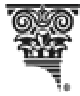 FEDERAL RESERVE BANK *of* ATLANTA

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Indexing the Housing Market Transcript

September 2009

Moderator: *Welcome to the Federal Reserve Bank of Atlanta's*Econ SouthNow*podcast. Today, we're joined by Dr. Karl Case, an economics professor at Wellesley College and codeveloper of the S&P;/Case-Shiller Home Price Index. He'll be speaking about house prices and the state of the housing market. Dr. Case, do you think we've reached the bottom in terms of house price declines, and if so did it happen sooner than you expected? Or is it possible we could see further declines?*

Karl Case: I think there's a significant probability that it's reached a bottom. Calling a bottom or calling a top or even timing the market's a very difficult thing to do, of course, because there's a great deal of uncertainty about employment and other things going forward. But it sure does look like in the last two months, there's been a sea change in these repeat sales indexes that we publish, and they look like they're coming off a bottom. It looks like they're certainly searching for a bottom. How much of it's exactly seasonality and how much is not â?¦ I think we believe that most of it is not seasonality, that we really do have 17 or 18 of our 20 cities rising. So I think there's a lot of evidence. By the way, if you look at the quantity figures, existing home sales, inventories, pending home sales, new home sales, housing starts, they're all up over the last five or six months. So, coincident with the increase in the stock market, there seems to be a stabilization beginning to occur in the housing market, which would be a good thing for most people involved.

Moderator: *Yes, 17 out of 20 markets is a pretty powerful indicator. Dr. Case, in your view, what role does employment play in the housing markets, and can the housing market meaningfully rebound until unemployment eases?*

Case: Well, first of all, if you look at the data, it's really true that unemployment's one of the major drivers of the housing market. When people have income and have jobs, they tend to buy more than, obviously, if they don't. But it's still true that with 10 percent unemployment, 90 percent of the labor force has a job. We know that duration is longer, spells are longer, severity as measured in a variety of ways is making the labor market look pretty grim, but it doesn't take a lot of houses to turn over to turn the market. If you think about it, we value the stock of housing by looking at the transactions that occur in a given period. And only about 5 percent of the properties turn over. So if, for example, in California you have a basically optimistic view coming from the people who have lived through these cycles before, combined with availability, you're only talking about moving 5 to 10 percent of the properties in a given year. So I guess it is possible to have a recovery if you remember that what we're doing is imputing the value of the whole stock of housing from the ones that transact in a given period.

Moderator: *Right. As you know, in the Southeast we had a very robust housing market for many years, and we have really felt the effects of the slowing housing market in this region. Do your data tell you anything interesting about the housing markets in the Southeast that makes it distinct from the rest of the country?*

Case: Well, if you look, Florida is of course is a separate part of the Southeast, and so leaving Florida out, talking about the states from basically North Carolina down through Georgia and into the Deep South, that Southeast portion has behaved a little differently than the coasts. None of those areas have had a big, rapid run-up and then rapid run-down; it hasn't been as cyclical. You look at Atlanta, for example: Atlanta is up 7.5 percent since 2000. That's one of the lowest total ups of all the cities in the country. And it's been sort of a steady rise, fall, and then beginnings of a rise again for a city like Atlanta. Whereas if you look at some of the other markets, the terrible markets have been Florida, California, Arizona and Nevada, which have had huge declines and massive numbers of foreclosure auctions. The northeast and parts of the West have been cyclical, with rapid booms and busts periodically, and then the Midwest has been really the Depression area —the Detroits and the Clevelands—that are still down from 2000 levels. So it depends on the region, what the cycle has been like. The most severe cycles—but the ones that have adapted to it the best—are the Northeast and, to a certain extent, California's had three of these booms and busts. They still haven't repaired the damage yet, but the answer is, it depends on what region you look at. The Southeast has been more stable: not so much boom side, a reasonable amount, not so much bust side, either. They're down from peak 20 percent; there are markets that are down well over 50 [percent].

Moderator: *Your reference to foreclosures actually leads me to my next question, which is, do you have any thoughts in how big a role foreclosures have played in the housing market swoon versus, say, oversupply and perhaps overconsumption of housing?*

Case: Well, there are two major aspects. One is these foreclosure auctions. Let me talk about those first, and then I'll talk about the boom side and the expansive credit that occurred in the midpart of this decade. But the foreclosures—a couple of things. One is, they're concentrated in four states. If you look at four states: California and Florida, which are unfortunately a third of the country; if you look at the value of real estate in Florida and California, it's literally a third of the country. If you add Nevada and Arizona, you get about 50 to 60 percent, depending on the month of the auction sales that are occurring. So it's concentrated. It struck me as odd that we have to send sort of an army of people down to those four states to try and get the restructurings done and so forth. But they're concentrated in a really small number of states.

But almost all states have been affected by them because the tremendous expansion of credit, which took place in the early part of the decade, was uniform across the country: We loaned money everywhere, to anybody who basically breathed. Your question was then the impact of those [foreclosures] on the indexes. They clearly have an impact. If you distinguish the high, middle, and low tiers by value, the low tier virtually tripled in a lot of cities. Look at Miami, Washington, D.C., California—the low end literally tripled, and it got pushed way beyond anything that people at the income levels that were buying them could afford. And that was in large measure the expansion of credit and the belief on the part of the analytical people working at Fannie Mae, Freddie Mac, the mortgage insurers, the banks, the Wall Street firms that got involved. It was based on the belief that writing this paper was profitable. But it was profitable during a 30-year period when house prices were rising, and that means that you didn't see the defaults. And when house prices started to fall, all this paper that was written at rates that had adjustments, and people with low and moderate incomes got in trouble because the value of the collateral fell, and the loans came due or they got delinquent.

In the old days, you could just cure by paying off the loan with the asset, because the asset had the value. That came home to roost, and the results are obvious. So when we look at the cities today, there are a lot of these auction sales that are influencing the indexes. The city, if you take one of our 20 metropolitan areas, is made up of probably 30 different housing markets. It's like the S&P; 500 index. You've got some places that are going up in value, some places are going down in value, and the cities that have large tracts of properties in the foreclosure areas are experiencing the largest decline in the index because they represent a larger sample in those cities. So, it's not like we're looking at something as simple as gold to understand. You've got some houses in neighborhoods that are increasing, some that are decreasing, and what's turned around now is the net, and what made it go down as far as it did go down is the fact that we included in those calculations these auction sales, which are heavily discounted—you can't take them out because on the way up, their value actually increased, and if you take them out on the downside, you get an index that looks like it's going to ratchet up and never go down. Well, these properties have fallen in value, and they've fallen a lot. They belong on the index, and so certainly they have an effect.

Moderator: *You mentioned different tiers of house prices. I wanted to know if you see a particular segment of the housing market, such as low-end homes, urban, exurban, etc., that is recovering faster than other segments.*

Case: I think if you look at the zip codeâ??level indexes—I get to see zip codeâ??level indexes—we publish the high, middle, and low tiers. The indexes that seem to be the most stable are not the real high end, which is quite small, but the upper tier and, to some extent, the middle tier seem to have held. In a normal market, when demand drops, prices fall. And the housing market's much like the labor market. When demand drops, prices are sticky. And they're sticky because people won't sell; they'll hold out. They know what their property's worth. I had an economist tell me one time, "I can't sell my house," and I said, "For God's sake, you're an economist!" So there's a sense that somehow housing, because it's bricks and mortar, isn't going to fall as much. People resist it, they're optimistic. It's also true that the dividend on owning a house—if you wanted to compare it to the stock market—is the imputed rent you get by living in it. And it's like driving your car. You don't worry about appreciation because you know it's going to depreciate. Nonetheless, you get car services out of it, which you pay for by buying a car. When you buy a house, you're buying a dwelling. It's like a consumer durable. That means that in a downturn, when the value falls, you don't lose the dividend. The dividend is constant in real terms. It makes it a more stable investment and it's part of what leads to this downward "sticky" phenomenon. So in a down market, people won't sell into it, and it actually has the effect, when you look at the transactions that occur, of making it appear as probably more stable than it is. But certainly, prices in those areas have held, in part because of this downward "sticky" phenomenon, which of course drains supply off the market. So I think the market that's doing the best is the market where there haven't been a lot of foreclosures, where income has been maintained. Obviously, those states that have had income hold up the best are doing better.

Moderator: *My last question to you is perhaps a bit more subjective. I want to ask you how it felt to have had a role in creating something that has practically become a household name in a relatively short time.*

Case: Well, it's really quite extraordinary. I mean, it feels good in a way because I wrote the first one down on paper. Actually, I had not seen the paper by [Martin J. Bailey, Richard F. Muth, and Hugh O. Norse] of some decades ago, but I was very frustrated with the use of median sales prices. I was trying to write about house prices and explain house prices, and there were no bloody data! I sat in my chair

and said, "What I want is same-house appreciation." And so I sort of figured out this little calculation, which kind of cured the problem for me. I looked at data set that explained how much house prices were going up at the time, which was the mid-'80s. I then couldn't explain it. I tried to use six or eight variables, I built a supply and demand model, and then I called Bob Shiller, who is the world's leading expert on bubbles. I said, "I think I've got a bubble for you." And we got together, and we really wrote down what we believed was true and the right way to do it. And to see something like that become sort of acknowledged to be the right way to do it —although there are plenty of people to argue with us about exactly how we do it— it's a pretty straightforward approach to a fairly straightforward problem. And now it's got lots of people looking at it and using it, and it's quite gratifying. It's not fun, unfortunately, because there's so much pain out there with this downturn, and the proximal cause of the downturn, in my belief, was the fall in home prices. So we were the guys who drew attention to the fact that house prices were stabilizing and beginning to fall when that turned out to be a very big thing in terms of the collapse of the mortgage market, the financial system, and all the derivatives that depend on it.

Moderator: *Well, you certainly have given us all a lot to think about and for that we're grateful to you and Dr. Shiller. Thank you for your time and, especially, thank you for the insights you've shared with us.*

Case: Great talking to you.

Moderator: *Again, we've been speaking today with Dr. Karl Case, an economics professor at Wellesley College and a codeveloper of the S&P;/Case-Shiller Home Price Index. This concludes our* Econ South Now *podcast on house prices and the housing market. For more information, please see the third quarter 2009 edition of* Econ South. *On our Web site, frbatlanta.org, you can read our article about house prices. Thanks for listening, and please return for more podcasts. If you have comments, please send us e-mail at podcast@frbatlanta.org.*

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