2 Housing Markets

The housing downturn intensified in 2008. By early 2009, home building and house prices had fallen more sharply than at any time since World War II. Although the cost of buying a typical home has dropped dramatically in many markets, staggering job losses and the ongoing credit crunch are dampening demand. In addition, record foreclosures continue to drive down prices, preventing current homeowners from selling at a profit and keeping many first-time homebuyers on hold to see whether prices fall further.

Plumbing New Depths

By all measures but homebuyer affordability, housing market conditions deteriorated further in 2008 **(Figure 6).** Housing starts were down by more than 30 percent for the year and more than 50 percent from the 2005 level. Manufactured housing shipments slid for the third consecutive year, falling to 81,900 units—their lowest level since recordkeeping began in 1959. Reported new home sales also showed a record-breaking plunge of more than 60 percent from the 2005 level **(Table A-2).** Actual declines were even larger because cancellations, which are not backed out of reported sales, rose over the period.

Although the number of new homes for sale (including those not yet completed) fell by 41 percent between July 2006 and January 2009, demand dropped even faster. As a result, the seasonally adjusted supply hit a record 12.4 months in January 2009.

Just as in each of the four previous downturns, new home inventories have declined much earlier than the months' supply of new homes for sale **(Table W-1).** In past recoveries, housing starts began to rise about three months after new home sales revived and months' supply peaked. It is too soon to know whether February's uptick in new home sales signals a turning point, especially since sales softened again in March. Furthermore, median new home prices fell sharply in the first quarter, suggesting that any sales gains were hard-won.

Existing home sales did pick up in a few states in 2008 and appeared to stabilize on a national level near the middle of that year. As the credit crunch deepened and job losses accelerated, however, existing home sales nationwide slipped again in the last quarter of 2008. All told, sales of existing single-family homes were down 30 percent last year from the 2005 level to 4.35 million, their lowest level since 1997. And whatever improvements have been seen largely reflect purchases of foreclosed properties at fire-sale prices. Indeed, the National Association of Realtors® (NAR) estimated that sales of foreclosed homes accounted for 30 percent of existing home sales

Figure 6

The Housing Downturn Accelerated in 2008

	2007	2008	Percent Change 2007–8	Percent Change 2005–8
New Single-Family Sales (Thousands)	776	485	-37.5	-62.2
Existing Single-Family Sales (Millions)	4.9	4.4	-11.9	-29.6
Existing Condo/Co-op Sales (Thousands)	713	563	-21.0	-37.2
Single-Family Starts (Thousands)	1,046	622	-40.5	-63.7
Multifamily Starts (Thousands)	309	284	-8.3	-19.6
Median Existing Single-Family Price ($)	226,266	196,600	-13.1	-18.6
Median Existing Condo/Co-op Price ($)	234,989	209,800	-10.7	-15.0
Home Equity ($ Trillions)	10.4	7.9	-24.1	-42.8
Mortgage Debt ($ Trillions)	10.9	10.5	-4.1	6.8
Mortgage Refinancing ($ Trillions)	1.2	0.9	-28.6	-48.7
Residential Investment ($ Billions)	654.4	487.7	-25.5	-42.5
Owner Residential Improvements ($ Billions)	144.4	125.7	-13.0	-13.0

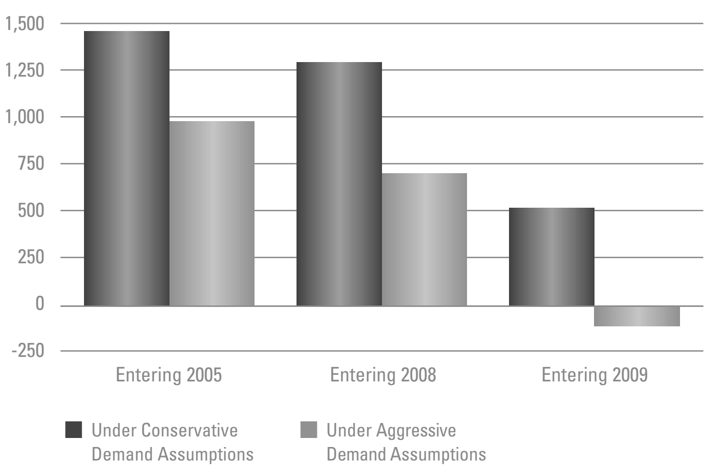
Notes: All dollar values are adjusted to 2008 dollars using the CPI-U for All Items. Percent change is calculated with unrounded numbers.

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

Figure 7

Production Cuts Have Moved Markets Closer to Balance

Finished Units in Excess of Long-Run Demand (Thousands)



Note: Finished units are the sum of housing completions and manufactured home placements.

Source: Daniel McCue, "Addendum to W07-7: Using Long-Term Demand Projections to Determine Short-Term Market Imbalances," JCHS Research Note N09-1.

in the fourth quarter of 2008, and short sales (homes sold for less than the outstanding mortgage) for an additional 15 percent.

Market Imbalances

In combination, depressed demand and the lingering effects of overbuilding have driven vacancy rates well above normal. Indeed, the number of excess vacant units—measured as the increase in vacancies since 1999–2001 when markets were closer to equilibrium—climbed in both 2007 and 2008 despite big production cuts. The largest increases in owner vacancy rates occurred in a mix of states that had especially severe overbuilding, especially weak economies, or both **(Table W-2).** These excess vacant units are holding down prices and must be absorbed before production will pick up significantly.

But just as inflated demand can temporarily mask overbuilding, depressed demand can temporarily mask a return to long-run market balance. During housing downturns, job losses, weak consumer confidence, elevated foreclosures, and expectations of further price declines all serve to dampen short-run demand. In the current cycle, these forces have had an especially large impact on housing markets.

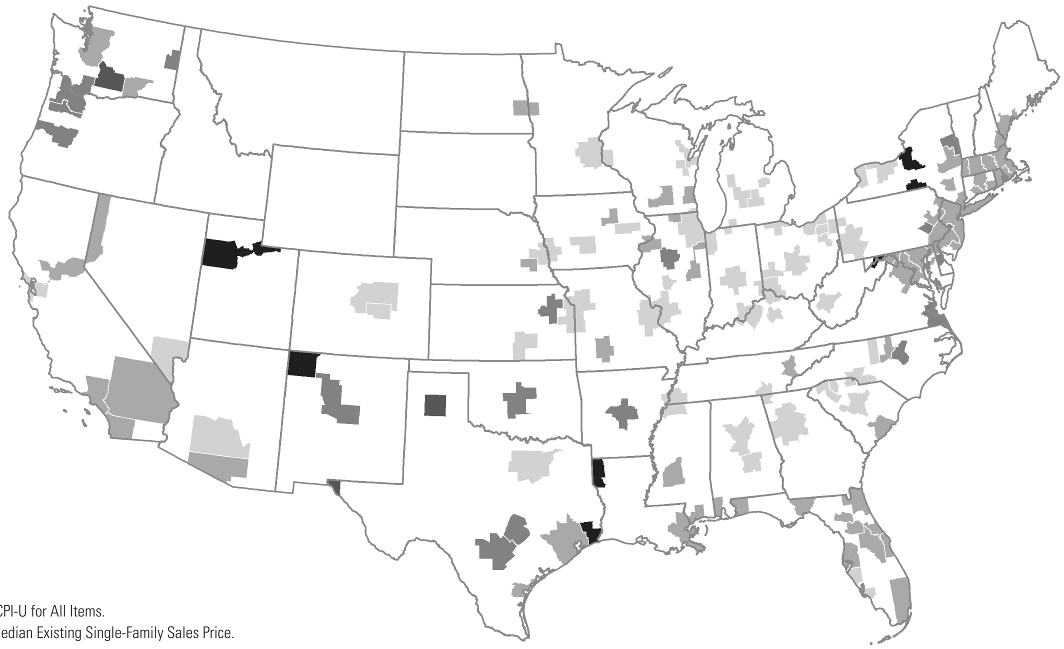
There are two ways to roughly gauge the extent of overbuilding relative to long-run demand for new homes. The first approach is to compare housing completions with an estimate of long-run demand built up from its components (household growth, normal vacancies including second homes, and replacement of units lost to disaster and disinvestment). By this calculation, deep production cuts through 2008 brought the oversupply of new housing down from 1.0–1.5 million units entering 2005 to near parity with long-run demand entering 2009 **(Figure 7).** The second approach uses an econometric model to estimate metropolitan area overbuilding in terms of starts. Based on long-run demand drivers (such as growth in population and real incomes) in the 100 metro areas with the highest number of housing starts during the boom, overbuilding began by 2001 and continued through 2005. This approach also suggests that markets are moving back into balance in 2009.

While neither calculation provides a reliable point estimate, both sets of results indicate that overbuilding was already occurring before vacancies spiked. It also appears that household growth has been running well below trend since 2005. Unless the downturn has a lasting impact on rates of immigration or doubling up, this factor points to pent-up demand for new homes.

While a turnaround in demand can sometimes surprise on the upside, the headwinds are stronger than in past cycles because credit is so tight and the economy is in such rough shape. Moreover, the recovery will not occur evenly across the country.

Figure 8

Real House Prices in Several Metros Have Fallen Back to 1990s Levels

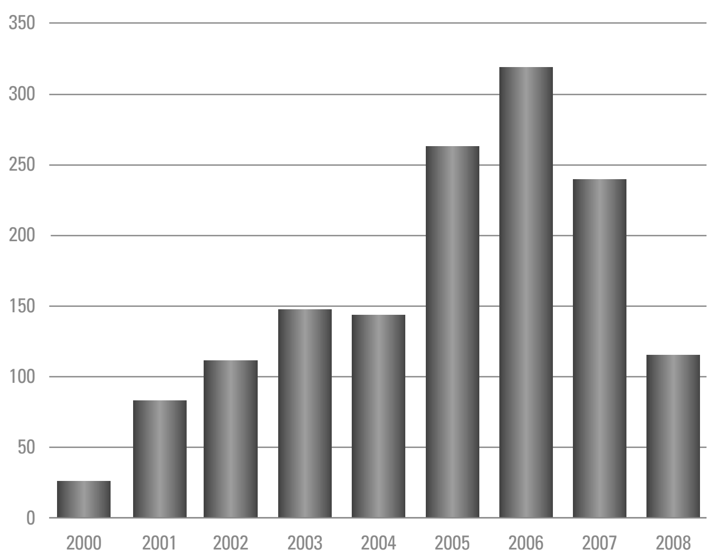


Note: Prices are adjusted for inflation by the CPI-U for All Items.
Source: National Association of Realtors®, Median Existing Single-Family Sales Price.

Figure 9

The Collapse of Cash-Out Refinancing Has Left Homeowners with Less to Spend

Home Equity Cashed Out at Refinancing (Billions of 2008 dollars)



Note: All values are adjusted for inflation by the CPI-U for All Items.
Source: Freddie Mac, Cash-Out Refinance Report.

Indeed, demand and even production are likely to increase in some parts of the country while vacancies continue to rise in others.

Falling House Prices

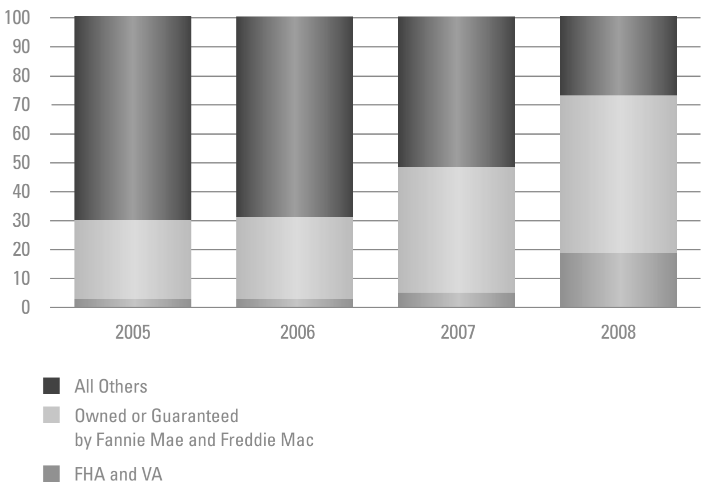
With the enormous overhang of vacant units and record foreclosures, house price declines accelerated last year. According to the National Association of Realtors®, the median price of existing single-family homes slipped 1.8 percent in 2007—the first annual nominal decline since the data series began in 1968. Another 9.8 percent drop followed in 2008. Measured on a monthly basis and adjusted for inflation, the median home price fell by an even greater 29.8 percent from October 2005 to January 2009. While showing some improvement from January's extremely low level, the median price has continued to decline on a year-over-year basis.

Marketwide measures such as the NAR and the S&P/Case-Shiller® Home Price Index report dramatically large price drops in part because they include more foreclosure sales. For example, the S&P/Case-Shiller index indicates that home prices in Cleveland plummeted more than 28 percent from the peak to the first quarter of 2008. But excluding sales of foreclosed homes,

Figure 10

Federal Intervention and Control Propped Up the Mortgage Markets in 2008

Share of Newly Originated Single-Family Loans (Percent)



Notes: Single-family properties may have 1–4 units. All other loans includes prime jumbo, subprime, Alt-A, home equity, and conventional conforming loans not bought or guaranteed by Fannie Mae and Freddie Mac. Fannie Mae and Freddie Mac entered federal conservatorship in September 2008.
Source: Freddie Mac, Office of the Chief Economist.

the drop was only 6 percent. Smaller but still sizable differences in price declines also exist in the handful of other metropolitan areas where the index was recalculated net of foreclosures.

Homeowners who are not under pressure to sell are usually unwilling to cut their prices drastically. This is especially true if the price they can get is not enough to pay off the mortgage. Many would-be sellers therefore prefer to stay put unless compelled to move. Still, the longer that foreclosures remain a problem, the greater the pressure on sellers to drop their prices.

Lower-income households have so far borne the brunt of falling prices because they are more apt to live in areas with widespread foreclosures. In Cleveland, Boston, and Washington, DC, price declines at the low end of the market through December 2008 were more than twice those at the high end in percentage terms, and in San Francisco nearly three times greater. Among the 17 metropolitan areas covered by the S&P/Case-Shiller index with price-tier information, only Portland, Oregon, saw prices fall more in the top third of the market than in the bottom third.

With these declines, home prices in many markets have retreated to pre-boom levels **(Figure 8).** In the Midwest, where house price appreciation was only modest during the boom, the setbacks have been especially large. Through the first quarter of 2009, real median sales prices in Cleveland, Akron, Youngstown, and Lansing stood at levels not posted in more than a decade. Meanwhile, home prices in the high-flying metros of California, Florida, and New England—including San Diego, Sacramento, Miami, and Boston—were all back to pre-2005 levels. The downturn has left few areas without significant declines in real median home prices **(Table W-3).**

The massive house price drops have brought standard affordability ratios closer to historical levels **(Table W-4).** Among the 122 metros consistently covered by NAR, the number where the median home price is less than three times the median household income is now back to what it was in 2003. Even so, only renters and first-time buyers can take full advantage of these lower prices, and to do so, must qualify for a conforming mortgage under relatively strict underwriting standards.

Housing and the Economy

The ongoing drop in residential construction spending shaved nearly a whole percentage point off economic growth in 2008 for the second consecutive year. Although accounting for just 2 percent of employment, residential construction contributed 13.5 percent (about 415,000) of last year's job losses. Including such housing-related positions as real estate agents, brokers, and lenders, employment declines in the industry approached 1 million—or about a third of the nearly 3 million total.

Meanwhile, home equity fell by $2.5 trillion in real terms in 2008 and nearly $5.9 trillion (or 43 percent) from the 2005 level. The loss of housing wealth caused consumers to curtail cash-out refinances and pull back on spending **(Figure 9),** knocking an additional 0.9 percentage point off economic growth last year, according to Moody's Economy.com.

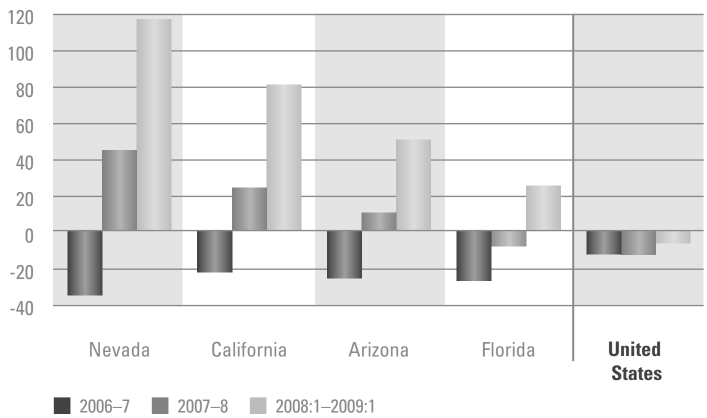
The impacts of the subprime market debacle continued to spread in 2008. Losses on subprime loans and other financial products pushed several large financial institutions to the brink of failure, and a few over it. Indeed, without unprecedented federal intervention, more banks surely would have gone under. So complete was the shutdown of private mortgage lending that 73 percent of loans originated in 2008—and more than 85 percent of loans originated in just the second half of the year—were bought, insured, or guaranteed by a federal agency or by Fannie Mae and Freddie Mac **(Figure 10).**

Since the fall of 2008, the US Treasury Department and Federal Reserve have moved aggressively to stabilize financial markets. Federal Reserve programs initiated or expanded to improve credit

Figure 11

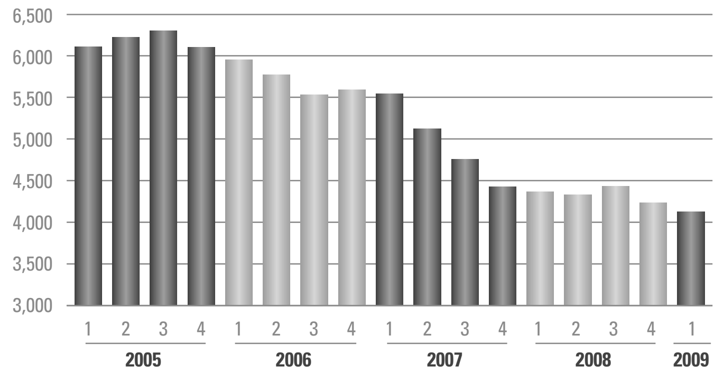
Existing Homes Sales Are Improving in Some of the Hardest Hit States …

Change in Existing Single-Family Home Sales (Percent)



… Although Sales Nationwide Continue to Ratchet Downward

Existing Single-Family Home Sales (Thousands)



Source: National Association of Realtors®, Existing Single-Family Home Sales.

markets since September 2008 nearly doubled the nominal monetary base from $890 billion to $1.74 trillion in a little over three months, with hundreds of billions of additional authorizations yet to be exercised.

Federal housing policy has so far focused on keeping credit flowing to housing and preventing foreclosures. Actions aimed at extending mortgage credit included taking Fannie Mae and Freddie Mac into conservatorship and expanding FHA lending. Foreclosure prevention efforts started with voluntary programs organized by the Treasury Department but expanded in 2009 to include loan restructurings to bring at-risk homeowners' monthly payments down to 31 percent of income, and instructing Fannie Mae and Freddie Mac to refinance loans with balances up to 5 percent greater than house values. Tax credits for first-time homebuyers have also been introduced. Despite these steps, the weak state of housing markets has prompted many to call for bolder, more directed initiatives to spur demand, such as larger tax credits and more aggressive efforts to buy down mortgage interest rates.

The Outlook

With prices down by double digits, interest rates moderating, and reasons to believe that pent-up demand is building, the prospects for a recovery have improved. Indeed, deeply discounted prices on foreclosed properties already helped to lift existing home sales in several states in 2008 **(Figure 11).** Markets got an additional boost in the first quarter of 2009 when rates on 30-year fixed mortgages dipped below 5 percent and the first-time buyer tax credit kicked in.

Still, clear signs of a recovery have yet to emerge, and job losses and the steady stream of foreclosures are keeping many markets under pressure. Sales of both new and existing homes continued to struggle to find a bottom through April. At the same time, however, the strong rebound in consumer confidence in March and April augers well for housing.

The longer-term outlook is also promising. The record size of the echo-boom generation now reaching young adulthood should help keep household growth at least on par with 1995–2005 levels even if immigration slows dramatically from its peak pace in the first half of this decade. Over time, the combination of pent-up demand from deferred household formation and low levels of home building will reduce the excess vacant inventory, bring markets back into balance, and send housing starts up sharply from early 2009 levels. If history is any guide, housing markets will rebound in advance of labor markets and help to spark the economic recovery.