



Housing Markets

Housing markets entered 2008 showing no signs of recovery. Credit markets seized up in the wake of higher than expected losses on subprime mortgages, and lending standards tightened. In addition, mortgage interest rates edged down only slightly despite aggressive cuts by the Federal Reserve in 2007. Although the slowdown in home building last year was not enough to drive the economy immediately into recession, tight credit markets and the impact of falling home prices on consumer spending now threaten to bring growth to a halt.

The Unraveling Housing Market

The housing market bust that began in 2006 deepened in 2007 (**Figure 6**). During the expansion that started in the early 1990s, demand fundamentals kept household growth going strong, real incomes were up, and interest rates were favorable. But just prior to the 2001 recession, the Federal Reserve began to cut interest rates to avert deflation and a deeper contraction of the economy. Soon after, home sales began to take off ahead of production. By 2003, these conditions helped to create the tightest housing markets and the lowest interest rates in at least a generation.

A dramatic run-up in home prices ensued as buyers with access to low-cost mortgage credit competed in bidding wars. For the first time since records were kept, median prices across the nation increased multiple times faster than incomes for several years in a row (**Table A-1**). The relaxation of underwriting requirements and the advent of mortgage products that initially reduced borrowers' payments—together with the unprecedented availability of mortgage credit to speculators, investors, and homebuyers with past credit problems—helped to fuel the boom.

But even lax lending standards and innovative mortgage products could not keep housing markets going indefinitely. With interest rates on the rise starting in 2004, price appreciation showed signs of weakening in late 2005. Investors quickly exited markets and homebuyers lost their sense of urgency. But builders had ramped up to meet the higher level of demand from investors as well as buyers of first and second homes, pushing single-family starts from 1.3 million in 2001 to 1.7 million in 2005. Just as housing demand started to abate, record numbers of new single-family homes were coming on the market or were in the pipeline (**Table A-2**).

With excess supplies beginning to mount and the temporary lift from mortgage product innovations coming to an end, nominal house prices finally turned down on a year-over-year basis in the third quarter of 2006. Meanwhile, interest rates on some adjustable loans began to reset and mortgage performance deteriorated as poor risk management practices took their toll. Lenders responded by tightening credit in the second half of 2007, dragging the market down even more sharply and exacerbating the threat of a prolonged housing downturn.

Figure 6

The Housing Downturn Accelerated in 2007

Dollars in 2007 Values

	2006	2007	Percent Change	
			2005–06	2006–07
New Single-Family Sales (Thousands)	1,051	776	-18.1	-26.2
Existing Single-Family Sales (Millions)	5.7	4.9	-8.1	-13.0
Single-Family Starts (Thousands)	1,465	1,046	-14.6	-28.6
Multifamily Starts (Thousands)	336	309	-4.8	-7.9
Median Existing Single-Family Price (\$)	228,200	217,900	-1.8	-4.5
Home Equity (\$Trillions)	10.3	9.6	-1.1	-6.5
Mortgage Debt (\$Trillions)	10.1	10.5	7.7	3.7
Mortgage Refinancing (\$Trillions)	1.4	1.2	-17.7	-16.8
Residential Investment (\$Billions)	786.6	640.7	-3.6	-18.5
Improvements & Repairs (\$Billions)	234.7	226.4	2.8	-3.6

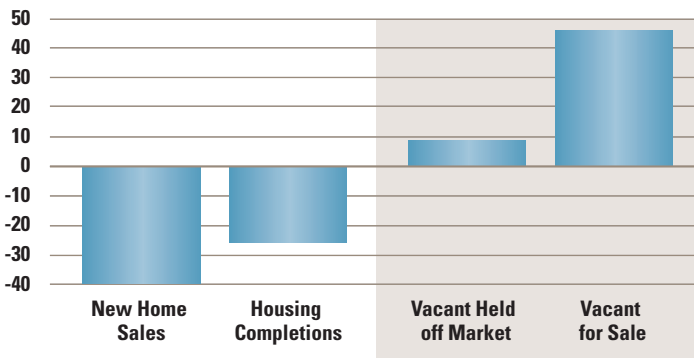
Notes: All values are adjusted to 2007 dollars using the CPI-U for All Items. Percent change is calculated with unrounded numbers.

Sources: US Census Bureau; National Association of Realtors®; Freddie Mac; Federal Reserve Board; Bureau of Economic Analysis.

Figure 7

With Demand Dropping off Faster than Production, the Number of Vacant Units Ballooned

Percent Change 2005–2007



Note: New home sales and housing completions include single-family units only.

Sources: US Census Bureau, New Residential Construction and Housing Vacancy Survey.

Lingering Oversupply

While drastic production cuts and deep price discounts in 2005–2007 helped to shrink the inventory of unsold new homes, the number of vacant homes for sale rose 46 percent over two years, to 2.12 million units (Figure 7). The number of unsold new single-family homes did retreat from a peak of more than 570,000 in mid-2006 to less than 500,000 in early 2008, but the precipitous drop in sales left the supply still high at 11 months—an excess not seen since the

late 1970s. Meanwhile, the months' supply of existing single-family homes rocketed to 10.7 months by April 2008.

With a supply of more than six months considered a buyer's market, homes for sale can languish for some time, inviting lowball offers that motivated sellers eventually accept. Since homeowners often resist selling at below-peak prices, adjustments in many markets have been larger on the new home than on the existing home side. Nonetheless, most current owners are unwilling to accept lower prices even if doing so enables them to buy new homes at more deeply discounted prices.

The homeowner vacancy rate continued to edge higher in the first quarter of 2008. Until the number of vacant for-sale units on the market, or held off the market for reasons other than seasonal or occasional use, falls enough to bring vacancy rates back down, house prices will remain under pressure. Working off the oversupply will require some combination of the following: housing starts fall even further, prices decline enough to bring out new bargain-seeking buyers, interest rates drop enough to improve affordability, job growth improves, consumer confidence returns, and mortgage credit again becomes more widely available.

Local Construction Downturns

Housing permits fell 24 percent nationwide in 2007, with single-family permits down 29 percent and multifamily permits down 9 percent for the year. This brings the total decline from the 2005 peak to 35 percent, including a 42 percent reduction in single-family permits. The downturn has been widespread, with permits declining in 94 of the 100 largest metropolitan areas over the two-year period. Smaller metropolitan areas have also been affected by the construction pullback, with 214 of 263 posting reductions in permits.

In some parts of the country, the drop in production last year was just the latest in a string of declines. Construction had already fallen for at least two years before 2007 in over a third of all metropolitan areas and in 16 states. The top five largest declines in metro area permitting in 2005–2007 occurred in Florida, led by Palm Coast with an 86 percent drop over two years (Figure 8). Not surprisingly then, Florida heads the list of states with the sharpest cutbacks at 64 percent, followed by Michigan at 61 percent and Minnesota at 51 percent (Table W-1).

The intensity of the retreat in demand took builders by surprise. Cancellations soared, coming closer to the time of delivery than ever before. Phoenix provides an extreme example. According to Hanley-Wood, cancellations as a share of gross home sales climbed from 2.8 percent in the fourth quarter of 2005 to 48 percent in the fourth quarter of 2007, just as gross sales dropped from about 10,600 to 7,400. Even in a relatively strong market like Seattle, however, the cancellation rate jumped from 1.2 percent to 12.6 percent over this period.

The shock to employment was significant. By the end of 2007, the nation had 232,000 fewer construction jobs than a year earlier.

Figure 8

Housing Permits in Many Metros Have Dropped Dramatically

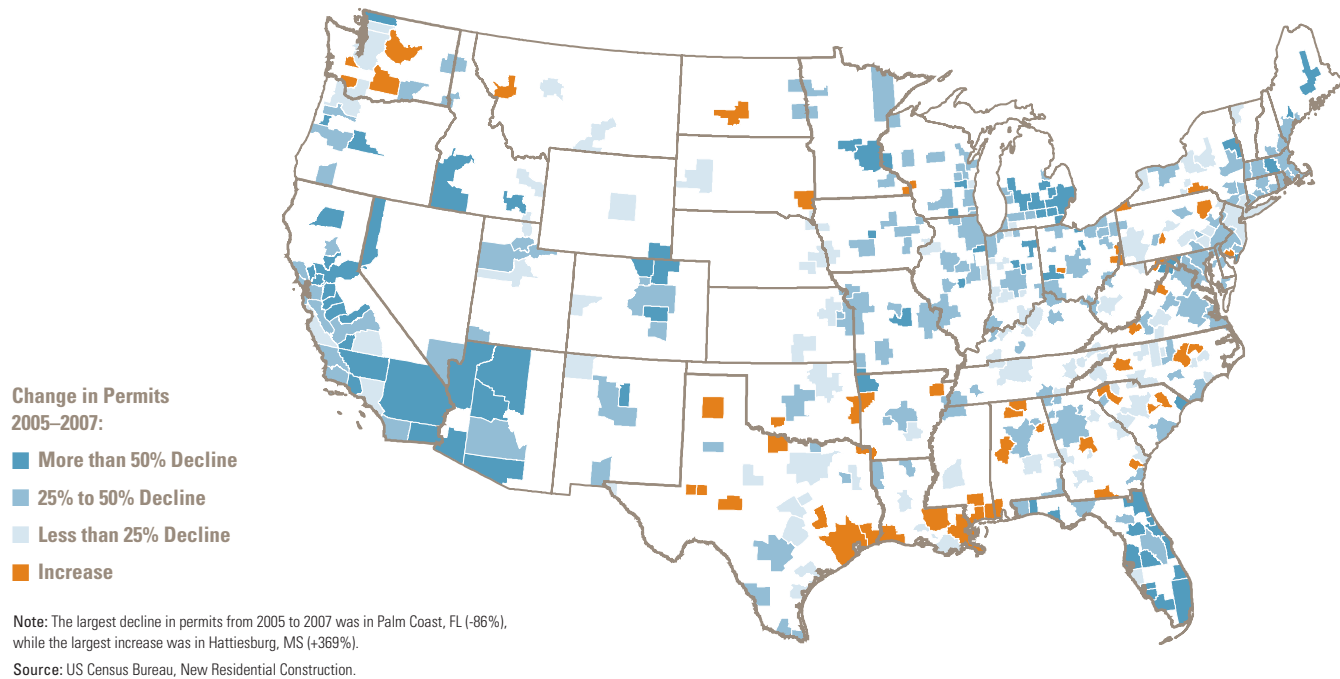
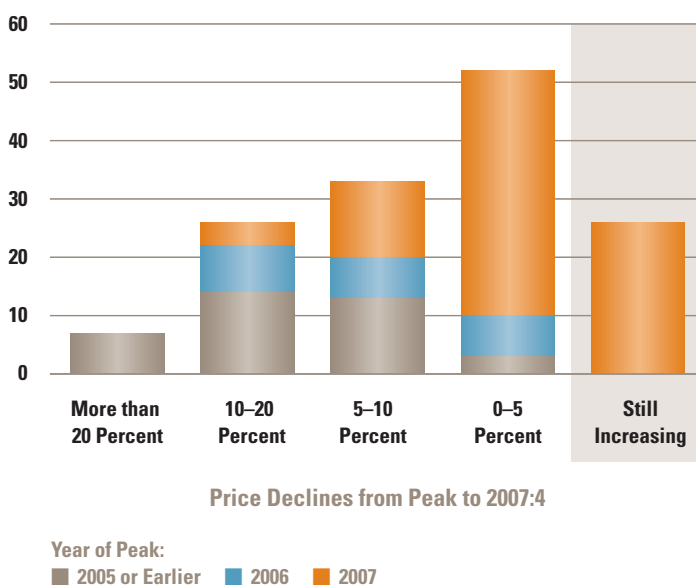


Figure 9

While a Handful Were Still Gaining, Most Metros Started to See Nominal Price Declines in 2007

Number of Metropolitan Areas



Notes: Peaks and declines are based on seasonally adjusted quarterly median single-family house prices. Still increasing means that nominal median house prices reached a new peak in the fourth quarter of 2007.
Sources: National Association of Realtors®, Moody's Economy.com.

These losses dragged down overall employment growth in many states, particularly those with previously booming markets such as Florida (74,000 construction jobs lost vs. 52,000 other jobs added) and Arizona (25,000 construction jobs lost vs. 23,000 other jobs added). California also lost 58,000 construction jobs, but more than offset this loss with gains in other sectors.

Only a few markets have so far weathered the storm better than the national numbers would suggest. At the state level, Mississippi and Wyoming issued more permits in 2007 than 2006. Among metros, just eight of the 100 largest saw increases last year, as even previously strong housing markets in the Carolinas, Texas, and Washington finally felt the pinch.

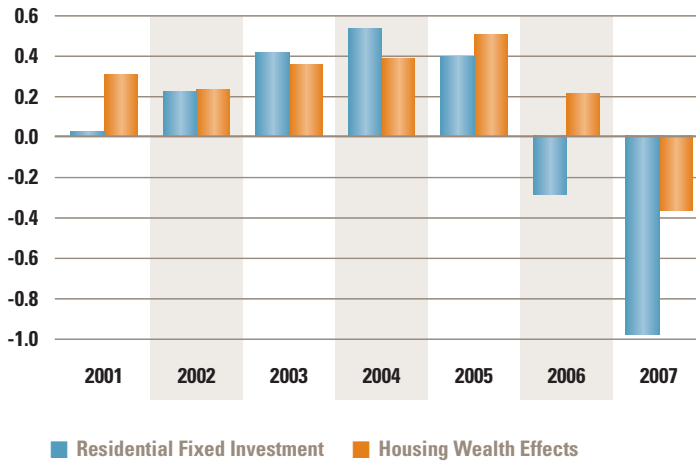
Falling House Prices

It is difficult to gauge with certainty how far home prices have fallen. Each of the three measures most commonly used to quantify house price trends paints a different picture of the magnitude of declines to date. The National Association of Realtors® (NAR) national median single-family home price—which is affected by the mix of homes sold—fell a modest 1.8 percent in nominal terms in 2007. When measured fourth quarter to fourth quarter, however, the decline was a much larger 6.1 percent. The S&P/Case Shiller® US National Home Price Index—based on repeat sales and therefore unaffected by the mix of homes sold—registered a hefty fourth-quarter to fourth-quarter nominal decline of 8.9 percent.

Figure 10

Declines in Both Housing Production and Housing Wealth Helped to Drag Down the Economy

Contribution to Change in Real GDP (Percentage points)



Note: Wealth effects include the impact of falling home prices on the marginal propensity of consumers to spend from their aggregate household wealth.

Sources: Moody's Economy.com; Bureau of Economic Analysis.

Meanwhile, the narrower purchase-only repeat sales index from the Office of Federal Housing Enterprise Oversight (OFHEO) eked out a 1.9 percent gain for the year despite posting a fourth-quarter to fourth-quarter nominal dip of 0.3 percent. The OFHEO index did, however, fall by a record 3.1 percent between the first quarters of 2007 and 2008 (**Table W-2**).

These national statistics obscure larger price drops in many metropolitan areas and mask how fast declines spread across the country. At the start of 2007, quarterly nominal NAR median sales prices were still rising in 85 of 144 metros. By the end of the year, however, prices were increasing in only 26 metros (**Figure 9**). Meanwhile, prices in 33 metros had declined by 10 percent or more from their peak to the fourth quarter of 2007 (**Table W-3**).

To wipe out past appreciation, home prices have to retreat the most in once-hot markets and the least in cold markets. For example, the 6.7 percent drop in the median house price in Indianapolis from the third-quarter 2005 peak to the fourth quarter of 2007 was enough to cancel out appreciation all the way back to 2000. In Sacramento, by contrast, the larger 21.8 percent drop in the median house price from its peak in the fourth quarter of 2005 to the end of 2007 only erased gains made since 2003. Among the 144 metropolitan areas with available data from NAR, fourth-quarter nominal house prices in 2007 fell back to 2006 levels in 12 metros, to 2005 levels in 35 metros, to 2004 levels in 19 metros, and to 2003 or earlier levels in 16 metros.

Once they begin, price declines usually take time to run their course. Of the 139 metros that saw their nominal OFHEO house price index values fall in the late 1980s and early 1990s, 18 took ten years or more to return to peak prices, another 56 took five to nine years, and 31 metros took three to four years. Among the 59 metros where prices fell more than five percent, the median time to make up for the lost appreciation was eight years. All but one of these metro areas took five or more years to recover.

Real price declines were even more dramatic and enduring. The real average annual OFHEO price index fell in 267 metropolitan areas in the late 1980s and early 1990s. The rebound to pre-decline levels took more than five years in 236 metros and more than ten years in 130. Indeed, real house price indices in 15 metros never returned to their previous peaks.

In previous cycles, employment losses and overbuilding played larger roles in how far metropolitan area prices fell. This time around, the extent of overheating is a much bigger factor in the magnitude of the declines. Still, job losses are likely to exacerbate housing market weakness, and overbuilt markets will suffer especially severe price corrections. In fact, prices are not expected to recover until excess inventory is absorbed, consumers are convinced that the bottom has been reached, and credit is less expensive and more available. Moreover, if the economy slides into a recession with significant employment losses, house prices are likely to take a further beating.

Impacts on the Economy

When house values increase and homeowners borrow against their equity, they typically spend more. When prices fall, the opposite is true. As a result, the sharp drop in prices has turned these housing wealth effects from an engine of growth to a drag on the economy. Real home equity fell 6.5 percent to \$9.6 trillion in 2007. The switch from home price appreciation to depreciation, plus the slowdown in home equity withdrawals, trimmed about one-half of a percentage point from real consumer spending and more than one-third of a percentage point from total economic growth.

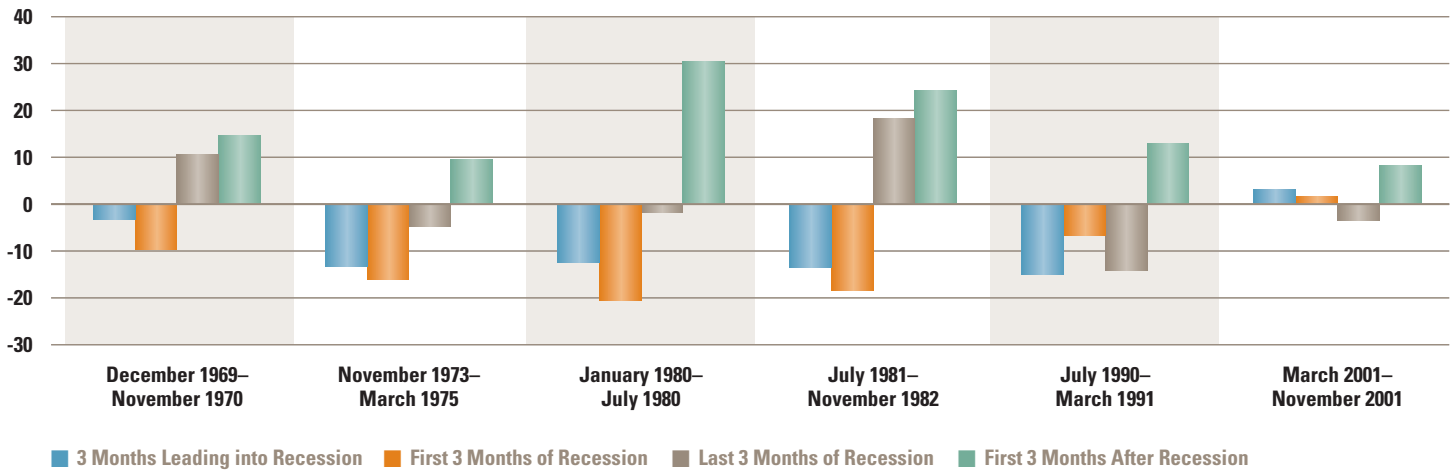
Moreover, the drop in residential investment shaved nearly one percentage point from growth (**Figure 10**). So far, home building has been responsible for nearly all the decline in residential fixed investment. Remodeling expenditures only started to weaken in 2007, largely as the result of falling home values. For housing to have a similar negative impact on economic growth in 2008, improvement spending would have to drop by an additional 3.8 percent and housing starts by another 450,000 or so to a level of 900,000, assuming the average cost of each new unit remains at 2007 levels.

Housing is having even wider impacts on the economy because of the subprime mortgage meltdown. As investors demand a higher return for assumed risk and limit credit to riskier borrowers, costs are rising for all types of mortgage, consumer, and corporate loans. Many would-be borrowers are now finding it impossible to get loans at any price.

Figure 11

Although Recessions Often Exacerbate Downturns, Housing Is Usually Quick to Recover

Quarterly Change in Housing Starts (Percent)



Notes: Dates shown mark the beginning and end of each recession. Quarterly data are derived from sums of monthly data, seasonally adjusted by Moody's Economy.com.
Source: US Census Bureau, New Residential Construction.

Housing Downturns in Perspective

The current housing slump is shaping up to be the worst in 50 years. This downturn rivals the first 30 months of the 1978–1982 cycle in terms of production and sales cutbacks, but eclipses that cycle in terms of price declines. The seasonally adjusted median single-family sales price peaked in October 2005, and then dropped by 12 percent in nominal terms and 18 percent in real terms over the following 30 months. By comparison, 30 months after real prices peaked in November 1989, the real median price was down just 4 percent and the nominal price was up 6 percent. Thirty months after the peak in May 1979, the real median price had fallen 8 percent and the nominal price had increased by 20 percent.

It is noteworthy that six of the last seven housing downturns preceded a recession—usually within two years. In the 1980s, however, housing was mired in a 54-month slump when the recession began and then bottomed out just 6 months into it. During these cycles, residential fixed investment was often the first to retreat, followed by spending on consumer durables, and then spending on nondurable goods. Once the recessions ended, housing starts usually rebounded strongly—although only after the new home inventory fell and new home sales began a vigorous recovery (**Figure 11**).

Turnarounds are often difficult to spot because false bottoms in sales and starts are common. Builders take their lead from consumers, ramping up production when sales increase and cutting back when they fall. Thus, only a sustained rebound in demand will bring the market back. If a recession takes hold, however, housing starts are likely to slide even further.

The Outlook

With vacant for-sale homes near a record-high share of the housing stock, this downturn may have a way to go. Mortgage interest rates have declined only slightly, contributing to the softness (**Table A-3**). In fact, after adjusting for points, real 30-year fixed mortgage interest rates were down marginally some 24 months after housing starts peaked. At the same point in previous cycles, real mortgage rates had fallen anywhere from 0.5 to 6.8 percentage points.

The dramatic drop in prices has also sidelined more buyers than in the past, and foreclosure rates are the highest they have been since recordkeeping began in 1974. All of these factors may make this downturn more protracted than usual, and credit market woes may slow the eventual rebound. Improvement spending will also come under increasing pressure because it is sensitive to both credit availability and house price appreciation.

Nevertheless, demographic fundamentals still point to increased housing demand over the next decade. But the excess inventory must be worked off before the demand for new homes rebounds. This in turn requires a return to stable-to-rising home prices, sustained job growth, and accessible credit. When that happens, and assuming immigration remains strong, the inventory overhang will start to thin, prices will firm even more, and average annual production, including manufactured housing, will likely head back toward 1.9 million units.