Credit Markets and the Great Housing Convulsion

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The Great Housing Convulsion

What Caused It?

• Low interest rates, easy mortgage approvals and high loan-to-value levels can only explain a tiny fraction of the boom and bust.

What to do about it?

• We still should rethink Federal subsidies to borrowing as well as stringent local land-use regulations.

• Bubbles will not disappear but their damage can be reduced if we stop subsidizing extreme borrowing and overly stringent land-use regulation.
The Credit Market View

- Many prominent economists have been associated with the view that low interest rates are responsible for the bubble.
- Basic logic is that the cost of carrying a home is
  \[- (\text{Interest Rate} + \text{Local Taxes} + \text{Etc.}) \times \text{Prices}.\]
- If the cost of renting and ownership are equal, then increases in price will offset declines in interest rates.
- During the boom, this logic justified high prices. ("Bubble Trouble, Not Likely").
Four Forces that Reduce the Connection Between Interest Rates and Housing Prices

1. Elastic housing supply means new building can satisfy demand.
2. Interest rates change and people will think about selling.
3. Interest rates change and people can refinance.
4. People do not necessarily value future price gains more if interest rates fall.

These effects can reduce the expected interest rate-house connection by more than 75 percent.
What Does the Data Say?

• Between 2000 and 2006, real rates fell by 1.3 percentage points and real prices rose by 74 percent (Case/Shiller) or 30 percent (FHFA).
• The longer-term relationship between prices and rates is 6.8 percent per 100 basis points.
• The effect is slightly larger at low rates and in inelastic housing markets (8 percent).
• At best, this gives you a 10.4 percent increase in prices – which does not explain the boom.
House Prices and the Federal Funds Rate

- Log Real FHFA National Price Index
- Real rate based on 10-year T-Bond
The Price Bubble and Limits on New Housing

- Classify areas in easy-to-build (elastic) [Houston, Dallas, Atlanta] and hard-to-build (inelastic) [Boston, San Fran] based on regulation and topography.

- The typical “inelastic” area saw real prices grow by 98% from 1996-2006.

- The median “elastic” areas saw real prices grow by 18.4%.

- This provides us with yet another reason for rethinking land use regulation– price stability.
Other Credit Market Effects

- Estimate mortgage approval rates using HMDA data – year/MSA effects with controls.
- Prices rise from .77 to 2.52 times approval rate increases across time and space (IV).
- Mortgage Approval Rates actually fell from 2000-2006 and only went up by 3.8 percent 2000-05.
- We also estimated Loan-to-Value Effects using DataQuick: price rise equals .54 times LTV.
- But median LTV only rose from .84 to .88 from 1998 -2006.
Mortgage Approval Rates and House Prices
1990 - 2008

[Scatter plot showing the relationship between mortgage approval rates and house prices from 1990 to 2008. The plot includes a trend line.]
Moving Forward

• Recovery vs. Reform:
  – Recovery pushes towards doubling down.
  – Reform towards rethinking the system.

• But prices seems to have stabilized and we can now contemplate serious action to reduce the costs next time.

• The federal government did not cause the bubble, but subsidizing borrowing with the Home Mortgage Interest Deduction and the GSEs did not help.
Reasons to be Against Subsidizing Borrowing

**Reason #1:** Since prices go down as well as up, promoting borrowing can lead to a “foreclosure” rather than an “ownership” society.

**Reason #2:** Promoting homeownership means being against density and being for sprawl.

- 86 percent of single-family detached houses are owner-occupied, while 86 percent of units in 3+ unit structures are rented.
- Car commuting is 10 percent higher among homeowners.
Building Stock and Owner-Occupied Housing
Reason #3: Homeownership and the Environment

Encouraging people to borrow to bet on housing also leads them to buy bigger homes and that makes no sense.

• Even poor Americans consume twice as much housing as average Englishmen or Frenchman.

• Homes with between 2,500 and 3,000 square feet of heated living space use 41 percent more electricity than homes with between 1,500 and 2,000 square feet
Reason #4: Homeownership and Redistribution

• According to Poterba and Sinai, tax savings are $523 per year in taxes for home-owning families earning between $40,000 and $75,000.
• But they are $5,459 per year for families earning more than $250,000.
• Poorly targeted to promote homeownership.
• One move is to reduce the $1 million limit on the HMID by $100k/year for 7 years.
In Conclusion

• Past decade illustrated the significance of the housing market to the U.S. economy.
• It also showed that house prices can move down as well as up and that buying a home is not always a wise decision.
• Hopefully, both private buyers and the public sector will apply that lesson to a variety of housing-related policies.