HIGHLIGHTS

Housing Prices Continue to Grow at Healthy Rates

Strengthening economy suggests no immediate decline in values

Real housing prices have been on the upswing since 1994, raising questions as to whether the market will soon cycle downwards. The largest housing price increases have taken place since 1997. In recent decades, housing prices have appreciated significantly for about 4 to 5 years prior to entering periods of real decline. This is the pattern that we observe from the cycles that characterized both the late 1970s and late 1980s.

In the cycle that characterized the late 1970s, annual average housing prices rose 13.8 percent between 1975 and 1979, and then declined by 9.6 percent by 1982 (see the dotted line on the figure below)[1]. An upward swing began in 1982 that extended through 1989 and resulted in a cumulative 18.7 percent growth. The bulk of the appreciation during this period occurred after 1984. This was followed by a more moderate decline of 7.6 percent, which bottomed out in 1994. The most recent expansion has resulted in over 22 percent annual average growth through 2001. The most recent quarter indicates this expansion is still continuing, with approximately 1.5 percent real house price growth since 4th quarter of last year.

So what is to be inferred from all of this information regarding the current state of housing markets? Based on historical experience alone, it would appear that some decline is forthcoming. However, a broader economic context should be taken into account. As is shown in the figure below, housing markets in the 1970s and 1980s generally followed trends in business cycles[2]. In the cycle of the late 1970s, an upturn in growth is timed perfectly with an upward business cycle, and the peak of the business cycle matches the peak of the housing cycle. A succeeding slowing of economic growth is matched with a decline in real housing prices that is longer in duration than the economic downturn. A similar phenomenon occurs in the 1980s, with housing prices rising during the boom time and then slowing with the recession of the early nineties.

What makes the current scenario markedly different is that while we see a commensurate upward swing in housing price growth timed with an economic expansion in the late nineties and through 2000, the "recession" experienced in 2001 was very moderate compared to those characterizing the early 1980s and 1990s. In fact, economic activity declined only between second and third quarters of 2001 and has been growing since then. As housing markets typically perform well in periods of economic growth, the current market characteristics do not suggest comparable declines to those we observed in previous downturns.

On the other hand, housing prices cannot appreciate at rates substantially greater than those of general inflation indefinitely. Eventually new supply will meet the demand, and housing prices will soften. Supply is often slow to respond to demand, as there is limited building space and also regulations that inhibit the speed at which new stock may be put into place. In a recent press release, however, the National Association of Realtors note that the inventory of housing is beginning to

[1] For smoothing, annual average HPI is used. This is deflated using the annual average CPI less shelter, provided by the Bureau of Labor Statistics at www.bls.gov.

[2] Real GDP is taken from the Bureau of Economic Analysis and is available at www.bea.doc.gov. An index of growth is created from the annual average GDP numbers for simplifying comparison to HPI growth.

increase. As the supply of available housing increases over the next few years, this should put some downward pressure on prices. However, potential declines may be significantly lower than those observed in the early eighties and early nineties if economic growth continues at a healthy rate.

Figure 1: Real Gross Domestic Product and the OFHEO HPI Since 1975