



# CONTAGION

THE FINANCIAL EPIDEMIC THAT IS  
SWEEPING THE GLOBAL ECONOMY... AND  
HOW TO PROTECT YOURSELF FROM IT

**JOHN R. TALBOTT**

Bestselling author of *The Coming Crash in the Housing Market*



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That Is Sweeping the Global Economy . . .  
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John R. Talbott



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Jesus left there and went to his hometown, accompanied by his disciples. When the Sabbath came, he began to teach in the synagogue, and many who heard him were amazed.

“Where did this man get these things?” they asked. “What’s this wisdom that has been given him, that he even does miracles! Isn’t this the carpenter? Isn’t this Mary’s son and the brother of James, Joseph, Judas and Simon? Aren’t his sisters here with us?” And they took offense at him.

Jesus said to them, “Only in his hometown, among his relatives and in his own house is a prophet without honor.” He could not do any miracles there, except lay his hands on a few sick people and heal them. And he was amazed at their lack of faith.

Then Jesus went around teaching from village to village. Calling the Twelve to him, he sent them out two by two and gave them authority over evil spirits.

These were his instructions: “Take nothing for the journey except a staff—no bread, no bag, no money in your belts. Wear sandals but not an extra tunic. Whenever you enter a house, stay there until you leave that town. And if any place will not welcome you or listen to you, shake the dust off your feet when you leave, as a testimony against them.”

They went out and preached that people should repent. They drove out many demons and anointed many sick people with oil and healed them.

Mark 6:1–13



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# Preface

I have a good friend in New York, Raphael, who co-owns a wonderful steak house on 110th Street and 2nd Avenue named Ricardo's. Somewhat as a joke, he has begun introducing me to his friends as Johnny Nostradamus. He then proceeds to tell them about my string of accurate predictions regarding housing, the mortgage markets, and the general economy over the past decade.

Facts are facts. I have had a fairly incredible run of accurate predictions, knock on wood. In 1999 I published a book that predicted the collapse of the Internet and high-tech bubble. In 2003 I published *The Coming Crash of the Housing Market*, which not only predicted the housing price decline, but said that it would be severe and national in scope, not local like all other real estate declines had been to date. Entire chapters were dedicated to the problems that Fannie Mae and Freddie Mac and the commercial banking system would have to endure in the future. In February 2006 the release of my new book, *Sell Now! The End of the Housing Bubble* coincided almost exactly with the peak of the housing market. In that text, I was able to show that the

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problem was much more serious than people realized and that it would not just be national in scope but international. I was able to identify the loose lending practices of the banks as the primary cause of the bubble and explained that lobbying pressures had prevented the government from not having done a better job regulating them. In early 2008, when most everyone was convinced that Hillary Clinton would be the Democratic nominee for president and that the major issue of the general campaign would be the war in Iraq, I wrote *Obamanomics*, not only identifying Barack Obama as the eventual winning Democratic nominee, but successfully identifying economic policy, and specifically the financial crisis, as the most important issue to Americans in the general election.

Now with *Contagion*, I am continuing the challenge of trying to foresee the future. It's not a steady job, but it's all I know. There have been books written that have attempted to explain what has happened in the past with regard to the subprime crisis and the housing price decline to date. Very few professional economists are willing to put their reputations at risk and make a prediction of what happens next. But, for investors and businesspeople and concerned citizens, that is exactly what they want to know. They want some idea from a credible person as to what might happen in the future based on the extent of the crisis to date. I am certain there are some historians and economists who would like to read a capsulation of what is happening, but that is not my intention. I want to, to the best of my abilities, try to help the reader understand where this country is going from here. I cannot guarantee the future, but by explaining the severity of the problems Americans face and the logic behind my argument I just may convince you to take action to better protect your assets, your livelihood and your country.

So how do I do it? How is it that I seem to be able to predict the future? Do I have a crystal ball or a divine talent like Nostradamus himself? Am I the smartest guy in the world? No, I am not the world's

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smartest man. I'm not stupid, but smarts are not the great competitive advantage I have relative to my peers.

My great competitive advantage in predicting economic events and consequences in the future is my independence. Decades ago, I left behind my job on Wall Street and the world of bosses and committees and boards and groupthink and toeing the party line. I wake up each day not knowing what problem I will attack, but simply knowing that my only objective is to uncover the truth. I have no business, commercial, or monetary incentive to promote anyone's agenda but my own, and I have chosen as my agenda to simply find the truth.

No one likes being lied to. The reason I was attracted to writing in the first place is that I felt the world, in general, was telling too many lies. Through writing, I hoped I might help the world uncover real truths. Business leaders, government leaders, and even friends and relatives had decided that lying was a victimless crime. A primary cause of the entire financial crisis today is due to the corruption and lies that were allowed to enter the sacred halls of our government. There is no such thing as a victimless lie. It is wrong, not only because it is hurtful, but as people in this country are so painfully learning, because as a society, it is unproductive and destructive.

Anyone who thinks, like Alan Greenspan suggests, that the housing, mortgage and banking events this country has suffered through are some kind of random elements that occurred naturally due to general business cycles similar to a hundred year flood needs to read this book. The suffering happening today was preordained years ago when U.S. citizens allowed the Congress and President to accept large campaign contributions from big business and Wall Street in order to avoid any new regulation and the proper enforcement of current laws on the books.

Unfortunately, the worst is not over. As the title of this book implies, this problem is not just going to stop with the decline in U.S. house prices. Residential real estate in the United States is such a large

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market, and had increased in value so tremendously during the boom years, that a readjustment in its pricing downward cannot help but have significant impacts in not only the United States, but in the world.

I want to thank Bill Falloon and the entire gang at John Wiley & Sons who supported my efforts at getting this important story into print. It is a real risk in the publishing industry to publish a book about current events, especially one that tries to predict future events. It is a testimony to their confidence in me as an author that they took this bet. I also want to thank my friends in Mexico; Peter, Elena, Harold, and Boca and Solovena. Without their support and long walks on the beach I could never have made it through this effort. The cervezas helped also.



I sincerely hope that this is the last book I have to write speaking of crashes or recessions or collapses. I hope that the American people wake up and demand better government from their elected representatives and stop the corrupting influence of lobbyists and corporate campaign contributions. And I hope that Americans emerge from the difficult days ahead with a new awareness of what really constitutes a full and meaningful life and never again let rampant consumerism and materialism so distort the direction of their lives.

JOHN R. TALBOTT  
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# Chapter 1

## Bamboozled

con·ta·gion [kuhn-tey-juhn] – *noun*

1. the communication of disease by direct or indirect contact.
2. a disease so communicated.
3. the medium by which a contagious disease is transmitted.
4. harmful or undesirable contact or influence.
5. the ready transmission or spread as of an idea or emotion from person to person: a contagion of fear.

**E**ach of the five preceding definitions of contagion could be appropriate to the current economic and societal circumstances occurring around the world. Although not exactly a disease, the greed, outsized consumerism, and virulent self-centeredness certainly appear to have devastating symptoms associated with them. The current illness is not transmitted directly by contact, but it certainly seems to have the capacity to spread broadly, especially through harmful or

undesirable contact. And it really was just an idea that spread, the idea that life is only about wealth accumulation and that men and women can be judged by some sort of bottom-line measurement system that ignores any sense of proper or ethical behavior in one's lifetime. People cared more about the ends than the means to reach those ends.

I don't remember who caught the greed bug first. I'm sure somewhere there were businesspeople who were rather unscrupulous and would sell any product for profit, usually on late night television. The politicians weren't far behind as it is difficult to be a politician without being ego-centric, which always seems to be one step away from unethical. I can still recall the first commercials I saw on television for lawyers offering their services to the recently injured. I remember when doctors and dentists became more interested in profits than patients. Everyone can name televangelists who were caught preaching the gospel more for profits than converts.

Of course, Wall Street has always been greedy. That is what they do. But, even on Wall Street things have deteriorated. Twenty years ago on Wall Street your word was your bond and the reputation of your firm was sacrosanct and to be protected at all times. You made money the old-fashioned way, by out-thinking and out-hustling your competitors and delivering a product or service to your clients that created real value for them.

Since then, trading and principal investing has turned Wall Street into a den of whores. There is no value in something other than what you can convince someone to pay for it. It is a reason to celebrate if you can mislead an investor and get him to pay more than what an asset or business is worth. If you can hide liabilities off the balance sheet and stick them with the customer, all the more reason for merriment.

But I don't want to give the impression that this current crisis started or ended on Wall Street. Wall Street could never have pulled this off on its own. Remember, this all began with an unsustainable housing boom and eventual housing market collapse. Home realtors pushed

their clients into ever-bigger homes based on phony high appraisals from non-independent appraisers with the money from mortgage brokers who fraudulently changed qualifying income amounts on mortgage applications, and all contributed to the dramatic boom in house prices. The commercial banks offered such aggressive terms for mortgages and knew full well they wouldn't sit on their balance sheet for long. Then the investment banks packaged these mortgages and sold them to unsuspecting institutional investors, such as pension funds and sovereign wealth funds. It may not have been ethical, but they paid the rating agencies hundreds of millions of dollars to rate much of this junk AAA. Even the dupes who ended up buying this junk were not without fault. They sought out the greater yield these investments returned, but the extent of their due diligence and credit analysis was to ask only about its credit rating. It leaves a lot of hours in the day to go golfing if your entire job consists of just investing in AAA securities with no further homework being done on the credit front.

But the real reason why this disaster was allowed to occur was that the U.S. government had been co-opted. None of this could have been accomplished without significant deregulation of the financial industry and the avoidance of previous regulation and of required supervision in many cases. It was the mantra of the American government for 30 years that less government and less regulation would lead to lower taxes and a stronger economy. Well, today, the United States has higher spending, higher taxes, more government, but a lot less regulation of the largest companies and banks.

Listen to your congressperson today say how surprised they are about the current crisis. Nothing could be further from the truth. They have been warned time and time again about this impending crisis, not only in home prices and in the mortgage market, but also about the high debt leverage of Fannie Mae and Freddie Mac as well as the entire commercial banking and investment banking and hedge fund industry. This crisis was no accident. It was just a matter of time until this

entire house of cards fell. Fannie Mae and Freddie Mac are the proper names of these large institutions that used to be abbreviations for their longer names, the Federal National Mortgage Association, for example, for Fannie Mae. They were put in business to buy existing mortgages from banks and to package them and to sell them as securities to investors, basically to turn mortgages into securities that looked more like traditional bonds.

So to understand the real reason why this occurred, you can't just stop at deregulation as an explanation. You have to ask why the deregulation was allowed to occur by our Congress and our President. The simple answer is that they were paid to deregulate industry. Our Congress and our President take billions of dollars each year from business and banks and Wall Street in the form of campaign contributions. They are by far the largest contributors to our national elections. Do you think a for-profit business would make a donation to a congressman unless they were getting something in return? John McCain admits taking money from the telecommunications companies that his committee regulates, but his defense is that it does not influence his voting. If this were true, it would certainly make the for-profit businesses that are handing him the money look awfully stupid for wasting their assets. No, just the opposite is true. A recent study on

[www.publiccampaign.org](http://www.publiccampaign.org) showed that for every one dollar in campaign contributions a typical American business makes, it gets back more than \$400 in tax benefits, tax deductions, and tax credits from the American government. Certainly a 400 to 1 return on your investment beats any of the alternative investments a company might have in its base operating business. And this does not measure the total benefit corporations receive from

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*Our Congress and our President take billions of dollars each year from business and banks and Wall Street in the form of campaign contributions.*

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## Bamboozled

lobbying. In addition to tax benefits, generous lobbying corporations also receive help in protecting their domestic turf from foreign competitors, union busting with their workforces, price supports for their products, and taxpayer assistance in opening international markets.

Here is some evidence. Senator Charles Schumer, a Democrat from New York, has as his top 10 contributors the biggest financial institutions he is supposed to regulate on the Senate Banking Committee. The list of the top 10 campaign contributors to all of Congress include the National Association of Realtors, the Mortgage Bankers Association, the American Bankers Association, Fannie Mae and Freddie Mac, the investment banks and the hedge funds on Wall Street. It certainly sounds like every player in the current housing, mortgage, and banking crisis. In 2007 alone the securities and investment industry spent more than \$86 million on lobbying and the real estate lobby spent \$78 million. Tell me when the evidence becomes more than just simple coincidence.

Do you want further evidence? Name another problem facing America today and I can tell you the lobbying force that is preventing a commonsense solution that would benefit all Americans. Global warming? The coal lobby and the electric utility lobby. Gas prices? The oil and gas lobby. Pharmaceutical prices too high? The pharmaceutical industry lobby. Health care costs and coverage? The hospital corporation lobby and the HMO industry. War and defense spending? The defense industry lobby. Social Security and Medicare reform? The AARP. Education reform? The teachers union lobby.

Coincidence? I don't think so. Look at the facts of the current crisis. Banks and nonbanks were completely unregulated and were allowed to leverage themselves up and extend mortgage financing in the craziest amounts on the craziest terms to home buyers. There was no supervision of real estate agents and appraisers or mortgage brokers. Fannie Mae and Freddie Mac's supervision was so lax that they both utilized 120 to one debt to equity leverage to buy or guarantee half of all mortgages in the country, approximately \$5.2 trillion

worth. Is it a coincidence that Fannie Mae and Freddie Mac also spent hundreds of millions of dollars on lobbying and campaign donations to your Congress? Rating agencies' and investment banks' activities went completely unregulated as they packaged these mortgage securities and sold them worldwide. Hedge funds, some of the biggest contributors to your Congress and President, had no reporting requirements, no transparency, and no supervision as they helped grow the credit default swap market from a \$140 billion market 10 years ago to a \$65 trillion completely unregulated market today. AIG, a supposed insurance company, had \$420 billion of exposure in the credit default swaps market, an exposure that ultimately was their undoing.

As certain as the sun rises, as sure as the rain falls, as predictable as the tide, this financial crisis was guaranteed to happen. Not only has the U.S. government allowed deregulation at home, it has exported the idea worldwide as a solution to the world's economic problems. There is good regulation and bad regulation. In Peru and India, it can take six months and 850 bureaucratic steps for an entrepreneur to acquire a government license to start a new small business. Certainly this type of over-regulation is bad for an economy.

But what American advocates of deregulation failed to realize in promoting unregulated capitalism around the world is that you cannot have a free market without proper regulation. There can be no market without the rule of law. The reason capitalist free markets were slow to catch on in Africa and much of the rest of the developing world was not a problem of business, but one of government. The governments did not provide the essential rules and regulations and the rule of law necessary to conduct business effectively. Without the rule of law, contracts are not honored, fraudulent activity is not punished, and property rights are not protected. If you look at a map of the world, of the 160 countries on the planet with more than a million population, all are doing quite well economically, growing fairly well, with the exception of approximately 50 countries. All 50 of these countries share one

attribute—bad government. The corruption endemic in many Third World countries' governments means that individuals forming new businesses and building factories will face the constant fear that government representatives will someday steal their profits.

In one of the great ironies, rather than America exporting our model of good government to the world, it appears that America has imported some of the government corruption endemic to the Third World. As our government became more corrupt and more co-opted by corporate donations and lobbying, they regulated business less and business itself became threatened. Karl Marx said that the capitalists will manufacture the rope that hangs them. As Raghuram G. Rajan and Luigi Zingales said in their book of the same title (Rajan 2003), it's a matter of "Saving Capitalism from the Capitalists." It would be ideal if businesses operating in their own individual self-interest and profit-maximization does nothing but good for the planet. But this is not the case. Businesses pollute, cause global warming, cause conflicts over access to raw materials, rip off consumers, make false advertising claims, and put their workers in competition with the lowest wage workers around the world. Anyone who believes that corporations acting solely in their own self-interest to maximize profits in a world of no regulation will ensure a prosperous global economy, a healthy environment, and a stable world needs to go back to school and study externalities and collective action problems. Although governments should not do anything that the free market can do, there are enormous problems that cannot be solved by self-interested corporations in the free market and need government involvement. Perhaps one of the most important of these problems is the regulation of the market itself. Be wary every time a government official tells you that an industry has agreed to be regulated and that they have decided to regulate it themselves.

In this book I examine the evidence and try to gain a better understanding of how the United States got into this mess. I examine the housing price boom and collapse in detail because it was the primary

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cause of all of our current financial problems. But the primary focus of the book will be a look forward to try to describe how far-reaching this contagion might spread. The word contagion entered the lexicon of regulators of financial markets during the Asian meltdown in 1998, also known as the Asian flu in finance circles, and came to be popular in describing a crisis in one market that has the ability to mutate into others. I use a much broader definition of the term to not only include financial matters, but also government concerns such as corruption and societal

problems such as greed. Although I will not be accurate in all of my predictions, it is helpful to investors and businesspeople and concerned citizens to take this look forward as they are much more interested in what might occur in the future than what has happened in the past.

A question facing many homeowners today is: When will the current housing price decline cease? Unfortunately, I show that the country as of the end of 2008 is only approximately halfway into what is already a record housing price correction. A recession is spreading now in the United States, but I argue that it will become one of the deepest and longest in our nation's history. Already many European countries have entered recession and it will be some time yet until they return to positive economic growth. The United States and Europe drive global consumer demand for goods and products and so the other economies of the world, especially the emerging growth economies that specialize in manufacturing products for these markets and providing raw materials and commodities to them, will suffer. I cannot think of a single country on Earth that will be exempt from this economic downturn.

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I describe what is happening on Wall Street and spend some time talking about the credit default swap market, that \$65 trillion completely unregulated market in which people can make bets on which company bankrupts next. I then turn around and demonstrate how problems on Wall Street and the freezing of credit worldwide can lead to serious problems on Main Street, in our own communities and in our own state and local governments.

An important question for investors is whether this is a temporary problem for the United States and the world or whether this is more permanent. The losses that have occurred in the housing market are permanent because no bank in the foreseeable future will be lending home buyers 10 times their annual income to buy a house as they have done in the past. If bank lending declines, the home prices have to follow. But it is also true that the problem extends further than just the housing price crash. The demographics of the United States are such that the baby boomers are just now starting to retire and this will represent a significant hit to our productive capacity and to our economic output. Just when the country starts to get over the housing collapse and the ensuing recession, demographically speaking, Americans will run into the baby boomer retirement, which will harm economic growth in the United States for decades.

In such a difficult crisis and terrible economic environment you can quickly see why cash is king. It is hard to come up with a list of good investment alternatives, but I do find a couple of interesting candidates. Similarly, there is not a long list of countries that I would recommend investing in, but there is at least one large one.

This analysis would not be complete without an understanding of the administration's plans to solve this crisis and a critique of their approach. Even after you stop the immediate bleeding of the financial institutions, you have to ask the question: What required reforms are necessary to the banking industry in general and to our government specifically? It makes no sense to talk about health care reform

or global warming or high pharmaceutical prices until big business is thrown out of our government. Until effective lobbying reform is enacted, this country is not going to be able to address any of the problems that Americans face. Remember, when these corrupt politicians were asked to come up with a plan to help the economy, they wanted to give \$700 billion of your money to the guys on Wall Street who caused the mess to begin with. The fact that many congresspeople and senators voted for this proposal even though their constituency e-mails and phone calls were 95 percent against the proposal makes you realize who they are really working for. I have some bad news for you, it isn't the American worker.

I conclude the book with a philosophical note as to what people in this country may have learned from this crisis. If the citizens survive it, it will make them stronger because everyone needs to do some serious introspection to determine if this country and this government and the their own lives are headed in the right direction. In a strange sense, it is good this crisis has happened. Americans never would have seen the error in their ways unless they were subjected to great pain and inconvenience. Now that they are feeling real pain with their jobs and homes threatened, only one final question remains:

Will they change?

## Chapter 2

# What Didn't Cause the U.S. Housing Boom and Bust

**T**o understand the future, it is sometimes helpful to gain a firm understanding of the past. You cannot make predictions about what is possible in our economic future until you understand exactly how the United States got here. Many years from now, when people reflect back on the global financial troubles of the early 21st century, it is important that they remember that it all started with the housing crash in the United States.

Even this analysis is not completely accurate, because you can't have a good crash without a preceding boom. For home prices to have declined dramatically over a period of years there had to have

been a necessary boom preceding it, during which home prices grew beyond reason, and in the United States this is exactly what happened. To understand why a housing crash in the United States was inevitable and to have an idea of how much more pain there might be on the housing front, it is important to look back and determine exactly how housing had become so overpriced over the past 30 to 40 years.

As Americans are well aware, nominal housing prices increased in the United States for nearly 50 years, from 1955 to 2005. In 1968 a typical home in the United States could be purchased for \$20,000 and by 2006, that average median home sold for close to \$220,000. This appreciation was not limited to any one geographic area of the country as all four regions—Northeast, Midwest, South and West—all showed remarkable appreciation during the period.

But it is not enough to say that nominal home prices increased every year over the past 50 years. Inflation also increased every year during the period, but rather how much did home prices appreciate more than general inflation. In other words, after accounting for the lower purchasing power of the dollar, did the average home in the United States still show significant real price appreciation?

The answer, of course, is yes, after accounting for general inflation, the real price of a typical home in the United States doubled from 1968 until 2005. And this is a median price of the average home for all the United States. There are a few cities in the United States, such as Phoenix, San Francisco, Las Vegas, New York, Boston, and Miami, that showed real appreciation in their homes of more than 500 percent during the period. In general the areas of highest appreciation were on both coasts and in Las Vegas and Arizona.

It is not enough to say that because housing prices went up during that period that they were overpriced. The reasonableness of prices, by definition, is always relative. With regard to houses, the appropriate relative measures seem to be how the market price of the home compares relative to its replacement value if you had to rebuild it; what

## What Didn't Cause the U.S. Housing Boom and Bust

is the home's value relative to its affordability, that is relative to one's income; and finally, what is the house's value relative to alternative living arrangements, namely renting.

By 2006 it should have been apparent to homeowners that the prices of homes in many American cities had become out of whack relative to their replacement values; that is, the cost of buying a piece of property, acquiring a building permit, and constructing a home. Homes in California by 2006 were selling at three to five times what it would cost to build a similar home from scratch. Even if you included the high cost for the underlying land, it is difficult to justify the high prices paid for homes in many cities across America relative to the cost of new construction.

This inequality can be seen most readily by looking at the profits of American homebuilders during the housing boom. In effect, homebuilders are sellers of homes. They do best when homes are overvalued because they step in and act as arbitrageurs, taking raw materials like nails and wood and dirt and turning them into homes for sale. Their profits increase if homes are overvalued. And boy did their profits increase. The homebuilders in America saw their profits increase more than 20 percent per year every year for 10 years running. In the Midwest, it is common for the cost of building a new home to run from \$70 to \$120 per square foot. In California and New York, this cost of construction can approach \$200 to \$300 per square foot because labor prices are higher, materials prices can be higher, the work area can be more congested, and the quality of the final house can be higher with more amenities (such as nicer cabinets or fancier kitchens). But, even these high costs of construction cannot justify homes in California and New York and elsewhere that sold at their peak price of more than \$1,000 to \$2,000 per square foot. There are many condominium apartments in New York City that sell between \$1,000 and \$3,000 per square foot, and yet the cost of new construction in New York, even in the most congested areas, is less than \$500 per square

foot at most, especially if all you are doing is adding an extra floor to an already planned new high-rise.

To determine whether houses are overpriced on an affordability measure, it is best to look at housing prices relative to income. What first alerted me to the unsustainable nature of the increase in U.S. house prices was that most wages in America have been stagnant for 30 years. There are disagreements as to why workers wages have not increased as U.S. productivity has expanded, but it is probably some combination of increased globalization in which American workers are forced to compete with low-wage countries such as Mexico, China, India, and Vietnam, and increased technology. Increased technology has dumbed down many jobs in America so that these jobs now require few skills. I met a woman in Kentucky who surprised me by telling me that she got a job as a welder at a car assembly plant. I was surprised because I knew she had no welding experience and no welding training. It turns out, as she proudly told me, that she was able to accomplish 140 complex welds per hour. The total effort required on her part was pushing a red button on the wall 140 times each hour. Technology did the rest. In a world where employees only require the skill necessary to push a red button on the wall, it is hard to argue that they deserve a premium wage.

Finally, there is a growing school of thought that what really happened to the American worker was a great power shift from workers rights to management and shareholders. Because of the Reagan revolution, and because of globalization and technology, it has been more difficult to organize workers, and unions have seen a dramatic decline in their membership. In the private sector, union membership peaked in the 1950s at 35 percent, but have declined to just over 9 percent today. Regardless of what you think about unions, it is rather apparent from their demise that workers do less well relative to shareholders and management in their absence. According to the Institute for Policy Studies (2008), because of the weakening role of unions and the increased difficulty of workers to organize, management at our biggest