



Executive Summary

Housing markets contracted for a second straight year in 2007. The national median single-family home price fell in nominal terms for the first time in 40 years of recordkeeping, leaving several million homeowners with properties worth less than their mortgages. With the economy softening and many home loans resetting to higher rates, an increasing number of owners had difficulty keeping current on their payments. Mortgage performance—especially on subprime loans with adjustable rates—eroded badly. Lenders responded by tightening underwriting standards and demanding a higher risk premium, accelerating the ongoing slide in sales and starts.

By early 2008, housing market problems had spread to the rest of the economy. The sharp drop in home building, the turmoil in the credit and stock markets, and the impact of falling home prices on borrowing and consumer spending all contributed to the slowdown. Mounting job losses in the first quarter of 2008 added to the misery, raising the risks of even sharper price declines and higher delinquencies ahead.

While deep construction cutbacks have begun to pare down the supply of unsold new homes, the numbers of vacant homes for sale or held off the market remain high. Reducing this excess will take some combination of additional declines in prices, a slowdown in foreclosures, further cuts in mortgage interest rates, and a pickup in job and income growth. Until the inventory of vacant homes is worked off, the pressure on prices will persist. Further price declines will not only increase the probability that mortgage defaults end in foreclosure, but also put a tighter squeeze on consumer spending.

Persistent Overhang

In the overheated markets of 2003–2005, house prices surged ahead of incomes and new construction outstripped sustainable long-term demand. But when the Federal Reserve started to raise interest rates in 2004, prices were climbing so rapidly that buyers still clamored to get in on the market. By late 2005, however, the combination of higher interest rates and higher home prices finally dragged down demand. Within the span of two years, sales and starts plummeted, prices fell, and home equity shrank (**Figure 1**).

In 2006 alone, existing home sales were off by 8 percent and new home sales by 18 percent. These declines accelerated in 2007 as falling home prices and the credit crunch deepened the crisis. With remarkable speed, the homeowner vacancy rate jumped from 2.0 percent in the last quarter of 2005 to 2.8 percent in the last quarter of 2007 as the number of vacant units for sale shot up by more than 600,000. Assuming the vacancy rate prevailing in 1999–2001 was close to equilibrium, the oversupply of vacant for-sale units at the end of last year was around 800,000 units, or 1.0 percent of the owner stock.

The inventory overhang was especially large in states that had either significant overheating or weakening economies (Figure 2). In addition, the number of vacant homes held off the market other than for seasonal or occasional use surged from 5.7 million units in 2005 to 6.2 million in 2007. Although the rental vacancy rate did not increase in 2006 and 2007, its climb earlier in the decade indicates that surpluses may exist in that market as well.

Despite production cuts rivaling those in the 1978–1982 downturn, the number of vacant for-sale homes on the market did not shrink in the first quarter of 2008. The weak economy, tight credit, and concerns over whether house prices had bottomed out continued to suppress demand and delay the absorption of excess units. Until this oversupply is reduced, housing markets will not mend.

Mortgage Market Meltdown

Mortgage markets have suffered mightily in the boom-bust housing cycle. During the boom, subprime mortgages and other products that helped buyers stretch their incomes were available as never before. In the hope of higher returns, lenders extended credit to borrowers previously unable to qualify for loans. Subprime mortgages rose from only 8 percent of originations in 2003 to 20 percent in 2005 and 2006, while the interest-only and payment-option share shot up from just 2 percent in 2003 to 20 percent in 2005.

Making matters worse, multiple risks were often layered onto individual loans. For example, large shares of subprime mortgages also had discounted initial rates that reset after two years, leaving borrowers vulnerable to payment shock. In addition, lenders eased underwriting standards, offering loans requiring little or no down-

payment or income documentation, and some engaged in behavior viewed as predatory. This meant that many loans were underwritten without a clear measure of the borrowers' ability to repay and without equity cushions as protection against defaults. Housing speculators were also readily able to get loans to buy investment properties, relying on soaring house price appreciation to flip the units and resell at a profit.

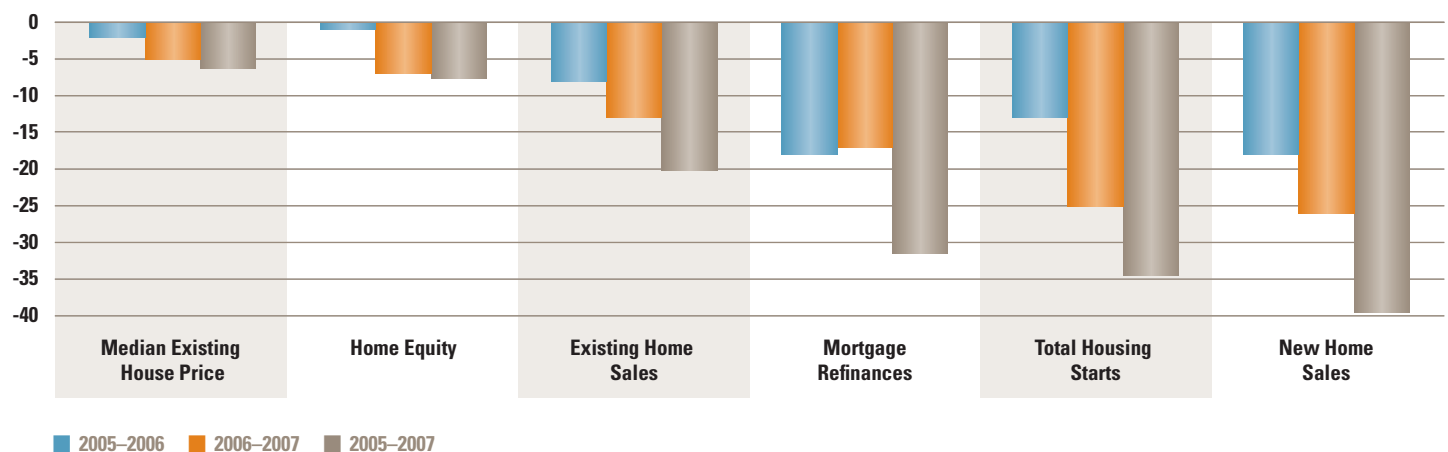
The layering of mortgage lending risks at the peak of the market had serious and far-reaching consequences. As the economy weakened and mortgage interest rates rose, the number of homeowners unable to keep current on their payments began to climb. With prices falling, many owners could not sell their homes to avoid foreclosure. Meanwhile, many housing speculators defaulted even before their interest rates reset. Indeed, the Mortgage Bankers Association reports that absentee owners accounted for almost one in five loans entering foreclosure in the third quarter of 2007.

As a result, serious delinquencies soared in late 2006 and throughout 2007. The swift deterioration, especially in subprime loan performance, caught many mortgage investors unaware. Demand for securities backed by subprime mortgages dried up so fast and so completely that investors were forced to sell them at a loss. Compounding the problems, several investment funds and mortgage companies had borrowed to purchase the securities with debt they had to roll over. When lenders were unwilling to provide more money as the debts came due, some companies were forced to default and lenders had to take many assets back onto their books. The sheer size of mortgage debt outstanding and the fear that the crisis would soon spread to consumer credit led to a freeze in credit markets and runs on investment banks and funds.

Figure 1

Housing Market Declines Are Steep and Accelerating

Percent Change

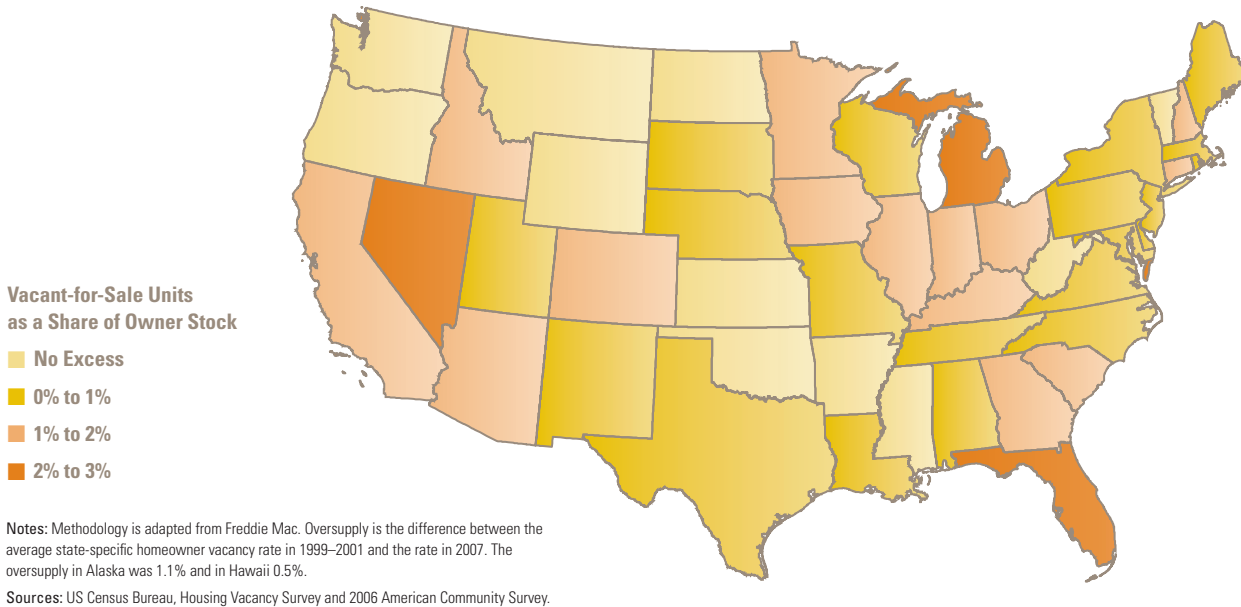


Notes: Changes in dollar values are adjusted for inflation by the CPI-U for All Items. New sales and median existing house prices include single-family units only.

Sources: US Census Bureau, New Residential Construction; National Association of Realtors®, Median Existing Single-Family Home Price; Freddie Mac; Federal Reserve Board, Flow of Funds Accounts.

Figure 2

In the Most Glutted Markets, Surpluses Exceed Two Percent of the Owner Stock



The full scope of credit market problems and the path to recovery remain clouded. Until credit markets return to normal, the economy will be in peril not only from the impact of falling home prices on loan performance and consumer spending, but also from the disruptions to corporate and consumer borrowing.

The String of Foreclosures

Estimates from the Mortgage Bankers Association drawn from about four-fifths of all loans suggest that the number of loans in foreclosure proceedings nearly doubled to almost one million by the end of 2007, while the number entering foreclosure topped 400,000 in the fourth quarter alone (**Figure 3**). The most rapid and dramatic increase was among riskier subprime loans. Indeed, foreclosure rates on adjustable subprime mortgages were over five times higher than those on adjustable prime loans.

Not all foreclosures end in families losing their homes. Of the prime loans it owns or insures, Freddie Mac estimates that less than half the homes with loans that enter foreclosure proceedings are ultimately sold. Nevertheless, hundreds of thousands of foreclosed homes have flooded into already bloated markets, with more to come. This will put more pressure on prices in places where foreclosures have reached a critical mass. In these communities, nearby homeowners will suffer drastic declines in home equity and local jurisdictions will face a drop in property tax collections.

The metropolitan areas at the greatest risk of widespread foreclosures are those with ailing economies, high shares of subprime

and so-called affordable loans, and large oversupplies of housing. Unfortunately, the majority of large metropolitan areas now fall into at least one of these three categories. The worst-hit locations are Midwestern metros with weak economies. Cleveland and Detroit, for example, both have subprime foreclosure rates above 20 percent. If economic distress spreads beyond the Midwest, other areas with high subprime shares will not be spared. Meanwhile, foreclosures within metro areas are especially high and rising in predominantly low-income and minority communities where subprime loans are concentrated.

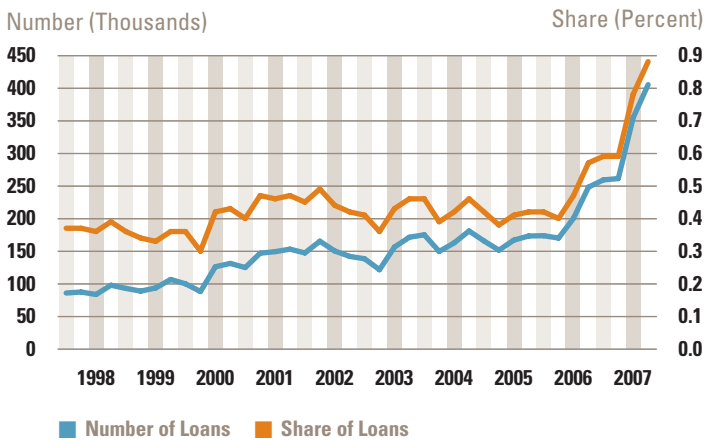
The scope of the foreclosure crisis has prompted responses from all levels of government. The federal government is scrambling to get lenders to make wholesale loan modifications, to help homeowners refinance with government-insured mortgages, to expand and promote credit counseling, and to provide state and local funding to deal with the problem. Several states have created programs to help at least some borrowers refinance their way to safety, and local governments are marshaling their own resources to cope with the rash of foreclosed homes in their communities.

Homeownership Cycles

Although subprime loans and new types of mortgages have been linked to a temporary increase in homeownership, the run-up in homeownership rates predates the proliferation of such loans. In fact, the largest homeownership gains occurred before 2001 when the subprime share was still small and price appreciation was only starting to take off.

Figure 3

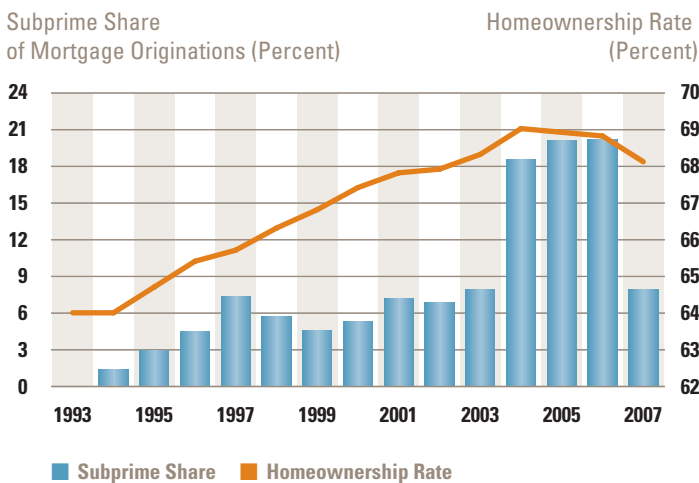
The Spike in Loans Entering Foreclosure Will Weigh Heavily on Markets



Source: Mortgage Bankers Association, National Delinquency Survey.

Figure 4

The National Homeownership Rate Peaked Before Subprime Lending Took Off



Note: Subprime share is of the dollar volume of all originations.
Sources: US Census Bureau, Housing Vacancy Survey; Inside Mortgage Finance, 2008 Mortgage Market Statistical Annual.

Several factors contributed to the surge in homeownership between 1994 and 2000. First, mortgage rates had started to decline in the 1980s and stood at much lower levels by the end of the 1991 recession. Second, the economy had entered a period of unusually vigorous and broad-based growth, with strong increases in incomes across the board. Third, home prices in some markets had fallen in the wake of the 1991 recession, improving affordability for many

buyers. Fourth, federal regulators had stepped up pressure on financial institutions to meet the mortgage needs of low-income communities and minority borrowers. And fifth, the prime mortgage market had begun to rely on automated underwriting and statistical models of loan performance, enabling lenders to relax downpayment and debt-to-income requirements while maintaining about the same expected default rates. Lenders were thus able to identify a broader range of borrowers that qualified for prime credit.

The expansion of mortgage credit in the 1990s was therefore accomplished with traditional products and without adding much to risk. The growth in mortgage credit after 2003, in contrast, came largely from gains in much riskier subprime, interest-only, and payment-option loans. These novel mortgage products provided only a temporary lift to homeownership. Indeed, the national homeownership rate peaked in 2004 and has since retreated below its 2003 level (Figure 4).

For the rate to fall below its 2000 level, the number of homeowners would have to dip by another million—a real possibility given the rising tide of foreclosures. Nevertheless, once the oversupply of housing is worked off and home prices start to recover, the use of automated underwriting tools, a return to more traditional mortgage products, and the strength of underlying demand should put the number of homeowners back on the rise.

Heightened Housing Challenges

At last measure in 2006, 39 million households were at least moderately cost burdened (paying more than 30 percent of income on housing) and nearly 18 million were severely cost burdened (paying more than 50 percent). From 2001 to 2006, the number of severely burdened households alone surged by almost four million. Because of the unprecedented run-up in house prices and lack of real income growth, over half of this increase was among homeowners.

The weight of high housing costs falls especially heavily on households in the bottom income quartile. Fully 47 percent of low-income households were severely cost burdened in 2006, compared with 11 percent of lower middle-income households and just 4 percent of upper middle-income households. On average, households with children in the bottom quartile of spenders with severe housing cost burdens have just \$257 a month left over for food, \$29 for clothing, and \$9 for healthcare. With food and energy costs climbing, these households will have less to spend on bare necessities.

Even households with one or more workers often spend more than half their incomes on housing (Figure 5). Four in ten low-income households with at least one full-time worker, and nearly six in ten households with one part-time worker, are saddled with severe housing cost burdens. The widening mismatch between housing costs and incomes reflects several forces—the growing number of low-wage and part-time jobs generated by the economy, the rising costs of operating and maintaining housing, and the upward pressure on construction and renovation costs created by local development restrictions. Indeed, in markets with the most stringent

regulations, house prices tend to rise faster and cost burdens tend to be greater than elsewhere.

With many former homeowners now turning to the rental market, the pressure on the limited supply of affordable rentals is mounting. Worse, losses of low-cost rental housing are alarmingly high. From 1995 to 2005, the supply of rentals affordable to households earning less than \$16,000 in constant 2005 dollars shrank by 17 percent. Unfortunately, these losses have continued in recent years even with the annual construction and preservation of about 135,000 rentals under the Low Income Housing Tax Credit program. These credits are sold to investors at a discount to compensate them for the risk of real estate investing. But like investors in other assets, tax credit investors are demanding higher returns in this riskier environment. As a result, tax credits will likely support fewer additional rentals this year and perhaps longer.

Meanwhile, only a quarter of eligible renter households receive housing subsidies, and the federal government does even less to relieve the cost burdens of low-income homeowners. While current interventions may mitigate the risk of massive mortgage defaults and foreclosures, any relief for cost-burdened homeowners is likely to be temporary at best.

Housing Demand Fundamentals

With many housing markets in a tailspin, the underpinnings of long-term demand have come into question. But unless the economy enters a sharp, prolonged recession that dampens immigration or

slows household formations, the current housing cycle in and of itself is unlikely to diminish the long-run growth of households.

The propensity for Americans to form households is driven largely by the age distribution of the population, slowly changing social norms, and the pace of immigration. In the decade ahead, the aging of the echo boomers into young adulthood, the longer life expectancies of the baby boomers, and projected annual immigration of 1.2 million all favor an increase in net household formations.

Meanwhile, the impacts of recent social trends are likely to be minimal. Although deferred first marriages, high divorce rates, and low remarriage rates will continue to make single-person households the fastest-growing household type, these trends have started to level off. Assuming that age-specific household formations remain about constant, changes in the number and age distribution of the adult population should lift household growth from 12.6 million in 1995–2005 to 14.4 million in 2010–2020.

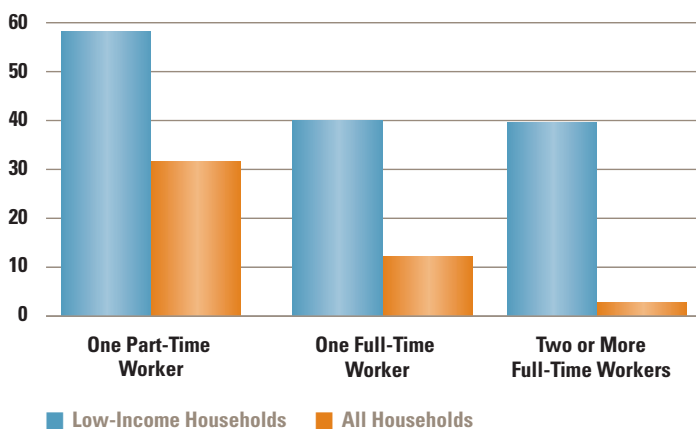
With their high levels of immigration and high rates of natural increase, Hispanics and Asians will contribute significantly to household growth. Minorities are expected to account for more than two-thirds of the net increase in households over the next decade, with the foreign born alone contributing at least one-third of the gains.

Because minorities have lower average incomes and wealth, some have argued that their growing presence in housing markets will be a drag on home prices and rents. But when the minority share of households increased from 20.2 percent in 1990 to 29.2 percent in 2007, rents and house prices still rose ahead of household incomes. While their low incomes may force them to spend less on non-housing items as housing costs rise, minority households will nevertheless provide broad demand support to housing markets in the years ahead.

Figure 5

Housing Costs Are Beyond the Reach of Many Working Households

Share of Households with Severe Cost Burdens (Percent)



Notes: Full-time is defined as working at least 35 hours per week for at least 38 weeks in the past 12 months. Low-income households are in the bottom fourth of all households sorted by pre-tax income. Severe cost burdens exceed 50% of total household income.

Source: JCHS tabulations of the 2006 American Community Survey.

The Rocky Road Ahead

With credit markets in such disarray, the for-sale housing inventory at record levels, and only small declines in interest rates, emerging from today's housing slump could take some time. Although demand fundamentals should support average annual completions of more than 1.9 million units over the next decade (including single-family and multifamily units plus manufactured homes), the housing market must first work off the one million or more excess units that were vacant and for sale or temporarily taken off the market at the beginning of 2008. This could trim underlying demand to an average of 1.8 million new units annually in the decade ahead.

If the economy slips into a severe recession, the prolonged contraction could drive down the sustainable level of housing demand by slowing the loss of older units, forcing more households to double up, and reducing sales of second homes. But in the case of a mild downturn, which most economists expect, the fundamentals of demand are likely to drive a strong rebound in housing once prices bottom out and the economy begins to recover.