ECONOMIC RESEARCH

The Myth of Rising Home Prices

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Kris Gerardi calls it a case of being in the right place at the right time.

Gerardi, a financial economist and policy adviser in the Research Department of the Federal Reserve Bank of Atlanta, took a job as a research assistant at the Federal Reserve Bank of Boston while he worked on his PhD in economics at Boston University in the mid-2000s.

The Atlanta Fed's Kris Gerardi. Photo by David Fine

Gerardi noticed that concern was mounting at that time about the mortgage market, so he went online to view mortgage records. He put together a data set of borrowers that included home purchase dates and loan amounts, type of mortgage, and refinance information. His research uncovered a troubling trend: a rising number of nonpayments by borrowers of subprime mortgages, products that were largely unregulated. Gerardi and the economist he worked for, Paul Willen, wrote a couple of research papers on their findings as they examined more data.

"We were among the first to start to see default rates increasing, and this was pretty early in 2006," said Gerardi. "There were people, including us, who thought the mortgage market was going to crash, but certainly the macroeconomists didn't believe that mortgage market problems would spill over into the broader economy."

An important finding

As national news headlines focused on subprime mortgage products that had adjustable rates, Gerardi and Willen looked deeper at that segment. In a lengthy 2008 paper written for the Brookings Institution, they pinpointed a major culprit in the mortgage meltdown that triggered the national financial crisis: the faulty expectation that housing prices would continue to rise. Their paper, written with two economists from the Federal Reserve System Board of Governors, explained that while market analysts understood the harm a drop in home values could cause, they downplayed the possibility of that occurring.

During the research work for that paper, it was Gerardi who flagged that pivotal finding as he combed through previous years of mortgage data, said Willen, who is now a senior economist and policy adviser at the Boston Fed. "Our theory at the time was that people did not understand how sensitive these loans were to falling house prices," he noted. "Kris kept coming to me and saying, 'That's not what I'm finding.'" They realized that the issue was not that people didn't understand what would happen if house prices fell, but that they didn't think prices were going to fall.

Like any economist, Gerardi likes debunking myths. He considers a discussion paper that pointed out several misconceptions about the housing crisis his most meaningful and accessible work. The paper, published in 2012, expanded on the Brookings report and presented 12 facts that exposed errors in conventional beliefs about the mortgage crisis, written in a nontechnical way. (Among the facts: no mortgage was "designed to fail," and adjustable-rate mortgage resets did not cause the foreclosure crisis.)

"We realized that a lot of the common narratives and conventional wisdom about the crisis were largely inconsistent with the data, and that suggests the truth was not really being uncovered," he explained.

Gerardi, a summa cum laude graduate of Hamilton College who majored in economics and physics, says subprime mortgages were unfairly blamed for causing the housing crisis. While lots of subprime mortgages defaulted during that time, so did lots of prime mortgages, he said. In fact, many consumers had success with subprime products, using them to help improve their credit scores. "There's a lot of evidence coming out now that suggests there were much more systematic problems in the entire market, not just subprime mortgages," he said.

Noted and quoted

Over the years, Gerardi's work on housing has been featured in top-tier economics journals as well as articles from leading media outlets such as the *Wall Street Journal*, *New York Times*, and CNNMoney. His research has addressed different facets of the housing market, from the benefits of hydraulic fracking on home values to effects of negative equity on mortgage default to efforts to help homeowners who have experienced foreclosure. He even cowrote a paper published in 2010 explaining how poor math skills contribute to mortgage defaults among borrowers.

"Kris is one of the leading real estate economists of his generation," Willen said. "He's a very rigorous scholar; he's very careful; he really wants to do it right."

Though topics related to housing take up most of his time, Gerardi has other research interests. For instance, he cowrote a paper about airline pricing. He analyzed data from 1993 to 2006 and determined that as airline competition rises, the cost of ticket prices tends to narrow as carriers hold down air fares. His study also concluded that as more airlines begin to service a certain route, the effects of that increased competition reduce the highest fares charged on that route more than the lowest fares.

More than 10 years after the housing crisis, Gerardi admits he is preoccupied with trying to figure out what caused the market to boom and bust. Though researchers are testing various theories, "the honest answer at this point is that we still don't know a whole lot," Gerardi said. These days, much of his housing-related work is focused on adverse effects from foreclosures.

A point on which researchers seem to agree about the crisis, he said, is that there was a housing bubble. But even that is a mystery.

"Unfortunately, we don't have great economic theories about bubbles—specifically, about how they form and how and when they burst," Gerardi said. As economists are often fond of saying, further research is required. No doubt Gerardi will be among those performing it.

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