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Why Was the Housing-Price Collapse So Painful? (And Why Is It Still?)

Foresight about the disaster to come was not the primary reason this year's Nobel Prize in economics went to Robert Shiller (jointly with Eugene Fama and Lars Hansen). But Professor Shiller's early claim that a housing-price bubble was full on, and his prediction that trouble was a-comin', is arguably the primary source of his claim to fame in the public sphere.

Several years down the road, the causes and effects of the housing-price run-up, collapse, and ensuing financial crisis are still under the microscope. Consider, for example, this opinion by Dean Baker, co-director of the Center for Economic and Policy Research:

> ...the downturn is not primarily a "financial crisis." The story of the downturn is a simple story of a collapsed housing bubble. The $8 trillion housing bubble was driving demand in the U.S. economy in the last decade until it collapsed in 2007. When the bubble burst we lost more than 4 percentage points of GDP worth of demand due to a plunge in residential construction. We lost roughly the same amount of demand due to a falloff in consumption associated with the disappearance of $8 trillion in housing wealth.
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> The collapse of the bubble created a hole in annual demand equal to 8 percent of GDP, which would be $1.3 trillion in today's economy. The central problem facing the U.S., the euro zone, and the U.K. was finding ways to fill this hole.

In part, Baker's post relates to an ongoing pundit catfight, which Baker himself concedes is fairly uninteresting. As he says, "What matters is the underlying issues of economic policy." Agreed, and in that light I am skeptical about dismissing the centrality of the financial crisis to the story of the downturn and, perhaps more important, to the tepid recovery that has followed.

Interpreting what Baker has in mind is important, so let me start there. I have not scoured Baker's writings for pithy hyperlinks, but I assume that his statement cited above does not deny that the immediate post-Lehman period is best characterized as a period of panic leading to severe stress in financial markets. What I read is his assertion that the basic problem—perhaps outside the crisis period in late 2008—is a rather plain-vanilla drop in wealth that has dramatically suppressed consumer demand, and with it economic growth. An assertion that the decline in wealth is what led us into the recession, is what accounts for the depth and duration of the recession, and is what's responsible for the shallow recovery since.

With respect to the pace of recovery, evidence supports the proposition that financial crises without housing busts are not so unique—or if they are, the data tend to associate financial-related downturns with *stronger*-than-average recoveries. Mike Bordo and Joe Haubrich, respectively from Rutgers University and the Federal Reserve Bank of Cleveland, argue that the historical record of U.S. recessions leads us to view housing and the pace of residential investment as the key to whether tepid recoveries will follow sharp recessions:

> Our analysis of the data shows that steep expansions tend to follow deep contractions, though this depends heavily on when the recovery is measured. In contrast to much conventional wisdom, the stylized fact that deep contractions breed strong recoveries is particularly true when there is a financial crisis. In fact, on average, it is cycles without a financial crisis that show the weakest relation between contraction depth and recovery strength. For many configurations, the evidence for a robust bounce-back is stronger for cycles with financial crises than those without...
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> Our results also suggest that a sizeable fraction of the shortfall of the present recovery from the average experience of recoveries after deep recessions is due to the collapse of residential investment.

From here, however, it gets trickier to reach conclusions about why changes in housing values are so important. ~~Simply put, why should there be a "wealth effect" at all? If the price of my house falls and I suffer a capital loss, I do in fact feel less wealthy. But all potential buyers of my house just gained the opportunity to obtain my house at a lower price. For them, the implied wealth gain is the same as my loss. If buyers and sellers essentially behave the same way, why should there be a large impact on consumption?~~ *

I think this notion quickly leads you to the thought there is something fundamentally special about housing assets and that this special role relates to credit markets and finance. This angle is clearly articulated in these passages from a Bloomberg piece earlier in the year, one of a spate of articles in the spring about why rapidly recovering house prices were apparently not driving the recovery into a higher gear:

> The wealth effect from rising house prices may not be as effective as it once was in spurring the U.S. economy...
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> The wealth effect "is much smaller," said Amir Sufi, professor of finance at the University of Chicago Booth School of Business. Sufi, who participated in last year's central-bank conference at Jackson Hole, Wyoming, reckons that each dollar increase in housing wealth may yield as little as an extra cent in spending. That compares with a 3-to-5-cent estimate by economists prior to the recession.
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> Many homeowners are finding they can't refinance their mortgages because banks have tightened credit conditions so much they're not eligible for new loans. Most who can refinance are opting not to withdraw equity after the first nationwide decline in house prices since the Great Depression reminded them home values can fall as well as rise...
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> Others are finding it difficult to refinance because credit has become a lot harder to come by. And that situation could worsen as banks respond to stepped-up government oversight.
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> "Credit is going to get tighter before it gets easier," said David Stevens, president and chief executive officer of the Washington-based Mortgage Bankers Association...
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> "Households that have been through foreclosure or have underwater mortgages or are otherwise credit-constrained are less able than other households to take advantage" of low interest rates, Fed Governor Sarah Bloom Raskin said in an April 18 speech in New York.

(I should note that Sufi et al. previously delved into the relationship between household balance sheets and the economic downturn here.)

A more systematic take comes from the Federal Reserve Board's Matteo Iacoviello:

> Empirically, housing wealth and consumption tend to move together: this could happen because some third factor moves both variables, or because there is a more direct effect going from one variable to the other. Studies based on time-series data, on panel data and on more detailed, recent micro data point suggest that a considerable portion of the effect of housing wealth on consumption reflects the influence of changes in housing wealth on borrowing against such wealth.

That sounds like a financial problem to me and, in the spirit of Baker's plea that it is the policy that matters, this distinction is more than semantic. The policy implications of an economic shock that alters the capacity to engage in borrowing and lending are not necessarily the same as those that result from a straightforward decline in wealth.

Having said that, it is not so clear *how* the policy implications are different. One possibility is that diminished access to credit markets also weakens policy-transmission mechanisms, calling for even more aggressive demand-oriented "pump-priming" policies of the sort Dean Baker advocates. But it is also possible that we have entered a period of deep structural repair that only time (and not merely government stimulus) can (or should) engineer: deleveraging and balance sheet repair, sectoral resource reallocation, new consumption habits, new business models driven by both market and regulatory imperatives, you name it.

In my view, it's not yet clear which policy approach is closest to optimal. But I am fairly well convinced that good judgment will require us to think of the past decade as the financial event it was, and in many ways still is.

**Update:* A colleague pointed out that my example describing housing price changes and wealth effects may be simplified to the point of being misleading. Implicitly, I am in fact assuming that the flow of housing services derived from housing assets is fixed, a condition that obviously would not hold in general. See section 3 of the Iacoviello paper cited above for a theoretical description of why, to a first approximation, we would not expect there to be a large consumption effect from changes in housing values.

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