

Reports of the Demise of U.S. Home Prices Have Been Greatly Exaggerated

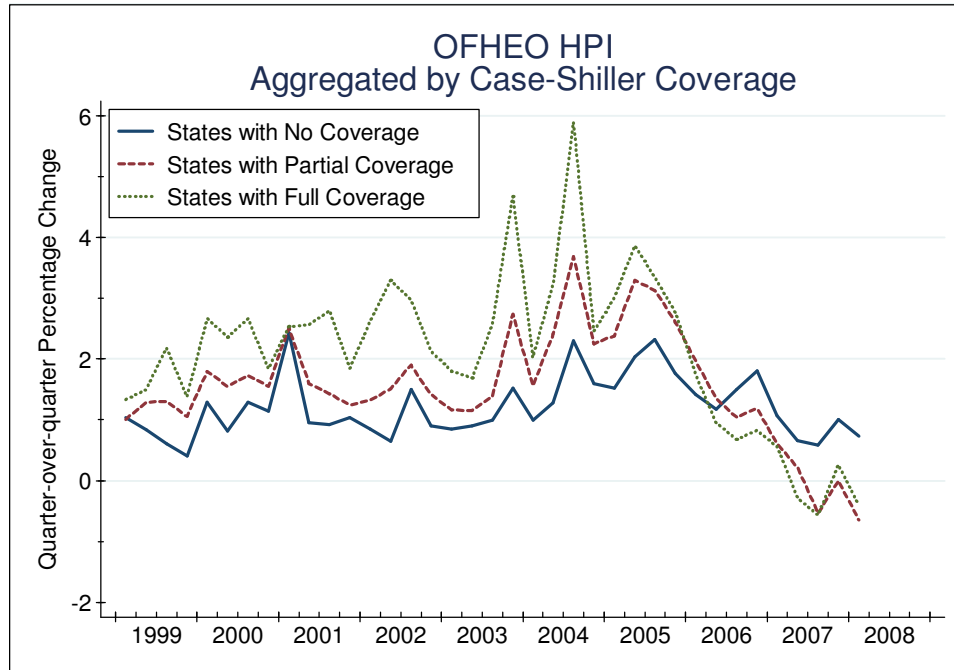
Charles W. Calomiris
Stanley D. Longhofer
William Miles

Recent housing market turmoil has led many to fear that house prices will drop precipitously, particularly if rising foreclosures force many more homes on the market during the coming year.

But this concern, so commonly voiced in the press, is overstated. Most Americans have not experienced – nor will they experience – any significant decline in the value of their homes. In fact, according to the OFHEO house price indexes, only two states (California and Nevada) have experienced average home price declines of more than four percent over the past year.

The fact that U.S. home prices aren't collapsing might surprise you, especially if you've been drawn in by the headlines reporting a 14.1 percent decline in the Case-Shiller house price index over the past year. Although this index receives a great deal of attention in the financial press, it turns out that the Case-Shiller index is a poor measure of what is really happening to the value of most American's homes.

The problem with the Case-Shiller index as a measure of the typical experience of US households is twofold. First, it has no data from 13 states (representing 11 percent of the U.S. housing stock) and has only partial coverage of another 29 states (with 79 percent of the U.S. housing stock). This is important because, as seen in the accompanying figure, the areas omitted or incompletely covered by the Case-Shiller index appreciated at a slower pace during the housing "boom" and have been more resilient over the past two years. In other words, the data behind the Case-Shiller index is biased towards the markets that are most susceptible to dramatic swings.



More importantly, the Case-Shiller index value-weights its transactions. This means that it gives, for example, eight times as much weight to the sale of an \$800,000 home as it does to the sale of a \$100,000 home. All of this implies that the Case-Shiller index is constructed to be particularly sensitive to what is happening to very high-priced homes in the largest, highest-priced markets.

In contrast, the OFHEO indexes have broad coverage of both large and small markets across the U.S. Furthermore, each home is equally weighted in the OFHEO index, meaning that it is more representative of what is happening to a representative U.S. homeowner.

Now some worry that the OFHEO indexes may be missing the full effects of the housing market crisis because it does not include (1) very-high priced homes with “jumbo” mortgages and (2) homes with subprime loans. After all, the critics argue, these are the homes being hit the worst by the housing crisis, so the OFHEO index is biased by not including them.

This problem is not as great as it may appear. The properties included in the OFHEO index are representative of the homes owned by middle-class American families. Although the OFHEO index would be more representative if it included jumbo and subprime transactions, the Case-Shiller index *over* weights jumbo mortgages, making it a poor reflection of what is really happening to the typical American homeowner.

“OK,” you may be thinking, “so maybe home prices haven’t dropped as much as I had thought. But surely price collapse is just a matter of time, given all the foreclosures that are going on.” While it is true that the recent rise in the national foreclosure rate is very high by historical standards, it turns out that for most states the recent rise in foreclosures is not as high as has been experienced in previous housing cycles.

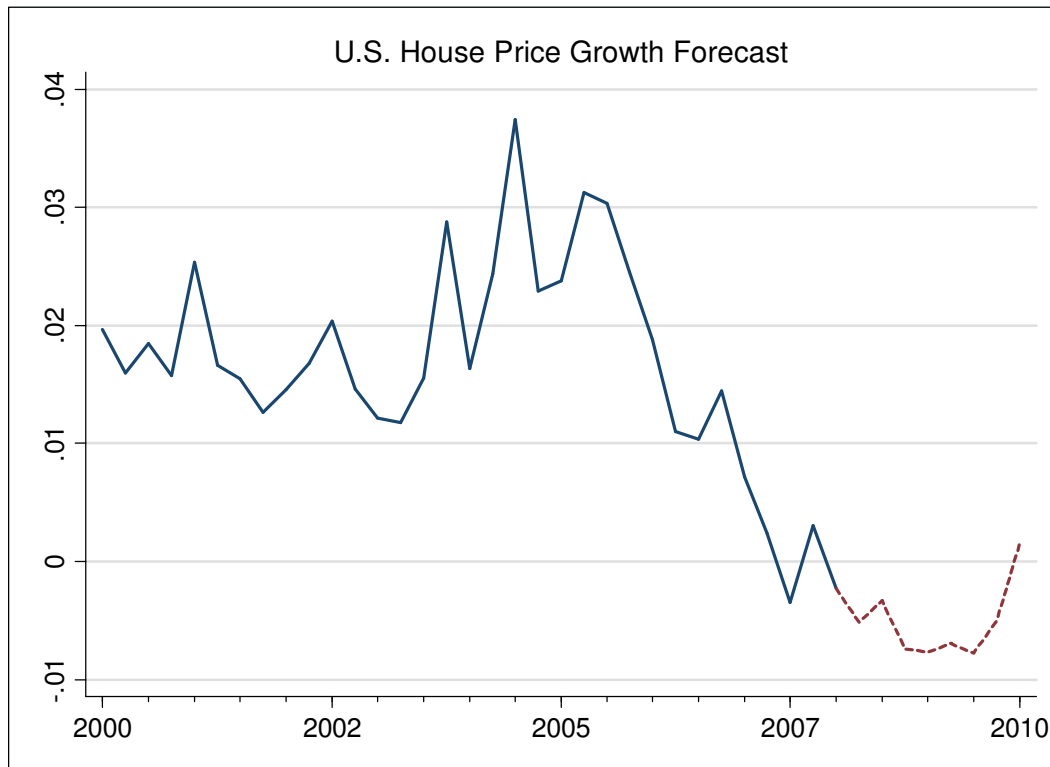
We have used this fact to estimate how the recent run-up in foreclosures is likely to impact home prices across the U.S. in the coming quarters. Our research indicates that it is unlikely that the recent foreclosure crisis will cause house prices to fall precipitously over the next two years, even in those states that have already experienced significant declines in prices.

Not only have price declines been small overall, but they are highly likely to remain so. Our analysis does reveal, unsurprisingly, that foreclosures and home prices have negative effects on each other over time, but this does not imply a vicious cycle of house price collapse. Our models predict that as foreclosures continue to climb in many states, house prices will remain flat or decline in those states, but prices will not collapse. One reason for this is that the effect of foreclosure shocks on house prices is small. Furthermore, other fundamental factors (e.g., employment growth, and reductions in housing supply growth over the past year and a half) will cushion the effect of foreclosures and keep house prices from collapsing.

Our conclusion about the limited potential for further house price decline is surprisingly robust. We constructed several forecasting models of house prices, which combine quarterly data since 1981 for home prices, home sales, building permits, employment and foreclosures. Even under an extreme worst case scenario for foreclosures (multiplying existing estimates of foreclosures through 2009 by 1.75), our conclusion remains the same: U.S. house prices just aren’t going to fall by very much in the next two years. According to our extreme worst case scenario, the average cumulative decline is 4.5% and only 11 states will experience a price decline of 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 that housing exhibits is reflected in the lower sales volumes and declining housing starts that we have witnessed for over a year, which have already slowed GDP growth. Many developers and financial institutions have been hard hit by the decline in sales. And, some homeowners who had the misfortune of buying in the hottest markets during the last few years have experienced significant declines and will continue to experience

further declines in value. But fears of a huge loss in home values for most homeowners – and especially for middle-income, young homeowners – across the United States are greatly overblown.



Charles W. Calomiris is Henry Kaufman Professor of Financial Institutions at Columbia University and a visiting research fellow at AEI. Stanley D. Longhofer is Stephen L. Clark Chair of Real Estate and Finance, and Director, Center for Real Estate, Barton School of Business, Wichita State University. William Miles is Associate Professor of Economics and Barton Fellow, Wichita State University.