Has the Effect of Foreclosures on Housing Prices Been Overstated?

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Peter J. Wallison

Introduction

Foreclosures of defaulted mortgage loans are very much on the mind of Washington policymakers. The Treasury has a HOPE Now program to avert foreclosures by renegotiating loans, the proposed Frank-Dodd bill would authorize the FHA to guarantee new loans after existing mortgage loans have been written down below market values, and similar plans have been outlined by the presidential candidates. The chairman of the FDIC has even proposed that the Treasury Department lend $50 billion directly to homeowners in danger of foreclosure.

No one wants foreclosures. The picture we have in mind is a family out on the lawn surrounded by their furniture, and this image is in part what drives the effort in Washington to prevent foreclosures.

But there are also hard-nosed economic policy reasons. The foreclosure process is lengthy and costly. The principal reason that plans like the Treasury and Frank-Dodd proposals might work economically is that it may cost more to foreclose on a residential property than to write down and renegotiate the mortgage. But apart from the general waste of society's resources, this is more a problem for the lender who made a bad loan than for the rest of us.

Foreclosures also waste resources because the vacant homes deteriorate or are vandalized. These are also problems for the lender, which is frequently holding the title to the home until it can be sold.

But the principal public policy reason that is cited for reducing foreclosures is the effect of vacant homes on the value of nearby homes—on whole neighborhoods. The theory, restated in just about every speech by a lawmaker or administration official about the housing crisis, is that vacant homes drive down the market value of nearby occupied homes—thus contributing to a downward spiral in home prices. A decline in the value of homes is also thought to reduce consumer spending—a reverse wealth effect—and thus to contribute to a slowdown in economic growth or an actual recession, which also contributes to a decline in home prices. No one seems to have any doubt about any of this.

But what if these assumptions are wrong?

This brings us to the paper by Professor Calomiris and his colleagues that we will be considering today. In the paper, the three authors first challenge the use of the Case-Shiller index

as the best data for assessing home prices. This index is the one usually cited in press reports, and the authors note that it tends to exaggerate the size of house price declines because it gives greater weight to more expensive homes. Instead, they base their study on the OFHEO home price index, which they contend has better data on middle-class housing prices and broader state-by-state coverage than the Case-Schiller index. This is important because there are significant variations in the housing price declines at the state level—in the current downturn and in the past—with some states much more seriously affected than others. These state-level differences have provided a rich source of data to test the authors' model.

The outcome predicted by the model is rather surprising for those who have assumed that widespread foreclosures will cause a downward spiral in housing prices.

Among other things, it suggests that policymakers should take another look at the data before committing the federal government to an expensive housing bailout.

There may still be perfectly good reasons to help people who are in danger of losing their homes—especially if they have been deceived into making the purchase—but if the effect of foreclosures on home prices is not substantial, there is a good deal less reason for political Washington to be pressing for expensive government programs to prevent foreclosure