Policy Brief 06-4

New England Public Policy Center
at the Federal Reserve Bank of Boston

December 2006

The changing housing market: A bang or a whimper?

by Karl E. Case

New England Public Policy Center

Director
Robert Tannenwald

Deputy Director
Carrie Conaway

Staff
Heather Brome
Tom DeCoff
Joanna Helou
Matthew Nagowski
Antoniya Owens
Darcy Rollins Saas
Alicia Sasser
Bo Zhao

The New England Public Policy Center is dedicated to enhancing access to high-quality analysis on economic and public policy issues that affect the region.

For more information about the New England Public Policy Center, please visit: www.bos.frb.org/economic/neppc/

The views expressed are the author's and not necessarily those of the Federal Reserve Bank of Boston or the Federal Reserve System.

FEDERAL RESERVE BANK OF BOSTON ™

New England Public Policy Center
at the Federal Reserve Bank of Boston

The U.S. housing market has had an extraordinary 15-year run in terms of prices, sales of existing homes, and new construction, especially on the East and West Coasts. Beginning in the spring of 2006, however, the housing market began to turn distinctly downward. We know that 2005 was a good year and that 2006 has not been such a good year, and we see indications that 2007 could be tough. To help understand why the market has shifted from hot to, at a minimum, cool, this paper, which is the first in a series of NEPPC policy briefs on housing, recaps some of the factors that contributed to this housing run and discusses some of the factors that will determine just how long and steep this reversal of housing fortune might be.

What a ride

The current sea change in the housing market has actually been long anticipated, mainly because of the strength of the last two decades. Consider just these facts:

- A decade ago, household holdings of real estate in the United States were valued at just under $8 trillion, or about 40 percent as large as household financial assets. By the end of 2005, household real estate holdings had nearly tripled to more than $19 trillion, or 56 percent as large as household financial assets.
- From 2000 to 2005, the total value of residential U.S. real estate increased by nearly $10 trillion.
- During the last decade, the total value of owner-occupied housing units in the six New England states quadrupled from under $300 billion to $1.29 trillion, adding nearly $1 trillion to household balance sheets.
- Also during the last decade, existing home sales nationwide grew steadily to record levels, peaking at 7.2 million in September 2005; new home sales peaked at 1.35 million in October 2005; and housing starts hit a new high of 2.27 million in January 2006. Home improvement spending hit $138 billion per year in 2003.
- In the third quarter of 2006, construction employment reached all-time highs in both the nation (7.5 million) and New England (more than 300,000). These are, respectively, 34 and 40 percent higher than a decade ago.

The housing boom reverberated far beyond the housing sector itself. Significant numbers of people work in real estate, from brokers and bankers to builders, appliance dealers, and construction workers. Factoring in all sectors, estimates suggest that between 12 and 18 percent of total U.S. employment was directly or closely linked to real estate over the last five years. Clearly, the housing market has been an engine of growth and stability during this period.

Understanding the past to anticipate the future

The housing boom was fueled by a number of factors, including:

- **Demographics.** Baby Boomers entered the housing market with a vengeance in the 1970s and 1980s. To some extent, Boomers have surprised us. They have not behaved as other generations. Boomers look at housing as previous generations looked at cars and TVs: rather than owning just one house, in many cases they own two and, sometimes, three or four.

- **Interest rates and a very liquid mortgage market**. Rates have been down for a long time at levels that have significantly increased housing affordability. But in addition to low rates, the mortgage market has been transformed in the past decade in ways that have expanded demand for housing. First, sub-prime lending grew significantly. Large numbers of households that previously would not have qualified for credit now do, which has been a major factor in the rise of the homeownership rate to nearly 70 percent. Second, new and exotic mortgage instruments, such as pay option adjustable rate mortgages and interest-only or negative amortization loans, have reduced initial carrying costs to very low levels.

- **The stock market and investment choices.** When the stock market is strong, people have more wealth, some of which naturally finds its way into housing. The housing market did well during the dot-com bubble. There is also evidence that when the stock market falters, real estate is a good refuge. Something stands out when comparing an investment in a house with a block of common stock: If you think of buying a house outright and living in it, you earn a rate of return that comes in the form of valuable housing services, even if the house doesn't appreciate. This "imputed rent" can be seen as analogous to the dividend that comes with a share of stock. In a downturn, the dividend on common stocks goes away as profits fall. Not so with a house, whose dividend stream is essentially fixed in real terms. Holding a home is thus a good way to preserve a positive return, even if the value falls.

- **Foreign demand.** When asked about the differences between the housing market in the last five years and the housing market of two decades ago, developers and real estate agents inevitably point to an increase in the number of foreign buyers. While it is difficult to find hard data to support the claim, it is clear that the number of buyers whose primary residence is abroad has increased and, when added to demand from immigrants, the impact on home prices has been significant.

- **Supply restrictions.** Some cite zoning and other restrictions that limit supply and drive up prices. And data show that prices have not escalated as steeply in parts of the country where housing supply has kept pace with or exceeded growing demand. Though there are exceptions—Las Vegas and parts of Florida come to mind—supply does not appear to adjust quickly in areas experiencing big housing booms.

- **Market psychology and expectations** People's views of the future can drive prices up—and, of course, down. When people buy an asset, they are buying the future. People are willing to pay more for an asset that they expect to increase in value. If their expectations are based on past price changes, even small price increases can lead to a rapidly escalating price level. Much evidence suggests that exuberant expectations played a major role in the booms of the last 30 years.

A sea change

Now the boom seems to be over. Volumes are decreasing substantially. Housing starts in August 2006 were down to 1.66 million from 2.2 million per year earlier, a fall of about 25 percent. Existing sales fell by about 14 percent, from 7.3 million to 6.3 million. In addition, home prices are falling. In seven of the ten metropolitan areas in which the S&P Case-Shiller repeat sales indexes are published, prices are down, as is the U.S. composite index. And the Chicago Mercantile Exchange's futures market shows virtually all markets in what futures traders call "backwardation," meaning that the futures price is below the spot price of housing.

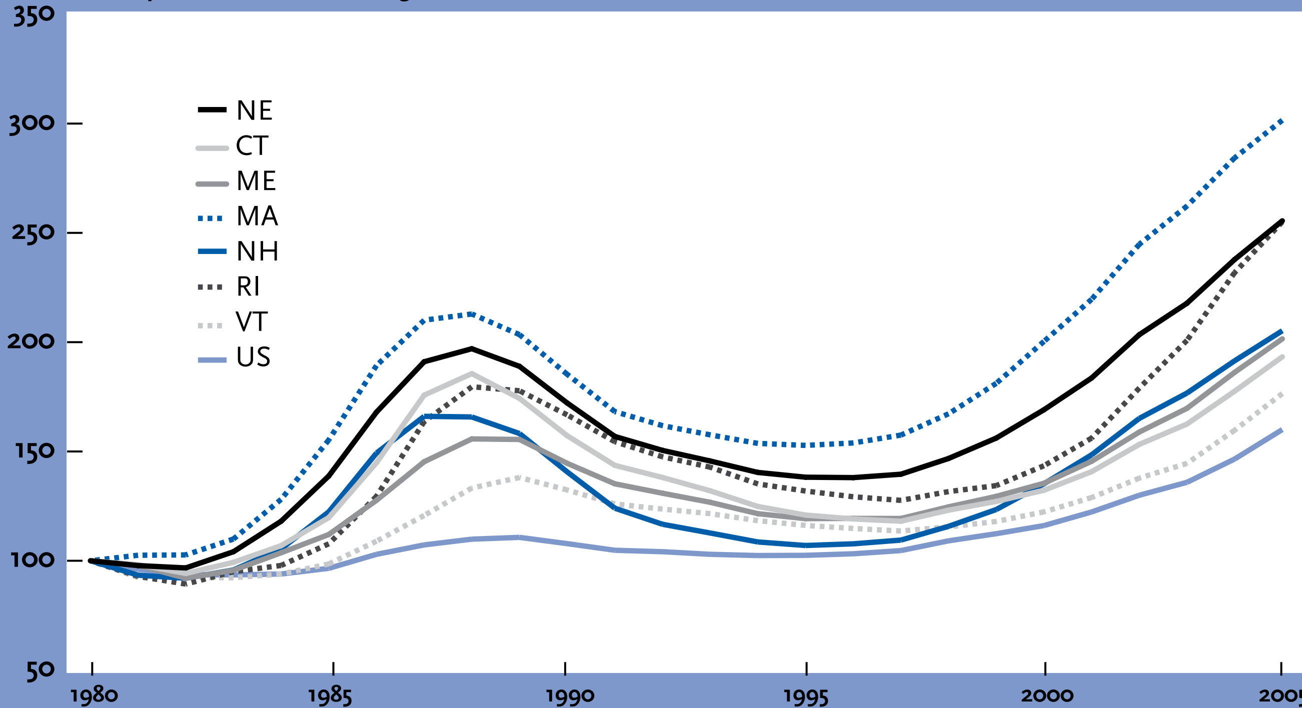
Some of the factors behind the boom have changed:

- There has been a nationwide change in the psychology of the market, fueled in part by a stream of magazine covers and news stories portraying a popping "housing bubble."

- Housing prices have been increasing faster than incomes, particularly on the East and West Coasts, and that cannot continue forever. Indeed, for most families on the coasts, housing has become increasingly unaffordable. In the long run, this income constraint must bind. Indeed, during the house price busts of the 1990s in both California

Real house prices soared after 2000, but the outlook is uncertain

House price index for New England states



Source: Office of Federal Housing Enterprise Oversight
Note: Prices are adjusted by the CPI minus shelter, 1980=100

and New England, prices did not rise again until the median house price to median income ratio was back to its original level.

- Evidence indicates overbuilding. As demand has dropped, the inventory of unsold homes has risen and the number of new units has run ahead of household formation.

- Aging Boomers are entering a period when, rather than fueling the market, they are creating a drag. As they retire, become empty nesters, or otherwise seek to downsize, many are moving into urban condo markets. Others are leaving high-priced markets such as Boston and buying into less expensive markets. Many are finding it difficult to sell their suburban homes, at least at the prices they had come to expect.

- Finally, sub-prime and exotic mortgage lenders seem to have run out of new households to qualify for credit. As Wall Street begins to recognize that the nation's portfolio of mortgage paper now contains much more risk than it did a decade ago, the homeownership rate is unlikely to rise much further. The sub-prime market has never been tested in a down housing market, and many fear serious default problems.

Sticky prices—and then what?

In most markets, when demand drops, prices fall immediately. In housing, however, there is always a period of time during which bid-ask spreads widen and buyers and sellers do battle. Buyers, long seeking a chance to purchase housing, see that the market is down. They either make low-ball offers or defer making offers at all. Sellers then hold out, refusing to sell at reduced prices, resulting in "sticky" prices. Historically, holding out has actually stabilized the market and has been a rational option for sellers. In past regional cycles holding out has been rewarded with timely recovery.

Much depends on whether sellers continue to hold out. What can turn a sticky period into a bust? If the market becomes an auction market, prices can fall sharply. In Vancouver and other parts of Canada, where long term fixed rate mortgages are not an option, rapidly rising interest rates in the early 1980s created a serious payment shock. With rates approaching 18 percent, monthly payments on adjustable rate mortgages rose dramatically, forcing many into selling out or foreclosure. In 18 months, house prices fell by 65 percent. But even with the recent growth of exotic lending instruments, more than 70 percent of all U.S. mortgages are still fixed-rate.

Finally, many point to the so-called "wealth effect." When people's wealth increases, they tend to spend more, and when it falls, people spend less. The fear is that lower housing wealth will reduce consumer spending, increasing the likelihood of a recession. Recent evidence, however, suggests that this wealth effect is asymmetric: if house prices fall, consumer spending does not appear to drop.

Looking ahead, many economists and people in the industry anticipate a fairly soft landing for the housing market. Demographics and other foundations remain reasonably solid, they say. Foreign demand continues. Prices fall somewhat, but volumes fall more substantially, bringing the market back into equilibrium. But even under this soft landing scenario, employment and income will suffer.

I currently lean toward the softer—though not easy—landing scenario. But it would not take too much to make a softer landing much harder. A recession or rising long-term interest rates are among the factors that could turn a soft landing into a harder one. So too could another factor that is difficult to quantify: a continuing negative housing market psychology. Like everyone else, I'll be watching out with a jittery eye.

Karl E. Case is the Katharine Coman and A. Barton Hepburn Professor of Economics at Wellesley College.

This first in a series of New England Public Policy Center policy briefs about housing is adapted from recent presentations by Karl E. Case to the Federal Reserve Bank of Boston's New England Study Group and to Harvard University's Joint Center for Housing Studies. For a comprehensive look at New England's housing affordability trends, see *The Lack of Affordable Housing in New England: How Big a Problem? Why Is It Growing? What Are We Doing About It?*, a NEPPC working paper available at http://www.bos.frb.org/economic/neppc/wp/2006/neppcwp0601.htm. To receive future policy briefs, please contact us at neppc@bos.frb.org or 617.973.4257.

New England Public Policy Center
Federal Reserve Bank of Boston
600 Atlantic Avenue
Boston, MA 02210