

Housing Collapse Ahead?

Not According to the Data

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Monday, August 4, 2008

The Washington Post, Page A11

Reprinted in Milwaukee Journal Sentinel, August 8, 2008, Page 11A

Turmoil in the housing market has led to fears that home prices will drop precipitously, particularly if foreclosures force large numbers of homes onto the market in the coming year. Recently, these fears have driven financial stocks down and led to the government rescue of Fannie Mae and Freddie Mac. But the projected losses have been wildly exaggerated. Most Americans have not experienced any significant decline in the value of their homes -- nor are they likely to.

Only four states -- Arizona, California, Florida and Nevada -- have had declines of more than 4 percent in home prices over the past year, according to the house price index of the Office of Federal Housing Enterprise Oversight. Some worry that OFHEO's index may be missing the full extent of the crisis because it doesn't include very high-priced homes with "jumbo" mortgages or homes bought with subprime loans -- the ones being hit hardest. While one could argue that the index would be more representative if it included these transactions, the properties it does include represent more than three-quarters of U.S. homes.

The OFHEO index provides broad coverage of large and small markets across the country, and each home is weighted equally. Furthermore, excluding subprime mortgages has an advantage -- doing so makes the index a more representative measure of the homes owned by middle-class families. Fire-sale prices from distressed sales of subprime mortgages exaggerate the declines that patient sellers are likely to experience.

This spring, it was much reported that the Standard & Poor's/Case-Shiller housing price index recorded a 14.1 percent decline from March 2007 to March 2008, and there is every indication that the index's June results will also be down significantly. But this is a poor measure of what is happening to the value of most homes. The Case-Shiller index includes no data from 13 states (representing 11 percent of the U.S. housing stock) and offers only partial coverage of 29 others (with 79 percent of U.S. housing). Homes in the areas omitted or incompletely covered appreciated at a slower pace during the housing boom, and their values have been more resilient over the past two years, so the data behind the index are biased toward the markets most susceptible to dramatic swings.

Also, the Case-Shiller index weights transactions by value. For example, it gives eight times as much weight to the sale of an \$800,000 home as it does to a \$100,000 home, meaning it is particularly sensitive to what is happening with high-priced homes in the largest, most expensive markets.

But even if price declines have been small so far, how can one gauge whether the increase in foreclosures will lead to accelerating decline? In our own research, we use

quarterly historical (1981-2007) state-level data on the OFHEO price index, foreclosures, home sales, permits and employment to explore how foreclosure shocks affect future home prices.

We conclude that declines in house prices are highly likely to remain small. Our analysis reveals, unsurprisingly, that foreclosures and home prices have negative effects on each other over time, but this does not imply a vicious cycle of collapsing prices. Our models predict that as foreclosures continue to climb in many states, house prices will remain flat or decline in those states -- but will not collapse.

One reason for this is that the effect of foreclosure shocks on house prices is small. Furthermore, other fundamental factors (such as employment growth and a slowing of the growth of the housing supply over the past year and a half) will cushion the impact of foreclosures.

We constructed several forecasting models. Even under an extreme worst-case scenario for foreclosures, our conclusion was that U.S. house prices just aren't going to fall by very much in the next two years. In our worst-case scenario, the average cumulative decline is about 5 percent, and only 12 states experience declines greater than 6 percent by the end of 2009.

The fact that home prices will remain stable does not imply that the housing downturn has been trivial. Indeed, the price stickiness has been reflected in the lower sales volumes and declining housing starts that we have witnessed for over a year. These factors have already slowed GDP growth. Many developers and financial institutions have been badly hurt. And some homeowners who had the misfortune to buy in the hottest markets have experienced significant declines in value and will experience further declines.

But fears of a huge loss in home values for most homeowners -- and especially for middle-income homeowners -- across the United States, and fears of the devastating losses by financial institutions that would accompany them, are greatly overblown.

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