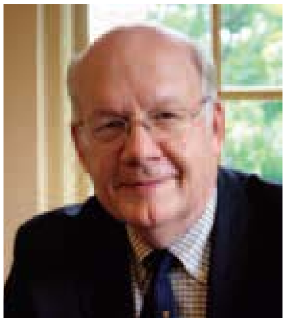
Housing: Future Imperfect



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From 2000 to the end of 2005, the value of U.S. residential land and dwellings increased from $14 trillion to $24 trillion. Until about 2002, housing price increases had followed the normal pattern from the mid-1980s, and housing prices grew along with household incomes. But starting in 2002 housing prices began to grow much faster than incomes in most metropolitan areas.

There were three main causes for this acceleration in housing prices. First, the interest rate for 30-year fixed rate mortgages declined from 7 percent in 2001 to 4.6 percent in 2003, buoying housing prices. Second, starting in the early 2000s mortgage originators began to reduce lending standards and to offer high-risk mortgage instruments such as no-document mortgages and other subprime mortgage instruments. Finally, the national policy to increase home ownership supported the latter trend because increased mortgage availability seemed to increase housing affordability.

These changes led to the rapid growth in mortgages with high loan-to-value ratios and to the approval of borrowers with modest financial reserves. This increasing risk of mortgages was assuaged by the belief that "housing prices could not decline," which was based on national housing price indices dating back a few decades. Of course, in several metropolitan areas housing prices had declined from 1989 to the mid-1990s, but the national price index had only flattened out in this period.

Nationally, house prices softened in 2006 and fell 30 percent to the present time, while housing starts declined precipitously from 2.27 million in 2006 to 500,000 now, a level well below the typical low point of 1 million starts experienced in the past half dozen recessions. The reduction in housing starts eliminated millions of construction jobs and contributed significantly to the rapid increase in the unemployment rate.

The accompanying financial crisis reduced employment more broadly as part of a severe recession. Mortgage defaults and subsequent foreclosures spiked, caused by the severe housing price decline that left many homeowners "under water" with a mortgage greater than their house value, combined with the loss of household income from unemployment and the tightening of lending standards that made refinancing impossible for many households. From 2006 through 2009, 6 million homes were foreclosed, and 2010 has seen another 2.9 million foreclosure filings. Foreclosure rates are likely to have peaked, and filings in December 2010 were a quarter lower than those in December 2009. But foreclosure rates remain far above historic levels—in 2005 banks foreclosed on about 100,000 homes. The lack of recovery in housing and other construction has in turn been a factor in the slow reduction in unemployment.

House prices may now be stabilizing—national housing prices rose in the second quarter of 2010, but have declined modestly in the third and fourth quarters. This has led some analysts to forecast a possible second round of price declines. In any case, the likely slow decrease in unemployment will continue to restrain income growth and demand for home ownership. Clearly, housing will not lead the economy out of this recession. Needed now is regulatory reform to prevent the repetition of a housing bubble and an inevitable subsequent housing bust and its related financial meltdown.

While some modest steps have been taken in this direction, much remains to be done and the announced reform of Fannie Mae and Freddie Mac have increased uncertainty about the course of future mortgage finance. The realization by households that housing price appreciation is not inevitable will likely slow the shift to ownership by younger households and encourage older empty-nesters to move their assets to investments less risky than housing. The resulting growth in rental demand will focus in denser parts of metropolitan areas and give some impetus to smart growth outcomes. Housing demand will be robust only in several years, driven by long-term growth in incomes, population, and household formation.