1 Executive Summary

Despite unprecedented federal efforts to jumpstart the economy and help homeowners keep up with their mortgage payments, home prices continued to fall and foreclosures continued to mount in most areas through the first quarter of 2009. While new and existing home sales and single-family starts have shown some signs of stabilizing, ongoing job losses, house price deflation, and tighter mortgage credit are placing any recovery at risk.

In the worst housing construction cycle since the 1940s **(Figure 1),** depressed demand is making it difficult for the market to work off excess vacant units. Restoring demand to more normal levels will take time since so many owners are in financial distress or trapped in homes worth less than their mortgages. The recession has also dampened both immigration and new household formation. But once new home sales rebound and the economy begins to pick up, the aging of the echo boomers—the largest generation to reach adulthood in the nation's history—should reinvigorate the housing market.

From Boom to Bust

The seeds of the housing bust were sown during the preceding boom. Following the 2001 recession, a combination of tight housing markets and the lowest mortgage interest rates in nearly 40 years sparked rapid house price appreciation. Afraid of missing their chance to get in on rising prices, homebuyers flocked to the market. Speculators looking to earn a quick return also jumped in.

Despite rising mortgage interest rates, buyers were able to chase home prices higher from 2004 to 2006 largely because of changes in lending practices. Lenders were willing to relax downpayment and debt-to-income requirements. They also offered products that lowered initial monthly payments but carried the risk of later resetting to sharply higher levels. In many cases, lenders did not verify applicants' incomes and assets. At the same time, borrowers who would have previously been denied credit because of past repayment problems were able to secure subprime loans, albeit at higher interest rates.

Although risks were mounting, loan performance held up as long as rising home prices allowed borrowers to refinance or sell their way out of a squeeze. But prices began to flatten at the end of 2006 in some of the formerly hottest markets and then dropped in an ever-growing number of locations in 2007 and 2008. As a result, the share of subprime loans entering foreclosure soared to 4.1 percent in 2008—shattering the 2.3 percent record set in 2001 when the subprime market share was much smaller. Problems eventually spread to the prime market, where the share of loans entering foreclosure more than tripled from 2006 to 2008 but still held under 1.0 percent. Investors quickly lost their appetite for mortgages and the securities they backed, sending the values of these investments down sharply.

After helping to fuel unsustainable house price appreciation, credit markets did an about-face in 2008. Many borrowers with excellent credit were suddenly compelled to make large downpayments, keep their payments well in line with their incomes, and back up every piece of information on their loan applications. But as the financial crisis worsened, even stricter underwriting was unable to guarantee the flow of mortgage credit. The federal government therefore intervened, taking mortgage giants Fannie Mae and Freddie Mac into conservatorship, purchasing their securities, and expanding FHA lending. What happens to mortgage credit now rests in the hands of the federal government.

Multiple Meltdowns

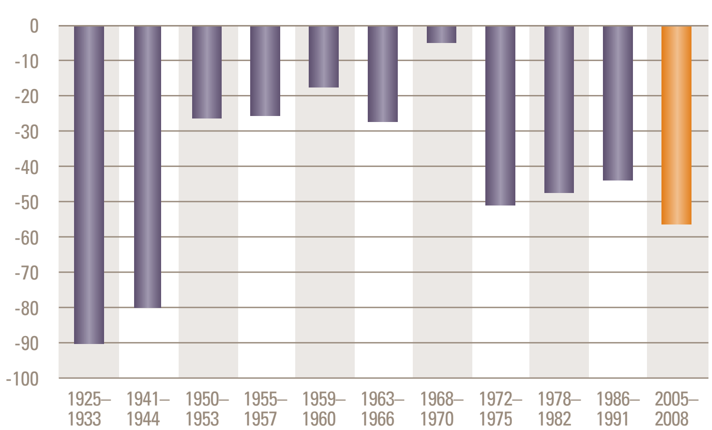
Problems emanating from the housing market forced financial institutions to take massive write-downs on their mortgage portfolios, igniting a broader banking crisis. Amid fears about the strength of banks and severe losses of both housing and stock wealth, consumer confidence plunged 41 percent below its lowest previous trough posted in the 1970s. Households slashed their spending and—for the first time on record—cut their net borrowing in 2008.

With that, the broader economy lurched into a severe recession that accelerated with stunning speed. From their quarterly peaks during the housing boom to the last quarter of 2008, real home equity was down 41 percent, existing median home prices 27 percent (and at least 40 percent in 26 metropolitan areas), new home sales 70 percent, and existing home sales 33 percent. Homeowners also pulled back on home improvement projects, with spending off 13 percent in real terms in 2008 and even larger declines expected in 2009. The cutbacks in home building and remodeling shaved a full percentage point off economic growth in 2007 and nearly another point in 2008. The collapse of home prices placed another drag on the economy by dramatically reducing household wealth, which further discouraged consumers from spending **(Figure 2).**

Figure 1

The Downturn in Home Building Is the Worst Since World War II

Percent Change in Housing Starts



Source: US Census Bureau, New Residential Construction data and *Historical Statistics of the United States, Colonial Times to 1970.*

Struggling Through the Downturn

Millions of Americans entered the recession with severe housing cost burdens and deep in debt. The number of households paying more than half their incomes for housing jumped from 13.8 million in 2001 to 17.9 million in 2007. While homeowners led this growth, the share of renters with severe burdens remained much larger.

Affordability pressures have continued to increase as employment losses have mounted. Fully 5.7 million jobs were lost from the December 2007 peak through April 2009, and another 11.0 million Americans were either working part-time involuntarily or had stopped looking for work altogether.

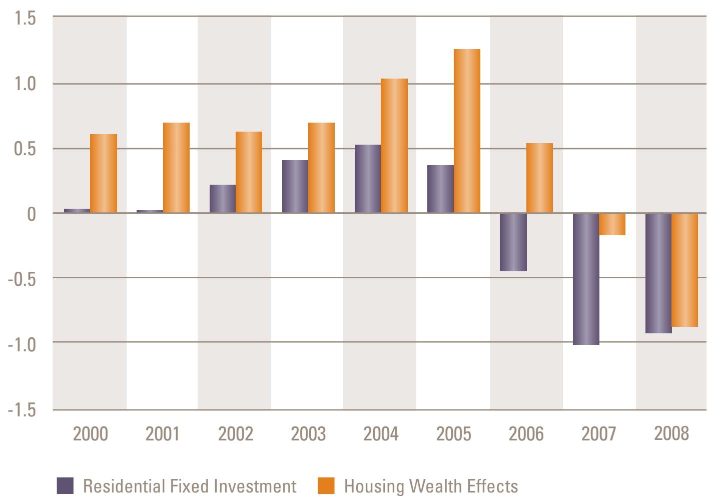
Being able to afford housing at the 30-percent-of-income standard depends critically on having full-time, well-paying work. Earnings from full-time minimum wage jobs are simply not enough. Indeed, no American household earning the equivalent of the full-time minimum wage ($11,500) can afford a modest two-bedroom apartment at the federal fair market rent. Making matters worse, a shockingly high 8.1 million households with at least some income from work in 2007 earned less than the full-time minimum wage equivalent, and 4.1 million earned less than half. Unsurprisingly, lower earnings or relying solely on Social Security retirement income mean that households are more likely to spend more than half their incomes on housing **(Figure 3).**

To supplement their meager incomes, many households loaded up on debt during the housing boom and are now struggling to meet their obligations. Although the share of low-income renters

Figure 2

The Drop in Housing Construction and Wealth Added to the Drag on the Economy

Percentage Point Contributions to Change in GDP



Note: Housing wealth effects measure the relationship between changes in housing wealth and consumer spending, as estimated by Moody's Economy.com.
Sources: Bureau of Economic Analysis; Moody's Economy.com.

Figure 3

Many Households with Low Incomes or Relying Only on Social Security Struggle to Pay for Housing

Share with Severe Housing Cost Burdens (Percent)

Notes: Elderly households are headed by persons age 65 and over. Minimum wage is $6.55 per hour. Full-time equivalent is based on working 35 hours per week for 50 weeks. Households with severe cost burdens spend more than 50% of pre-tax income on housing.
Source: JCHS tabulations of the 2007 American Community Survey.

spending more than one-fifth of their incomes on debt payments fell from 15.2 percent in 2001 to 13.9 percent in 2007, the average amount owed increased 34.7 percent in real terms. At the same time, the share of low-income homeowners spending more than 40 percent of their incomes on debt payments fell from 26.1 percent to 22.7 percent, but the average amount of debt went up by 62.8 percent.

A recent Federal Reserve report estimates that of the trillions of dollars in real home equity cashed out between 2001 and 2007, homeowners used $874 billion to pay off non-mortgage debt—in effect rolling consumer debt into their home loans. Unlike consumer debt, mortgage debt cannot be discharged through personal bankruptcy. This is no small matter, given that personal bankruptcies nearly doubled from 600,000 in 2006 to 1.1 million in 2008. Furthermore, a total of about 3.2 million homeowners entered foreclosure in 2007 and 2008.

The downturn is hitting minority households particularly hard. The incidence of high-cost loans and foreclosures is much higher in minority than in white neighborhoods, and highest in low-income minority neighborhoods. And with foreclosed properties selling at steep discounts, homeowners in these neighborhoods are seeing some of the largest drops in house prices. Making matters worse, minority unemployment rates started out higher in December 2007 (at 8.9 percent for blacks and 6.2 percent for Hispanics, compared with 4.4 percent for whites) and climbed more by April 2009 (to 15.0 percent and 11.3 percent, compared with 8.0 percent).

Government Responses

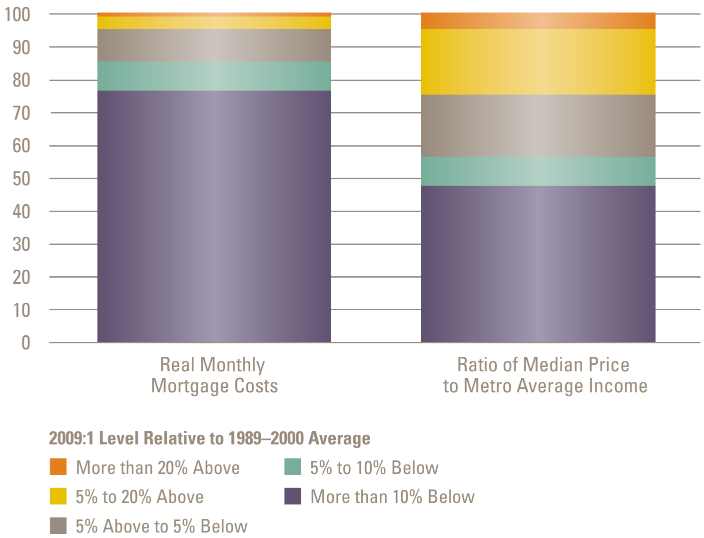
The federal government has taken extraordinary steps to stabilize the housing market and get the economy back on track. Early efforts in 2007 focused on encouraging lenders, counselors, and borrowers to voluntarily work out subprime loans heading for foreclosure. While helping millions of distressed homeowners, these programs failed to stem the rise of loan delinquencies and foreclosures. In consequence, the Obama Administration launched a far more ambitious plan to help as many as 3–4 million homeowners reduce their mortgage payments to 31 percent of their incomes, using a combination of carrots and sticks for lenders.

Recognizing that rising unemployment rates and other factors would mean increases in the number of distressed properties, the federal government provided additional funding in 2008 and 2009 to help state and local governments deal with foreclosed homes. With the help of the Neighborhood Stabilization Program and an additional $11 billion in housing bond authority, state and local entities are now developing strategies to acquire, renovate, and sell foreclosed one- to four-unit properties. While modest

Figure 4

Housing Affordability Has Rebounded in Many Metropolitan Areas

Share of Metros (Percent)



Notes: Monthly mortgage costs assume a 10% downpayment and Freddie Mac conventional 30-year fixed interest rates, and are adjusted for inflation by the CPI-U for All Items. Metro areas evaluated are the 80 metros in the National Association of Realtors® series with quarterly data for 1989–2000 and 2009:1.

Source: JCHS calculations using the National Association of Realtors®, Median Existing Single-Family House Price and Moody's Economy.com, Average Household Income.

in relation to the size of the problem, these resources could be instrumental in helping to stabilize neighborhoods where foreclosures are concentrated.

The federal government has also provided funds to redevelop public housing, a tax credit of up to $8,000 for first-time homebuyers, and an opportunity for homeowners who are up to 5 percent underwater on their mortgages to refinance at lower interest rates. Other efforts to keep mortgage credit flowing and reduce its cost include buying Freddie Mac and Fannie Mae mortgage-backed and debt securities, providing equity injections to financial institutions, and developing a plan to buy troubled loan assets from banks. While current initiatives to bolster financial institutions and prevent foreclosures eclipse any previous attempts to stabilize housing markets, the federal tax credit (in real terms) and interest-rate reduction are still less generous than the stimulus used to jolt the housing market back to life in 1974.

Finally, the federal government took a number of steps to address the falling prices for Low Income Housing Tax Credits (LIHTCs). These measures are important because LIHTC is the principal program for preserving and building low-income rental housing. At a time when millions of households are being forced out of homeownership, when many others are choosing to rent, and when demographic forces are set to drive up rental demand, expanding the supply of such housing is critical.

Housing and Energy

Renewed concerns over carbon emissions and dependency on foreign oil are likely to prompt increased government-led efforts to reduce residential energy use, which accounts for 21 percent of the nation's consumption. The federal government has already increased funding for weatherization of existing properties and tax credits for energy-efficient improvements. Indeed, upgrading the existing stock to the efficiency levels of new housing would provide significant energy savings.

Reducing the number of vehicle miles that households travel every day—by encouraging more compact forms of residential development—could also have a substantial impact. But along with the population, employment has become much more dispersed over the last century. In fact, from 2000 to 2006, job growth was faster in suburbs than central cities in 68 of 75 of the nation's largest metropolitan areas. Reducing auto use thus means providing transit-oriented and mixed-use development so that workers can live closer to their jobs as well as to non-work destinations. In a metropolitan area where workers must criss-cross back and forth and around central cities and suburbs to get to their jobs, savings on high-frequency non-work trips may be easier to achieve than on work commutes.

The Way Forward

While it is too soon to tell whether housing markets will stabilize in 2009, conditions that could support a recovery are taking shape. Based on today's median prices, conservative lending standards, and a conventional 30-year fixed-rate mortgage, affordability for homebuyers has returned at the national level and in many metro areas **(Figure 4).**

Meanwhile, housing production has dropped so dramatically that long-run supply and demand are now approaching balance. In the short run, however, demand is also remarkably low. Indeed, the numbers of vacant housing units for rent, sale, or being held off the market are at record highs despite the improvement in some underlying conditions.

The massive shock to housing markets has raised questions about the future strength of demand. Although demographic trends provide a solid underpinning for the long run, market conditions over the next 5–10 years will surely have an impact. A deep, prolonged recession would likely suppress immigration to levels that are never fully made up. Moreover, such conditions might even lead to enduring changes in household formation behavior.

To reflect these uncertainties, the Joint Center for Housing Studies has released two new household projections based on the Census Bureau's latest population projections. The high series assumes that net immigration rises from 1.1 million in 2005 to 1.5 million in 2020. The low series assumes only half that pace of immigration, as well as a small decline in headship rates among the native-born population. Under these assumptions, household growth in 2010–20 could total as much as 14.8 million or remain closer to 12.5 million (nearly the same as in 1995–2005).

Even lower immigration is unlikely to drive down household growth further than that because the echo-boom generation is replacing the far smaller baby-bust generation in the young adult age group. Indeed, the echo boomers are entering their peak household formation years of 25–44 with more than five million more members than the baby boomers had in the 1970s. The echo boomers will help keep demand strong for the next 10 years and beyond, bolstering the markets for rentals and starter homes **(Figure 5).** Still, while boosting the quantity of homes demanded, the echo boomers will likely enter the housing market with lower real incomes than people the same age did a decade ago.

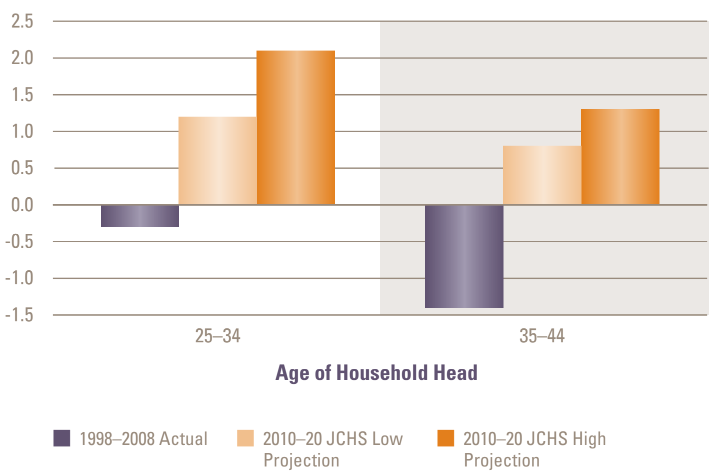
Meanwhile, as the leading edge of the baby-boom generation reaches age 65, demand for retirement housing will rise. Increased longevity among those born before World War II will also lift demand for assisted living facilities. How this demand is expressed will depend importantly on how much, and how quickly, these households can rebuild their recently decimated wealth.

The aging of the large and diverse echo-boom generation will increase the minority share of households. In fact, even under the low immigration assumptions, minorities will fuel 73 percent of household growth in 2010–20, with Hispanics leading the way at 36 percent. As a result, the minority share of households is projected to increase from 29 percent in 2005 to 35 percent in 2020. Unlike white household growth, which will occur primarily among single-person households, minorities will add to households across the full spectrum of family types. Given their lower average incomes and wealth, however, the increase in minority households could add significantly to the nation's already widespread housing affordability challenges.

Figure 5

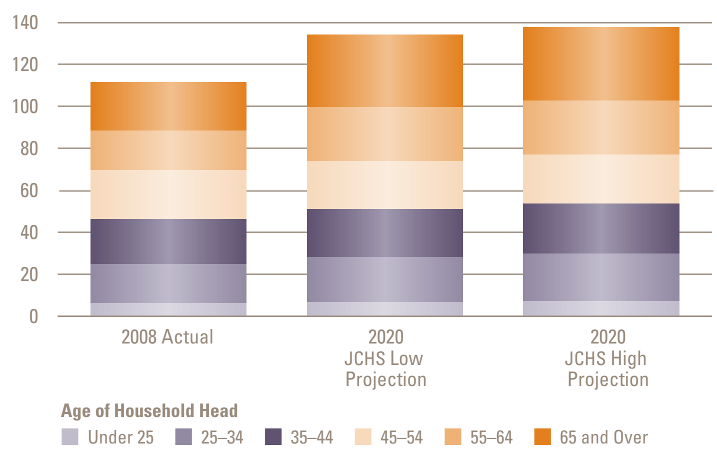
Over the Next 10 Years, Echo Boomers Will Reverse the Declines in Younger Households …

Change in Households (Millions)



… While the Baby Boomers Drive Growth in Older Households

Households (Millions)



Notes: JCHS high projection assumes annual immigration rising from 1.1 million in 2005 to 1.5 million in 2020, as estimated by the Census Bureau's 2008 population projections. JCHS low projection assumes annual immigration is half the Census Bureau's estimates.
Sources: US Census Bureau, Housing Vacancy Survey; Table A-7.