Testimony of

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The Housing Downswing:
Causes, Dimensions and Economic Consequences

Chairman Allard, Chairman Bunning, Ranking Member Reed, and Ranking Member Schumer, my name is David Seiders and I am the Chief Economist for the National Association of Home Builders (NAHB). I am pleased to appear before you today to share NAHB's views on the outlook for housing and the economy. NAHB represents 235,000 member firms involved in home building, remodeling, multifamily construction, property management, housing finance, building product manufacturing and other aspects of residential and light commercial construction.

Summary and Conclusions

The U.S. housing market exhibited "boom" conditions during most of the 2004-2005 period but home sales and housing production now are coming down. Indeed, housing has already swung from a powerful engine of economic growth to a significant drag on the economic expansion, and there are serious questions about the impacts of housing on the economy going forward.

This statement outlines the basic causes of the current housing downswing, estimates the depth and duration of the downswing, and discusses the likely economic consequences of the falloff in housing market activity as well as the likely impacts of several secondary effects of the evolving housing cycle. The basic conclusions are as follows:

- Both the housing boom of 2004-2005 and the current housing contraction have unique features that make them substantially different from previous housing market swings. The big differences relate primarily to unusually stimulative financial market conditions during the boom, record-breaking increases in inflation-adjusted house prices, and an outsized presence of investors/speculators in single-family and condo markets.
- The current contraction amounts to an inevitable mid-cycle adjustment, or transition, from unsustainable levels of home sales, housing production and house

price appreciation to levels that are supportable by underlying market fundamentals.

- The previous boom involved more than two years of unsustainable housing market activity, and we're likely to experience a below-trend performance of home sales and housing starts of roughly similar duration. The downswing in home sales and housing production should bottom out around the middle of next year before transitioning to a gradual recovery that will raise housing market activity back up toward sustainable trend by the latter part of 2008.
- National average house price appreciation is likely to be quite limited in the near term. Indeed, some decline is a distinct possibility, and the rate of price appreciation should remain below trend for some time. "True" house price appreciation, accounting for upward bias in key price measures as well as price support from non-price sales incentives provided by sellers, presumably will be even weaker.
- The downswing in home sales and housing production will continue to detract from overall economic growth through mid-2007. However, much of this negative impact should be offset by strengthening activity in other sectors of the U.S. economy, keeping GDP growth reasonably close to a sustainable trend-like performance.
- There are bound to be some adverse secondary effects of the recent housing boom and the subsequent downswing on the ongoing economic expansion. These effects include negative impacts on consumer spending from a fading wealth effect as house prices adjust as well as from the impacts of "payment shock" on homeowners facing upward adjustments to monthly payments on "exotic" types of adjustable-rate mortgages (ARMs) originated since 2003. However, the size and timing of these effects are not likely to seriously threaten the economic expansion.
- The housing and economic outlook characterized above rests on a number of key conditions, and downside risks to the outlook are considerable. These risks include the possibility of spikes in interest rates or energy prices as well as large resales of homes back onto the markets by investor/speculators. There also are

considerable uncertainties about the true dimensions of the risk facing homeowners with “exotic” ARMs, and there are major uncertainties regarding the size of the inventory overhang in the market for new homes.

<u>Causes of the Housing Downswing</u>

The roots of the current housing downswing were cultivated before and during the housing boom of 2004-2005. The housing boom actually was touched off by the extraordinary monetary stimulus enacted by the Federal Reserve to fight off the threat of price deflation in the U.S. economy. The Fed dropped the federal funds rate to 1 percent at mid-2003 (a negative “real” rate), held it there through mid-2004 and then embarked on a gradual path back toward monetary “neutrality”-- a journey that didn’t reach its goal until the early part of this year. Furthermore, the extraordinary degree of monetary stimulus in the U.S., together with low long-term rates abroad, kept long-term interest rates in the U.S. at historic lows during most of the 2003-2005 period. This extremely favorable financing environment fueled buying activity in the interest-sensitive housing sector, pulling some demand forward in the process.

The surge in housing demand quickly put substantial upward pressure on house prices, aided and abetted in many parts of the country by land-use constraints that limited the amount of supply that builders could bring onto the markets in short order. Surging prices bolstered expectations of future price appreciation, driving down the user cost of capital and bolstering the investment aspects of homeownership. The extremely favorable tax treatment of capital gains on housing (enacted in 1997) certainly contributed to these developments.

The extraordinarily low interest rate structure and the rise in house price expectations attracted many households out of rental apartments and into first-time homeownership, driving both the homeownership rate and the rental vacancy rate to record highs by early 2004. Furthermore, waves of investors/speculators bought into the single-family and condo markets to share in the unprecedented real capital gains being generated--at a time when our stock market was in questionable condition, yields on interest-bearing investments were at rock bottom and it was difficult to find attractive investment alternatives in foreign markets.

The mortgage lending community also contributed to the housing boom, marketing a wide range of “exotic” ARMs (to coin a Greenspan term) that were designed to help get prospective buyers (including subprime credit risks) into homeownership and to accommodate investors/speculators with short-term investment objectives. These lending practices naturally fueled demand further, adding to the already considerable upward pressures on prices of single-family homes and condo units. Both federal regulators of depository institutions and financial rating agencies raised flags about overly aggressive mortgage lending practices, particularly payment-option ARMs that permit negative amortization, but these flags apparently had little influence on lending practices in either the regulated or unregulated markets.

The ongoing accumulation of large house price increases began to weigh on housing affordability measures by the early part of 2004, despite the stubbornly low interest rate structure. However, proliferation of the “exotic” ARMs kept a lot of prospective homeowners in the game, particularly in relatively high-priced markets. Meanwhile, the investors/speculators continued to plough ahead, still drawn by the lure of future price appreciation.

Home sales and house price appreciation kept rising to higher and higher records throughout 2004 and into 2005, and the affordability measures kept falling. Affordability was subject to additional downward pressure after mid-2005 as the whole interest rate structure finally shifted upward, and the aggregate demand for homes finally started to give way in the third quarter of last year.

The combination of fading demand on the part of prospective homeowners and a supply train that still was moving ahead quickly changed a raging “sellers’ market” into a market where inventories were climbing and buyers could shop and bargain. Symptoms of the switch naturally caught the attention of savvy investors who cut back on buying, started cancelling sales contacts before closing and even started reselling vacant units they had closed on earlier.

In retrospect, it was the finance- and price-driven acceleration of buying for homeownership and for investment that drove housing market activity into unsustainable territory during the boom. We're now experiencing a "payback" in demand for homeownership, following the surge that pulled demand forward into the boom years, and net purchases by investors/speculators are coming down considerably as price expectations are being marked down.

Dimensions of the Housing Downswing

The 2004-2005 housing boom took home sales and housing production well above levels supportable by demographics and other fundamental demand factors. The cumulative excess of housing starts apparently amounted to at least 400 thousand units, and the excess supply now resides in builder inventories or in the hands of investors who may cancel contracts or sell vacant units at any time. In this regard, it's worth noting that the single-family rental vacancy rate soared to record highs during the boom, came down to some degree during the first half of this year, and presumably is heading lower for some time.

It's clear that the housing downswing still has some distance to go, if only to work off excess supply in markets for both new and existing homes (including the condo market). Builders are cutting back on new permit authorizations as well as on starts of new units, and they are trimming prices and offering sizeable non-price sales incentives to limit cancellations and bolster sales. Furthermore, various economic and financial market fundamentals figure to be supportive of housing demand for the foreseeable future, helping to facilitate the inventory correction. These fundamentals include the following:

- Payroll employment growth is proceeding at a decent and sustainable pace.
- Household income growth is strengthening as the economic expansion proceeds.

- The interest rate structure is favorable, mortgage credit is readily available and monetary policy has stabilized following a long run of upward rate adjustments.
- Energy prices have receded from record highs earlier this year.

As long as the economy remains in good shape, interest rates remain close to current levels, energy prices remain below recent highs and sellers of new and existing homes adjust prices or offer incentives to fit current market realities, the rest of the housing market correction should be of limited depth and duration. It's likely that the bulk of the downswing in home sales and housing production will occur this year, with market activity stabilizing around mid-2007 and moving back up toward trend by late 2008. NAHB's forecast has a cumulative shortfall of housing starts (below our estimate of sustainable trend) of roughly 400 thousand units from the middle of this year through the end of 2008, in line with the estimated excess supply generated during the boom period.

House Price Adjustments

House price appreciation was very rapid during the housing boom, and "real" house price appreciation soared to record rates. The national appreciation rate has slowed considerably since then, in both nominal and real terms, as sales volume has fallen and inventories of both new and existing homes have climbed. Absolute price declines actually were recorded for some markets in the second quarter of this year, although most of these markets were located in the beleaguered economies of the Great Lakes region rather than in previously overheated areas.

The size of the current inventory overhang and the marked slowdown in price appreciation that's already occurred point toward a generalized flatness in nominal house prices in the near term, and some price erosion certainly could occur in coming quarters. In any case, an extended period of below-trend national house price appreciation lies ahead, and "real" house prices should come down to some degree. These adjustments certainly will give a boost to affordability for prospective homeowners as time passes.

It's worth noting that all available measures of house price appreciation have technical deficiencies -- even the purchase-only version of OFHEO's quarterly repeat-sales House Price Index. This measure is not reflective of the entire market, it contains some upward bias because it does not account for improvements to homes over time, and there's no way to adjust price appreciation downward to account for non-price sales incentives provided by sellers. Despite these limitations, it's the best available gauge of house price change in the U.S. as well as in regions, states and metro areas.

Economic Consequences of the Housing Downswing

The U.S. economy can continue to grow at close to a trend pace even as the downswing in home sales and housing production runs its course. For one thing, the housing correction is a relatively isolated sectoral event, primarily reflecting recoil from earlier excesses within the sector. Unlike previous downswings, housing affordability has been squeezed primarily by price increases and the normally close correlation between housing activity and other interest-sensitive components of aggregate demand is not strong this time.

It's also true that the housing downswing is occurring at the same time that other sectors of the economy are in mid-cycle expansion phases. This apparently is true of spending on capital equipment and software, nonresidential structures and exports. This type of sectoral rotation actually could give new life to the economic expansion (now nearly 5 years old), and the net outcome could very well be trend-like GDP growth with manageable core inflation and reasonably stable interest rates. That's an environment where housing would be able to deliver healthy trend-like performances of its own, riding on strong demographic trends and other fundamental demand factors.

Household Wealth and Consumer Spending

The ongoing deceleration of house prices, and possible national house price declines, will take some strength out of consumer spending. After all, the rapid runup in house values and household wealth clearly fueled consumption expenditures during the housing boom, allowing the personal saving rate to go negative for an extended period of time.

Furthermore, much of this spending was financed via borrowing against accumulated housing equity (cash-out refinancings and home equity loans) at a time when interest rates were lower than now.

It's true that the housing wealth effect on consumer spending will be weakening to some degree as house prices slow and possibly even decline, but the erosion of support to consumer spending should be gradual over time and occur primarily after the downswing in home sales and housing production has run its course and residential fixed investment has completed its contraction (mid-2007). Households typically react to changes in wealth with long lags (one to three years), and the influence of the recent dramatic wealth buildup on consumer spending should carry through for some time.

With respect to the influence of increases in the cost of accessing housing wealth via mortgage borrowing, a wealth of research shows that it's the wealth (or net worth) effect that really matters, not the amount of housing equity that's "withdrawn" via mortgage borrowing. Wealth-driven consumer expenditures can be financed by spending more out of current income (for those with positive savings), by running down financial assets or by using non-mortgage debt (e.g., personal loans).

Mortgage Payment Shock

The proliferation of "exotic" ARMs during the housing boom (payment-option, interest-only, etc.) has raised the specter of widespread "payment shock" for homeowners when such loans hit their first rate resets and/or when the loans begin to require repayment of principal. These adjustments, when they occur, will put heavier demands on household budgets, with downside implications for consumer spending, and some homeowners will be forced into delinquency and even loan default. Subprime mortgage borrowers presumably are the most at risk.

There's no doubt that the surge of "exotic" ARMs, and the associated relaxation of lending standards at both regulated and unregulated financial institutions, helped fuel the housing boom and will be creating problems for some homeowners. However, most outstanding mortgage debt is either fixed-rate or standard types of ARMs, and household income growth since loan origination should enable the majority of homeowners facing ARM payment adjustments to handle the higher monthly payments. Price appreciation since origination also will provide a financial buffer for many of those facing unanticipated increases in monthly payments.

Homeowners facing large payment adjustments on exotic ARMs also can refinance into other types of ARMs or into fixed-rate mortgages at historically low rates, and most of the "exotic" ARMs apparently do not carry substantial prepayment penalties.

It's also worth remembering that there was a strong correlation, across metro areas, between the frequency of "exotic" ARMs and investor shares of home mortgage originations. Many investors apparently used these types of loans to minimize short-term financing costs, and many presumably will be paid off or refinanced before upward payment adjustments occur.

Everything considered, payment shock associated with "exotic" ARMs written during the boom will most likely be a negative for consumer spending in the next few years but should not threaten the projected economic expansion.

Downside Risks

The housing and economic outlook described above rests on a number of key conditions, and downside risks to the outlook are considerable. Housing forecasts always are subject to the risk of unanticipated interest rate spikes, and reluctance by foreign investors to continue to finance our huge current account deficit could put serious upward pressure on the U.S. interest rate structure. Furthermore, recent experience in energy markets suggests that a major surge in energy prices can't be ruled out.

There also are major uncertainties about the prospective behavior of the unprecedented numbers of investors/speculators that bought single-family homes and condo units during the boom. NAHB's surveys of builders show large numbers of cancellations of sales contracts before closing as well as less-frequent reports of resales of units closed on earlier. Our forecasts assume that any reflow of units back onto the markets is of manageable proportions and that wholesale dumping does not materialize.

The prospective impact of payment resets on “exotic” ARMs, particularly payment-option ARMs with negative amortization, also is difficult to predict. It’s possible to estimate the volume of potentially troublesome loans outstanding as well as the approximate timing of the first payment resets. However, there are a lot of uncertainties about the quality of loan underwriting during the boom housing years, including the degree of “layering” of permissive lending practices, and it’s hard to predict the ultimate outcome on loan quality and consumer spending.

Another uncertainty relates to the true size of the inventory of new homes for sale. The Commerce Department’s estimates exclude homes left with builders when sales contracts are cancelled, and cancellations have been rising sharply since this time last year. NAHB’s forecast attempts to account for this factor, but the true size of the inventory overhang remains a grey area at best.

Mr. Chairman, that concludes my remarks. Again, thank you for the opportunity to appear before this joint subcommittee today. I look forward to answering any questions you or the members of the joint subcommittee have for me.