures skyrocketing and the mortgage industry reeling because of too many bad loans, the foundation of the Southern California boom is slowly crumbling.

Housing prices also jumped during the region's three most recent booms -- in the

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1960s, mid-1980s and late-1990s. But in those cases, the rising prices generally were not the primary driver of economic activity. Instead, the engines of expansion were multiple -- international trade, diversified manufacturing, entertainment and, in the 1960s and 1980s, aerospace.

Consider the boom in L.A. and Orange counties in the mid- to late-1990s. Job growth was hefty across the board. There were big gains in the movie industry, sound recording, publishing and telecommunications. Some 85,000 high-paying jobs in accounting, computer systems design and management-consultant companies were created. And good-paying blue-collar jobs in warehousing and merchandise trade also rose, while factory jobs increased by 40,000 from 1994 to 1998, according to an analysis of U.S. Bureau of Labor Statistics by the Praxis Strategy Group, an economic consulting firm in North Dakota.

Now look at today's fading boom. To start with, annual job growth has been less than 60% of the rate in the previous boom, according to the Bureau of Labor Statistics. Job gains in the information, professional and business sectors, as well as trade, have lagged considerably behind those from 1994 to 1998. The number of manufacturing jobs, especially hard hit in the early years of this decade, has largely stagnated.

But growth in the home-building and mortgage industries significantly popped, as would be expected in a boom fueled by an exploding housing market. Much of the job growth in finance was in the now-combusting mortgage industry, says Cal State Northridge economist Dan Blake, who is the director of the San Fernando Valley Economic Research Center. From 2001 to 2005, the number of new mortgage brokers nearly tripled, to about 18,000. When you add that number to job gains in construction (about 52,000), realty, leasing and lending (about 18,000), you get roughly half the 170,000 net jobs created in the boom. By contrast, only 10% of the jobs created in the 1990s expansion were related to real estate.

An economic boom in which half the new jobs are tied to an overheated real estate market will not long survive a slide in housing prices, as is increasingly evident today. The layoffs in the mortgage industry have already begun, and the strip-mall loan shops that specialized in sub-prime loans are disappearing. If houses aren't selling or going up in price, there's no need nor motivation for a swelling army of real estate agents. But the greatest effect of the real estate bust will be on construction workers, whose numbers will dwindle as pre-bubble financing dries up and home building slacks off.

There may be more trouble ahead: Demand for housing may fall because population growth is slowing. Political leaders -- chief among them Los Angeles Mayor Antonio Villaraigosa -- and their developer allies who have called for higher-density development repeatedly cite population projections of 100,000 new residents a year for the foreseeable future, especially in Orange and Los Angeles counties.

But the most recent census numbers suggest that population growth in the two counties is slowing and may continue to do so. Two years ago, California's Department of Finance cut its population estimate for 2040 by 7 million, to 51 million. It also reduced the expected number of new residents in California from 600,000 to 400,000 annually.

The falloff in population growth may hit Los Angeles County harder than other parts of the state, says demographer Wendell Cox, who has analyzed the census numbers. Last year, the rate of increase fell a whopping 90% from rates earlier this decade. In absolute numbers, more than 115,000 residents settled in the county from 2001 to 2002; last year, newcomers totaled a mere 7,000, according to census estimates.

If the trend continues, it means bad news for those developers who believe in the inevitability of an ever-expanding market for anything they want to build.

Randall Lewis, executive vice president for the privately held Lewis Group of Companies, a real estate development company, believes that the effects of what's shaping up as a regional housing recession will become more evident in the next year or so. Speculators building "McMansions" in formerly modest middle-income neighborhoods in such places as Chino Hills and the San Fernando Valley are already feeling the pressure of sliding home prices. And if history is a guide, Lewis predicts, high-end condos, a staple of the building boom in L.A., will soon feel the sting of declining prices, greater competition with cheaper houses and tighter lending standards instituted after the sub-prime meltdown.

Paradoxically, a weakening real estate market may be precisely what L.A. needs. Lower housing prices could keep businesses from leaving the region because their workers could afford to buy houses. Cheaper condos could make living downtown or in other high-density areas more affordable to the largely young, urban-oriented professionals who desire it. Immigrant entrepreneurs pressured by high housing costs might choose stay put. And the prospect of fewer buyers and lower home prices may persuade residential developers to sell their land, which could open it up for industrial, warehouse and other productive uses.

Far-fetched? Well, much of these scenarios played out after the collapse of the L.A. real estate market in the early 1990s. It could happen again, to the benefit of the region and the long-term sustainability of the real estate market.

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