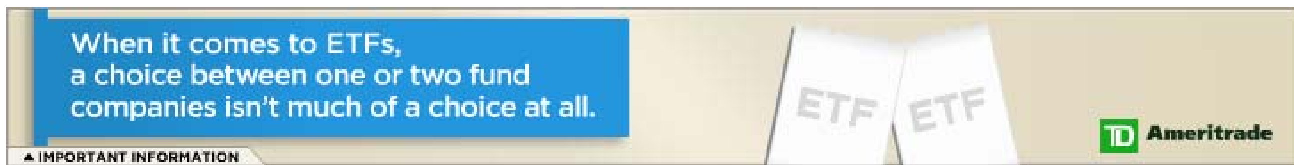

Do Falling Home Prices Imperil Recovery?

By ALAN REYNOLDS
Posted 12/30/2010 07:05 PM ET

Non-Wealth Effect

Estimated household net worth, in trillions

	Total	Home equity
2005	$59.5	$13.2
2006	64.1	12.8
2007	64.2	10.3
2008	51.5	6.9
Q1 2009	48.9	6.0
Q2 2009	50.7	6.3
Q3 2009	53.1	6.5
Q4 2009	53.8	6.7
Q1 2010	55.1	6.9
Q2 2010	53.7	7.0
Q3 2010	54.9	6.4

Source: Federal Reserve

View Enlarged Image

A front-page Wall Street Journal feature, titled "Housing Recovery Stalls," worries that "a new bout of declining home prices is threatening to hamper the U.S. recovery."

A dip in the Case-Shiller moving average of home prices in 20 cities for August to October is said to be "troublesome headwind" for the economy in 2011, and "markets such as Sacramento, Las Vegas and parts of Arizona and Florida are at risk of more declines."

Some of those cities may indeed account for a significant share of the Case-Shiller index, because that index covers only 20 cities (and Sacramento, the centerpiece of the story, is not one of them). However, a few troubled cities in a few states do not represent the entire nation.

The Federal Housing Finance Agency (FHFA), which examines all 50 states, reported home prices rising in October. The FHFA found third-quarter home prices higher than a year ago in 10 states, but seven of those 10 are excluded from the Case-Shiller index.

Yet even Case-Shiller shows home prices higher than a year ago in three cities where the boom-bust cycle was quite severe — Los Angeles, San Diego and San Francisco.

Writing ominously about the Case-Shiller index in the Wall Street Journal, however, bearish author Peter B. Schiff prophesizes that home prices all over the country will fall by somewhere between 24.32% and 28.3% over the next five years.

He imagines home prices must magically revert to some "3.35% annual 100-year trend line," even though no prices of any assets or goods have ever followed such a century-long "trend." This is utter nonsense.

To get closer to reality, suppose home prices in 2011 really did keep falling in "Sacramento, Las Vegas and parts of Arizona and Florida." So what? GDP growth depends on new production, not on prices at which existing homes change hands. In November, housing starts were up 3.9% and new homes sales were up 5.5%.

Falling home prices ultimately help the homebuilding industry because lower prices increase home sales and shrink the excess inventory of existing homes. The stock of existing homes fell to 9.5 months of supply in November from 12.5 months in July. That, not "stalling" prices, is the housing recovery that matters.

Moreover, new homebuilding often occurs in cities where home prices are not falling. Regardless of troubles in Sacramento and Las Vegas, the National Association of Home Builders reports year-to-date increases in building permits of 172% in San Jose (through October) and 88% in Carson City. Surprisingly, building permits were also up 59% in Miami and 133% in Detroit.

The most persistently incorrect argument about the alleged dangers of letting overpriced homes fall to an affordable level is that falling home prices supposedly have a devastating effect on household wealth.

"Homes remain a key part of Americans' wealth," says the Journal article. "Households held $6.4 trillion of home equity at the end of the third

quarter, alongside $12.2 trillion in stocks and mutual fund shares. ... For every dollar decline in housing wealth, consumers reduce spending by about a nickel in the subsequent 18 months, Moody's Economy.com chief economist Mark Zandi estimates."

The table alongside shows that the $6.4 trillion of home equity in the third quarter was only 11.9% of estimated household wealth, which was $54.9 trillion. The Journal's reference to "$12.2 trillion in stocks and mutual fund shares" leaves out retirement accounts, bonds, rental property, farmland, precious metals and family-owned businesses, among other things.

Housing wealth has no more impact on consumer spending than any other sort of wealth. In fact, the $6 trillion increase in overall household wealth since early 2009 was nearly as large as total home equity. The five-year decline in home equity is partly because homeowners took out larger mortgages to cash out equity while home prices were rising.

The notion that an assumed "double dip" in housing prices might cause a double dip in real GDP confuses home prices with homebuilding. Many who now warn of grave dangers arising from a brief dip in the Case-Shiller index are the same folks who once told us, quite incorrectly, that the economy could never recover until the Case-Shiller index turned decisively upward.

Lower prices on homes are clearly helping recent home buyers, leaving them with more money to spend on other things. Sellers, real estate agents and mortgage lenders prefer higher prices, of course. But that is why government policy should never favor sellers over buyers.

In short, anxiety about falling home prices is based on (1) a limited sample of 20 cities, (2) confusing home prices with homebuilding, (3) forgetting that lower prices are as beneficial to buyers as they are harmful to sellers and (4) grossly exaggerating the importance of housing to overall wealth.

• Reynolds is a senior fellow with the Cato Institute and the author of "Income and Wealth" (Greenwood Press, 2006).

© 2010 Investor's Business Daily, Inc. All rights reserved. Investor's Business Daily, IBD and CAN SLIM and their corresponding logos are registered trademarks of Data Analysis Inc. Copyright and Trademark Notice | Privacy Statement Terms | Conditions of Use