

Housing in the U.S.

Past, Present and Future



From 2005 through 2008 annual sales of existing single family homes in the United States fell by 30%, the average price of a single family home fell by about 26%, and new construction of such homes declined by a mind-boggling 64%.¹ By the end of 2010 more than 500,000 jobs had been lost in residential construction alone (from a peak in April 2006), with many more layoffs in allied occupations, including manufacturers and retailers of furniture and home furnishings (down 285,000 jobs), real estate professionals (down 250,000 jobs), manufacturers of wood products (down 230,000 jobs), and employment of plumbers, electricians and other speciality contractors off almost 1 million jobs. These are big numbers and represent considerable suffering across the country.

While it appears that the housing market has bottomed out, or nearly so, in many areas, a recovery is hard to find and the vast majority of those in the industry and millions of homeowners are still suffering. How did we get into this predicament and where are we headed?

Background

For 50 years or more, elected government officials, voters, and policy advisors have embraced the notion that owning one's home is part of "sharing in the American dream." The non-partisan appeal of this simple idea, thought by many to be a measure of our progress as a nation, cannot be underestimated. Accordingly, various bills were passed over the years by Congress to make it possible for a growing share of the population to acquire a home. Tax laws were altered, subsidies were created, new institutions were created to increase the supply of funds available to borrowers and lower the cost of borrowing, and government guarantees were provided to encourage lending to lower income households who might otherwise have been considered too risky to lend to and thus denied loans. To boil it down to basics, such policies, along with the overall growth in employment and the economy at large, boosted the demand for housing. In response, housing prices rose and the supply of housing also expanded significantly as builders responded to the rise in prices and profitability.

¹ The "housing industry" is comprised of many sub-sectors; for ease of exposition this article will focus on single family housing. Virtually everything said also applies to the other sectors, including multi-family housing.

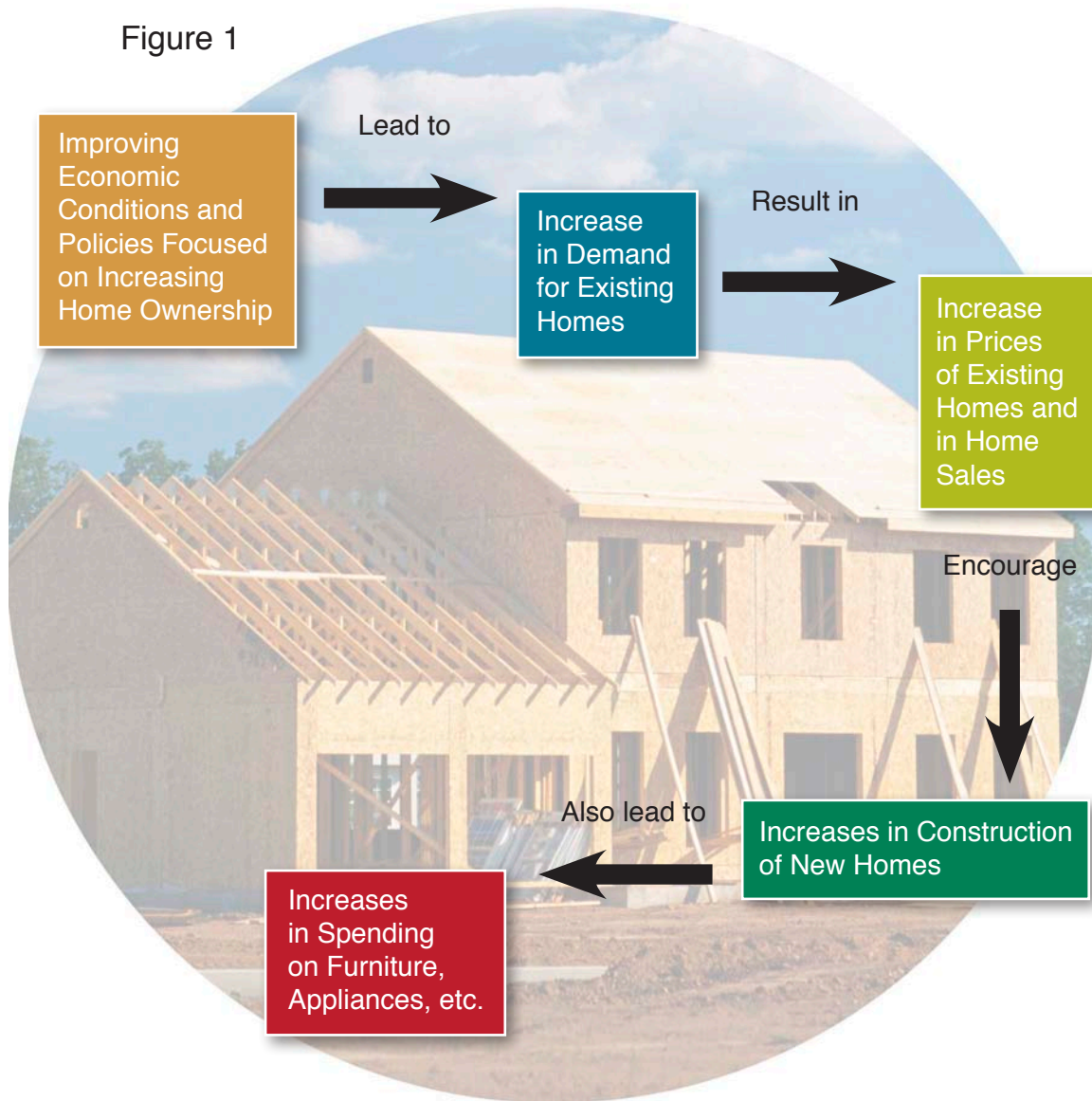


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The schematic diagram below summarizes how the various elements propelling housing forward are related:

The Housing Boom

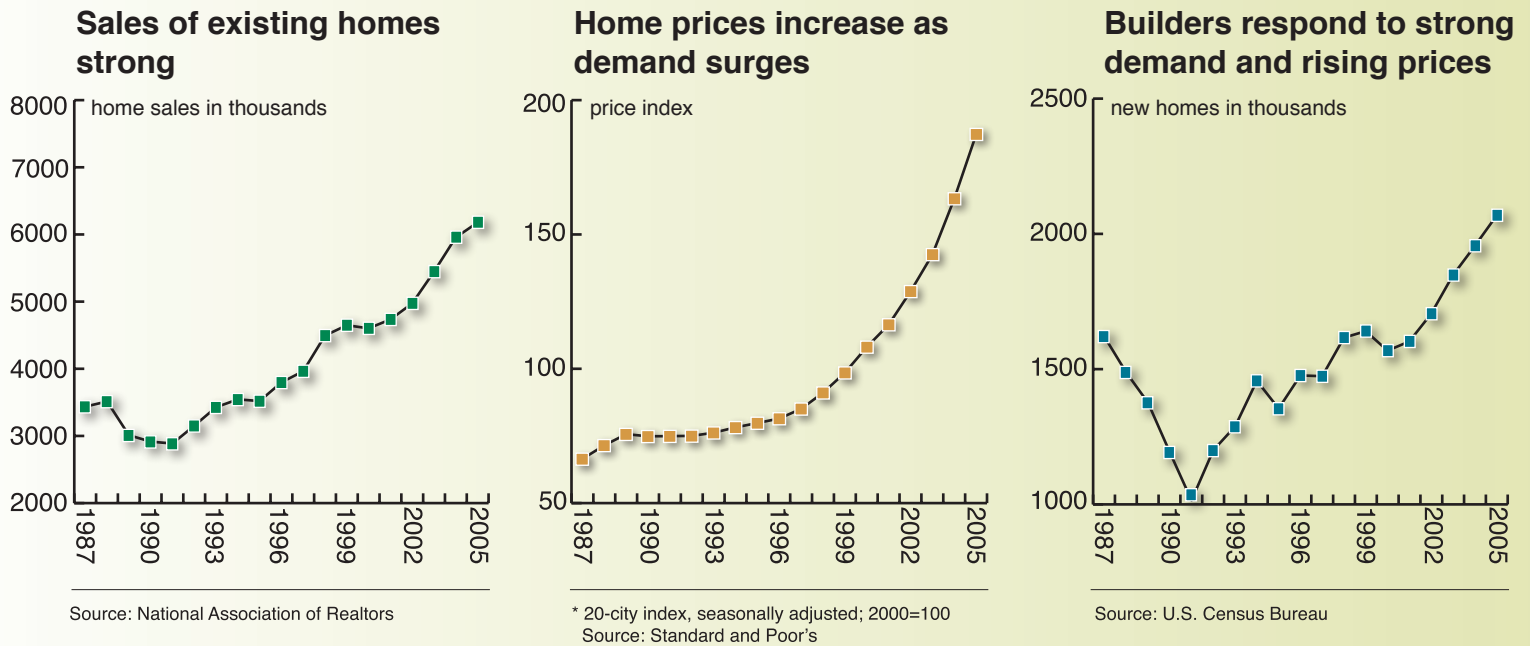
Figure 1



The figure is a simplification to be sure, and, of course, some parts of the country will do better and others worse at any particular time depending on local forces affecting demand and supply, including the availability of jobs and various amenities, including climate.

To breathe life into Figure 1, the actual national data, shown in the three panels of Figure 2, paint a fairly clear picture; through 2005, the housing market was doing very well overall with demand expanding, prices rising, and new construction booming.

Figure 2



Of course, considerable benefits flowed from the array of policies adopted to encourage home ownership. To cite just one key statistic, the proportion of households who owned their home increased from the 64% that had prevailed in the 1970's to 69% by early 2006; in case you think that the 5 percentage point gain from 64% to 69% is "small," put another way, over 6 million more households owned their homes by 2006 than would have been the case if the percentage had remained at the 64% level prevailing earlier.

Laying the Foundation for the Collapse

In earlier Junior Achievement articles (www.ja.org/files/white_papers/USFinancialCrisisGlobalEffects.pdf), the global financial crisis has been discussed in some detail. A point of emphasis was the fact that many forces converged in a kind of “perfect storm” to produce financial problems, the United States recession and the dramatic increase in unemployment. Certainly, the collapse in the housing market was both a contributing element and consequence of the economic recession that began in December 2007.

Prominent among the specific factors operating in the collapse of the housing market was a trend toward laxity in lending standards imposed by many financial institutions and other lenders in the mortgage market. Such standards included, documentation of credit histories of prospective borrowers, their current income and assets, evidence of job stability and pay, and related factors that in theory help a lender assess a potential borrower’s ability to pay for a mortgage.

To oversimplify a bit, lending standards were eased as the decade of the 2000’s unfolded, as both competitive pressures and seemingly large profits encouraged lenders to grab a bigger share of the market for mortgage loans. These developments converged with the previously noted government policy emphasis on expanding home ownership. Less documentation was required and credit histories and income levels that might have earlier disqualified prospective borrowers were now found acceptable. Down payments, which had most often required borrowers to put up 20% or so of the purchase price of a home were lowered dramatically. In fact, zero down payments or 3-5% were increasingly common, which, of course, opened the door to a home purchase by many buyer/borrowers who did not have sufficient funds for larger down payments.

At the same time, the interest rates on mortgages were at levels that seemed attractive compared to historical levels, and a growing number of lenders offered “interest only” mortgages that required borrowers to pay only the interest due each month, rather than interest plus a portion of the original amount borrowed (called “the principal”). Such lending terms left the monthly payments for new borrowers lower than they otherwise would have been; this also encouraged more demand for housing and thus borrowing.

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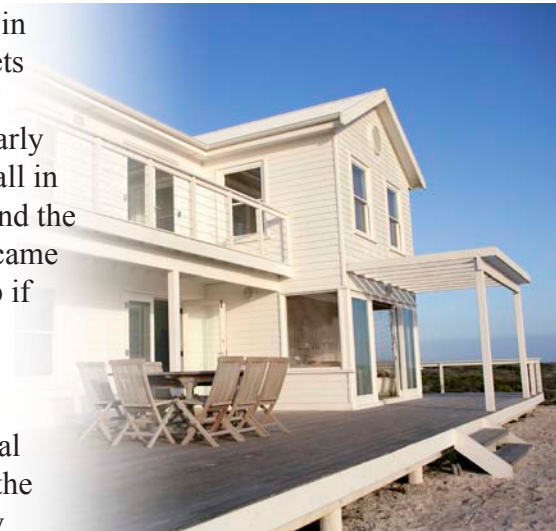
An over arching assumption that was helping to drive the surge in housing demand and the willingness of various lenders to expand their lending on ever more attractive terms for borrowers was the notion that *housing prices would most likely continue to increase*, in general, even if they might dip here and there across the country from time to time. By lending across the country, and especially in rapidly expanding markets in California, Arizona, Nevada, and Florida, just to name a few of the most prominent areas, lenders convinced themselves that such diversification protected them against a downturn in a particular geographic area. Such rosy expectations about housing prices were an important driver for participants in the housing boom—home buyers, lenders, builders, and government officials.

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Of course, new borrowers who took on the financial and other obligations associated with home ownership were not blameless for the collapse that followed. More specifically, millions of home buyers borrowed well beyond what might otherwise have been considered prudent. Many bought larger houses, others second houses, some to use as vacation homes, or as a way to invest in the hope of being able to sell at a later date at a significantly higher price.

The overall increase in housing prices, averaging 12% nationally in 2003 and 2004, and more than 20% annually in some local markets in Florida, California and elsewhere, led an increasing number of people to view housing as an attractive asset to invest in, particularly in relation to stocks where prices had languished some after the fall in internet company stock prices in 2000, the 9/11 terrorist attacks and the ensuing recession in the United States. The term “house flipper” came into common use as people began to purchase homes, fix them up if necessary, and resell them at higher prices. Speculation was in!

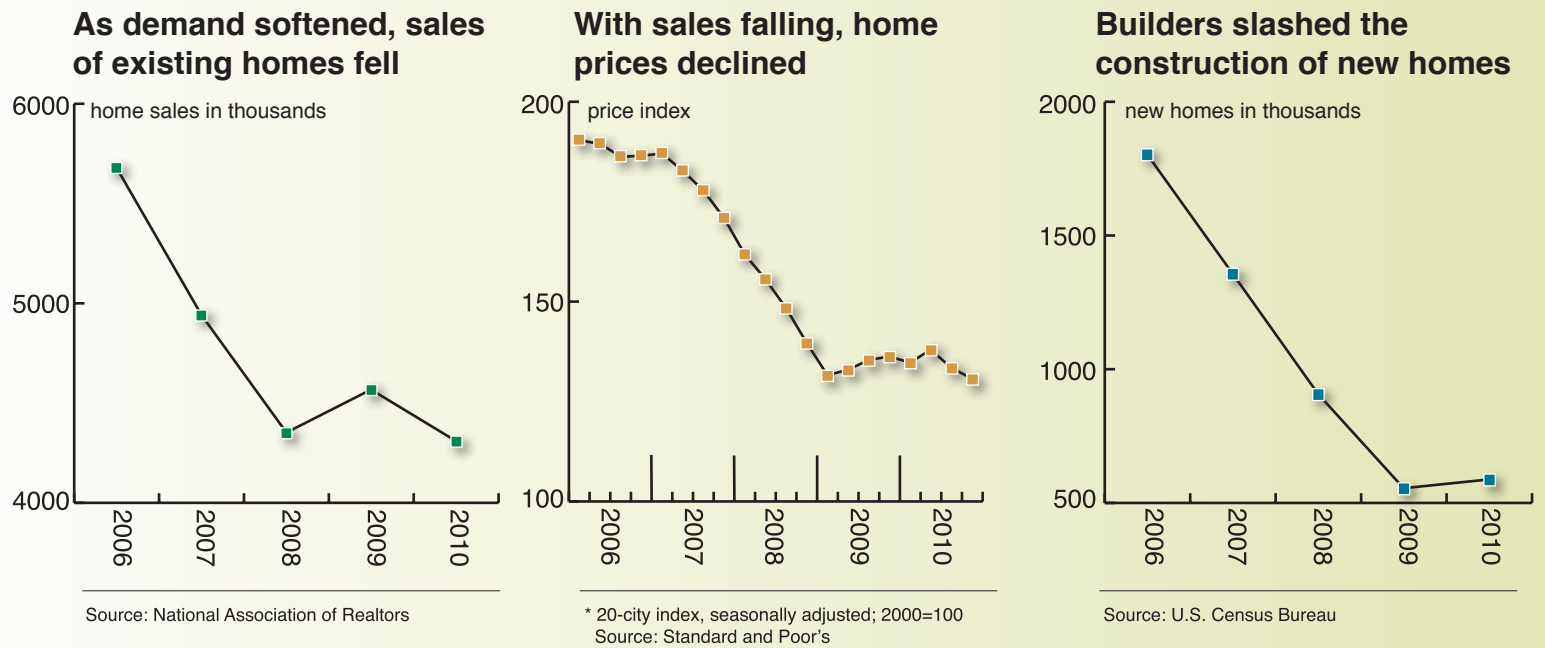
As all this unfolded, Robert Shiller, a prominent professor of economics at Yale University wrote and then updated an influential book, *Irrational Exuberance*; in the 2005 edition, he argued that the surge in housing prices and boom in buying and building strongly suggested: “Irrational exuberance really is still with us” and was not confined to just the stock market.



The Collapse

In Figure 3 the dramatic turnaround is chronicled.

Figure 3



It retrospect it is clear that building (which represents an increase in the supply of housing) was expanding faster than demand, particularly in many areas in Florida, California and Nevada, among others. At the same time, a number of financial institutions began to experience severe financial problems, especially those that responded vigorously to government policies and encouragement, and extended a large number of loans to so called “sub-prime” borrowers—that is, borrowers with less than stellar credit histories. With many such borrowers beginning to have difficulty making payments on their loans, lenders reevaluated the wisdom of making such loans.

With mortgage loans becoming somewhat harder to secure from distressed financial institutions, and lenders becoming more cautious across the board, regardless of credit history, the demand for houses softened. The result was prices moved lower as sellers tried to find a level that would prove attractive to the dwindling number of buyers, the inventory of unsold homes expanded dramatically, and builders scaled back their plans to build homes.

Regardless of which particular development occurred first, and it varied somewhat across the country, the previous momentum in the housing market, and the psychological forces which helped propel it, collapsed. This reversal, which helped to produce the ensuing economic recession commencing at the end of 2007, was greatly exacerbated by the accompanying surge in unemployment and decline in the stock market which helped to undermine consumer confidence.

The unemployment rate doubled, rising from 4.5% in 2006 to more than 9% in 2009. Those who lost their jobs and had purchased a house in the previous few years found it increasingly difficult to make their mortgage payments. Others, still working, feared for their economic futures and were less willing to consider the purchase of a new home than would have been the case in more normal economic times.

This first wave of distress in the housing market was then amplified by a tsunami of **foreclosures** that swept across many local and regional housing markets. As home buyers lost their jobs, their ability to make mortgage payments was obviously compromised. At the same time, as housing prices fell, and other homeowners, who often had borrowed all or nearly all of the original purchase price (recall the zero or low down payments referred to earlier), found they owed more on their homes than they were worth. The larger the fall in home prices the more such borrowers were “under water”—that is the bigger the gap between what they owed and what the house was worth (sometimes referred to as “negative equity”). CoreLogic, a well-respected producer of information on the housing market, estimated that as of January 2011, 23% of all homeowners in the United States with a mortgage were under water, with the figures in some local and regional areas over 40% ([corelogic.com/About-Us/News/New-CoreLogic-Data-Shows-23-Percent-of-Borrowers-Underwater-with-\\$750-Billion-Dollars-of-Negative-Equity.aspx](http://corelogic.com/About-Us/News/New-CoreLogic-Data-Shows-23-Percent-of-Borrowers-Underwater-with-$750-Billion-Dollars-of-Negative-Equity.aspx)).

Foreclosure: a mortgage is a legal agreement between a borrower and a lender secured by residential real estate. If a borrower defaults, that is, does not make the payments called for in the agreement, the lender can foreclose, meaning they will file with a court to take legal ownership of the property. The lender will then sell the property to recoup as much of what it originally lent as possible.



Over time, those in such situations, including the flippers and many who bought second homes in resort areas, have defaulted and lenders have foreclosed. The numbers are staggering. According to RealtyTrac, nearly 6 million homeowners received foreclosure notices in 2009 and 2010, with another 3.5 million or more likely in 2011, given the number of homeowners “under water”.

It is important to note that the foreclosures represent more supply that needs to be purchased in any given local market. In fact, recent data suggest the inventory of unsold homes amounts to about a 8-10 months supply nationally, given the rate at which homes have been selling in recent months. This compares to the 5 months supply that prevailed in 2005-06 and that most housing market professionals consider an important indicator of a healthy market with demand and supply roughly in balance. Accordingly, with the existing larger than normal inventory and the ongoing weakness of demand, prices could keep falling in many areas and neighborhoods with a number of foreclosed units will suffer as such homes are often abandoned and vandalized.

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Where are we now and where are we headed?

An unhappy story to be sure. Unfortunately, there is no pain free path to prosperity in the national housing market. We can summarize the key issues:

1. With unemployment likely to remain historically high for some time and lenders remaining cautious following the near collapse of the financial system, housing demand is unlikely to strengthen dramatically in 2011. In fact, many prospective buyer/borrowers with good credit histories report that it is very difficult to secure a mortgage. Remember that financial regulators have urged banks and other financial institutions to manage risks better in the future; hence, a quick return to the loose lending practices of several years ago is not likely.
2. Foreclosures will remain a serious problem for some time to come, particularly in areas where overbuilding and speculation were prominent.
3. Assuming the economy continues to recover, interest rates, including mortgage interest rates, will gradually move up; this too will constrain the growth in housing demand.
4. Consulting key so-called fundamentals governing activity in the housing market--the terms on which loans can be secured



(credit standards and down payments), household formations (due to population growth , marriage, etc.), the cost of buying vs. renting, and the unsold inventory of existing homes hanging over the market, suggest, on balance, that any pickup in housing prices and new construction will be constrained in most markets across the United States through 2011 and into 2012.

In February 2011, the Obama administration released “Reforming America’s Housing Finance Market” (treasury.gov/initiatives/Documents/Reforming%20America%27s%20Housing%20Finance%20Market.pdf). The wide ranging and important report was prompted by the view that:

“The housing finance system *must* be reformed. It is the vital link to sustainable home ownership and rental options for millions of Americans, and it is central to our nation’s economy. We allowed its flaws to go unchecked for too long, contributing to a financial collapse that strained families, decimated communities, and pushed the economy into the worst recession since the Great Depression” (p.31).

Many of the options presented would reduce the government’s support for housing at a moment when the industry remains in difficult straits. Needless to say, many, including the National Association of Homebuilders, the Mortgage Bankers of America and a host of others that comprise the industry have serious reservations about many of the proposals.

What can be said is that with the large government budget deficit already a burning political issue, most observers expect that direct and indirect government support for housing will not be increased in coming years and could well be cut back. As a result, most experts agree with CNBC senior editor, Mark Koba: “The glimmer of hope that housing would stage a sustainable comeback this spring has melted with the winter snow.”



