September 25, 2008

Wall Street worries, Main Street woes

A fair amount of the discussion around what now seems to be an imminent rescue plan to settle unsettled financial markets has been focused on a debate as to whether Main Street should pay or Wall Street should pay for the plan. Pimco's William Gross, however, is suggesting it is a false choice:

> "If this were a textbook recession, policy prescriptions would recommend two aspirin and bed rest—a healthy dose of interest rate cuts and a fiscal package that mildly expanded the deficit.… But recent events have made it apparent that this downturn differs from recessions past.…
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> "And so, instead of mild medication and rest, it became apparent that quadruple bypass surgery is necessary. The extreme measures are extended government guarantees and the formation of an RTC-like holding company housed within the Treasury. Critics call this a bailout of Wall Street; in fact, it is anything but. I estimate the average price of distressed mortgages that pass from 'troubled financial institutions' to the Treasury at auction will be 65 cents on the dollar, representing a loss of one-third of the original purchase price to the seller, and a prospective yield of 10 to 15 percent to the Treasury.…
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> "The Treasury proposal will not be a bailout of Wall Street but a rescue of Main Street, as lending capacity and confidence is restored to our banks and the delicate balance between production and finance is given a chance to work its magic."

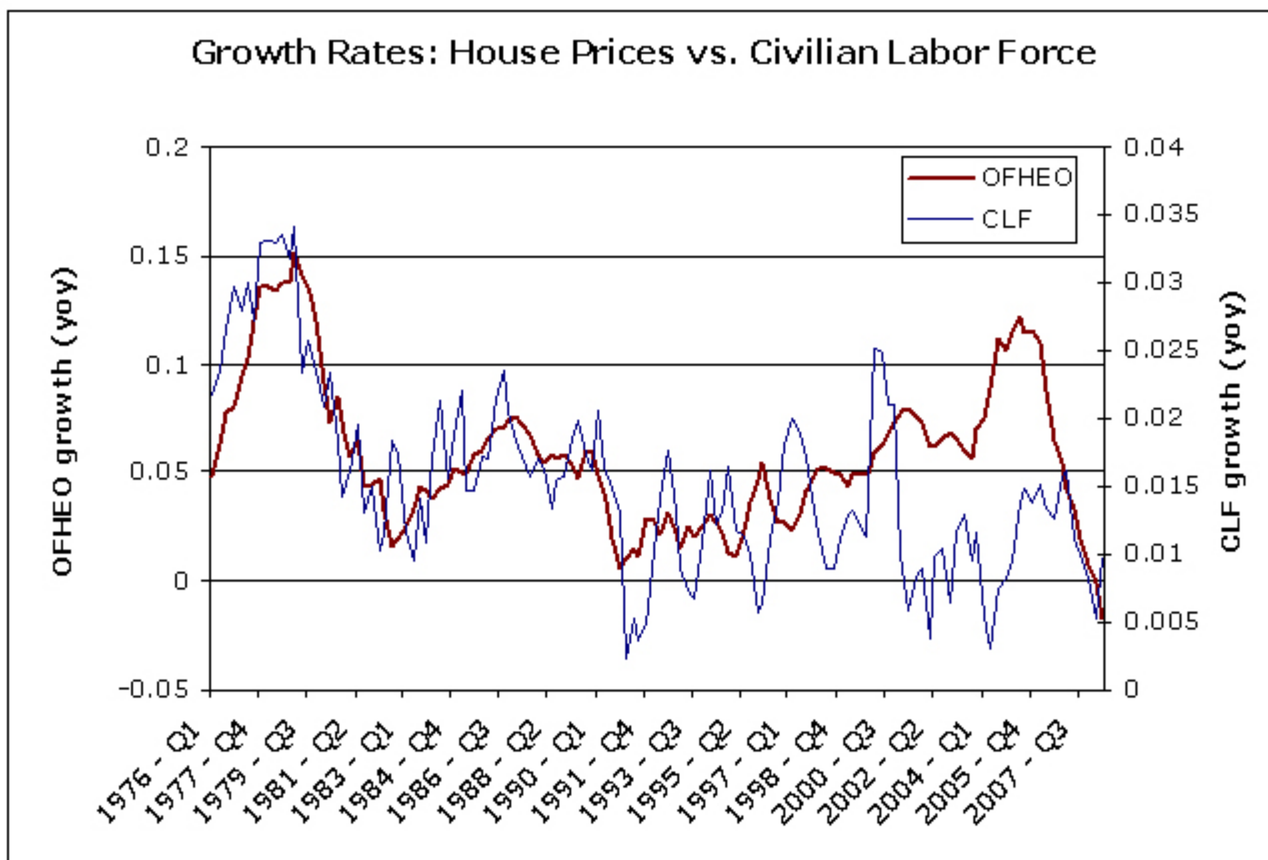
That assessment—that the goal is to get market-mechanisms working again—was expressed by Chairman Bernanke in his Tuesday testimony before the Senate Banking Committee:

> "If you have an appropriate auction mechanism, together with other types of inputs, with flexibility to address different assets in different ways, I think what you will do is you will restart this market. And then you'll get a sense of what the more fundamental value is."

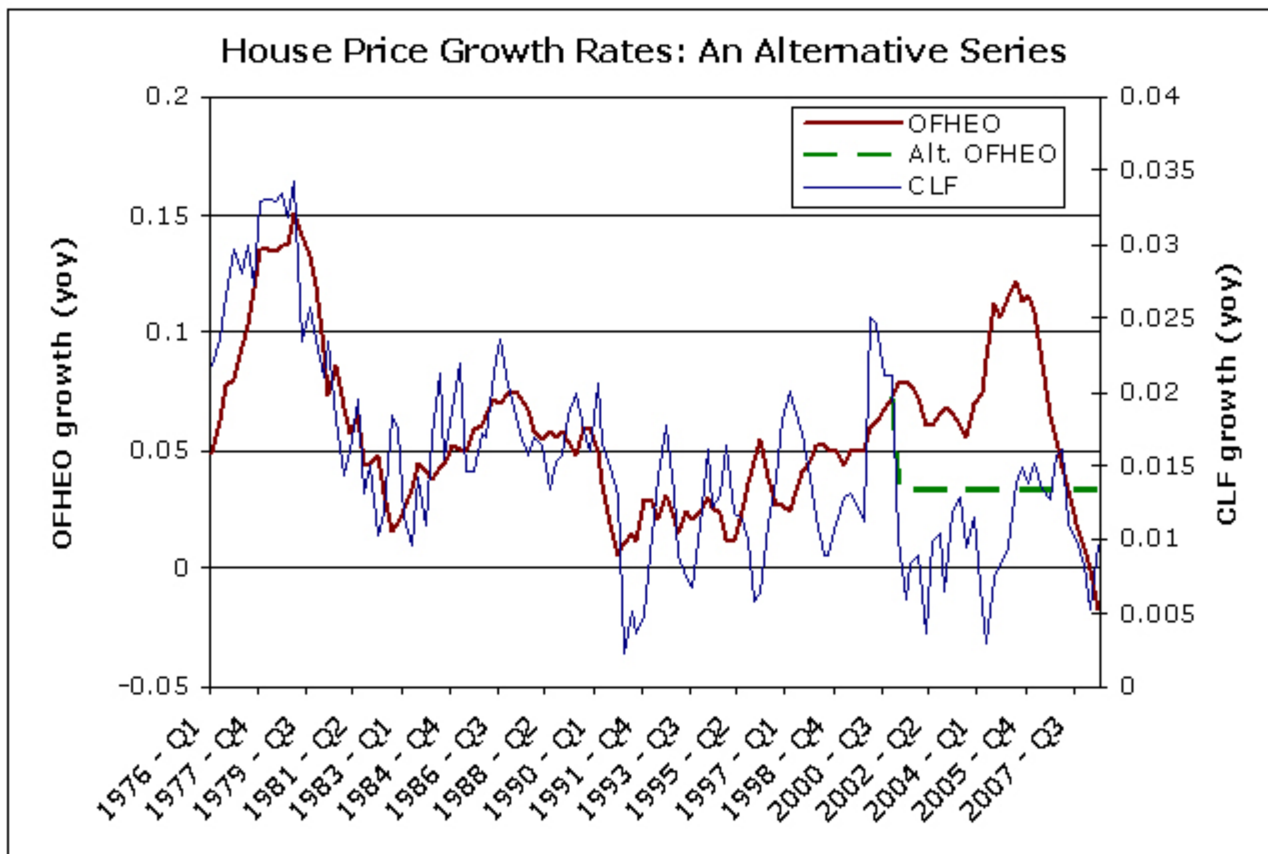
It may be a good point to note that there is no guarantee that the magic worked by markets will be quick. Yesterday's report on existing house sales and today's news on new home sales—covered by the go-to guy Calculated Risk here and here—clearly indicate that the fundamental Main Street adjustments are not yet complete.

Unfortunately, it is difficult to make the case that the trip to stabilization of house prices will be a short one. Simple economics predicts this relationship: movements in house prices are the result, mainly, of movements in land prices (as shown in a good piece of analysis by Morris Davis and Jonathan Heathcote, respectively, from the University of Wisconsin-Madison and the Federal Reserve Board of Governors). The supply of land is fairly inelastic and as a result, changes in house prices should be determined primarily from demand factors. According to Gregory Mankiw and David Weil, this demand is related to the number of prime-aged, child-bearing households.

As the following chart illustrates, house-price growth (measured by the year-over-year growth rate of nominal house prices constructed by the Office of Federal Housing Enterprise Oversight, or OFHEO) and the growth rate of the civilian labor force (CLF)—a reasonable proxy for prime-aged, child-bearing households—were tightly linked for more than two decades.



That pattern broke down around the time of the 2001 recession. This deviation from presumed fundamentals is well known, and we can use the underlying economic theory to get a rough benchmark for how far from complete the adjustment process may be. Consider a hypothetical path for house prices such that the ratio of the growth rate of the OFHEO index to the growth rate of the civilian labor force is maintained at its pre-2001 historical value. That exercise suggests house-price appreciation of 3.3 percent, represented by the green dashed line in this chart:



An estimate of the "overvaluation" of housing is given roughly by the area below the red line (the actual growth in house prices) and above the hypothetical dashed line. With this alternative growth rate series, the OFHEO index would have been at a level of 301 in the second quarter of 2008, instead of the realized value of 381. If the ratio for the post-2000 period is to return to its historical value, house prices would drop 21 percent from second-quarter 2008 levels.

These numbers are, of course, just ballpark calculations. The future need not look exactly like the past, and even if it does there is no way to predict how close we have to get before economic conditions normalize. But to the extent that the past is in fact a reasonable guide, this simple exercise may provide a sense of how much work remains to be done.

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