

## **Housing in Colorado and the Nation**

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The Colorado economy has outperformed the national economy in many respects over the last year. Employment growth, for example, has been stronger in Colorado than in the nation. But there are some serious concerns about growth at both the national and state levels, and the housing market is one of those concerns. Declining residential investment has been a drag on national economic growth over the last year. The Colorado news reports are also filled with stories of softer housing prices and rising mortgage foreclosures. Should we expect a weakening housing market to pull Colorado's economic growth down closer to—or even below—the national growth rate?

I will spend some time reviewing economic developments in the state and national housing markets. The bottom line is—in my view—a fairly positive one. Although declining home building and softer house prices may hold back economic growth somewhat, Colorado is well positioned to weather the housing market correction. But before I get into the specifics on housing, let's look briefly at the broader Colorado economy.

### Colorado's Economic Performance

How does Colorado's economic performance compare with the nation's? An important and timely indicator of the state economy is employment. Nonfarm payroll employment grew faster in Colorado than in the nation as a whole over the last year. Colorado's nonfarm employment grew by almost 48,000 jobs over the year ending in April. That amounts to 2.1 percent growth in nonfarm employment, well above the national growth rate.

Employment grew nearly 20 percent over the last year in Colorado's booming energy and mining sector. But despite these rapid gains, natural resources and mining is a small sector with only 24,000 jobs out of the state's total 2.3 million jobs. The rapid growth in natural resource employment thus had a limited effect on labor conditions statewide, although the effect was larger in energy-producing regions. Other goods-producing sectors were much weaker over the year ending in March, with construction employment and manufacturing employment both declining.

The bulk of employment growth was in the service sector. Service-producing industries account for 85 percent of Colorado's employment, and many of these sectors have grown solidly. For example, employment grew 3 ½ to 4 percent in education and health services, leisure and hospitality, and professional and business services. Two of the weaker service-producing sectors were retailing and financial activities.

Above-average employment growth has produced relatively tight labor markets in Colorado. The unemployment rate was 3.5 percent on a seasonally adjusted basis in April, well below the national rate of 4.5 percent.<sup>1</sup>

Moreover, unemployment fell in all major Colorado cities over the year ending in March. The unemployment rate fell 0.6 percentage point in Denver over the last year, matching the state's decline. The lowest unemployment rates on a seasonally unadjusted basis were in Boulder and Grand Junction (both at 3.4 percent).

Colorado's per capita income was among the highest in the nation last year. Per capita personal income rose 4.5 percent in Colorado, slightly below the national rate.

That should not obscure the positive news that Colorado's personal income was the

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<sup>1</sup> On a seasonally adjusted basis, Colorado's unemployment rate was 3.6 percent in March, compared with a national rate of 4.4 percent.

eighth highest in the nation. Colorado's educated workforce and diversified economy should keep the state high in the per capita income rankings in the years ahead.

The Colorado economy has thus performed well over the past year. But the national adjustment in housing activity and rising subprime mortgage problems create uncertainty about the future economic performance.

#### The National Housing Correction

Since the beginning of last year, there has been a substantial cooling of housing activity in most of the country. Nationally, single-family housing permits are about 40 percent below their previous peak in September 2005. In addition, new and existing home sales have declined sharply, and real residential investment—the housing component of GDP—has declined for six straight quarters.

Some further weakness in residential investment is already built into most economic forecasts. For example, the latest Blue Chip consensus survey of economic forecasters has residential investment falling again this year but flattening out in 2008. Although the risk of a sharper-than-predicted slowdown in residential investment and large home price declines cannot be dismissed entirely, there are reasons to think the adjustment in the housing market may be more moderate going forward.

We have begun to see some signs that the housing market may be nearing the bottom. Housing starts, for example, have increased for the last three months. That said, the sharp weather changes from the end of 2006 to the first part of 2007 make it difficult to discern the underlying trends in housing. Several more months may be needed before we can confidently judge the state of the housing market.

The slowdown in home sales and the increased inventory of unsold homes have dramatically reduced the rate of home price appreciation. The OFHEO national house price index rose at less than a 2 percent rate in the second half of 2006. Other price indexes that include the subprime market show even lower rates of price growth, and in some areas of the country where house prices were most elevated, home prices have been falling.

Both nationally and in Colorado, a leading story has been rising delinquency and foreclosure rates in the subprime market. A subprime mortgage is a loan made to a borrower who cannot qualify for a “prime” interest rate because of a credit history involving a low credit rating, payment delinquencies, high debt burdens or other credit problems. Subprime mortgages were 14 percent of outstanding mortgages at the end of 2006, and many of these had an adjustable rate.

The increase in short-term interest rates over the last few years has caused monthly payments on adjustable-rate mortgages to rise, pressuring the finances of some subprime borrowers and raising foreclosure rates. Growing subprime credit problems have raised concerns about future economic performance. Here in Colorado, the Division of Housing forecasts that foreclosure filings may increase to about 36,000 this year, a 25 percent increase over 2006. However, foreclosure rates are much lower for counties on the Western Slope than for those on the Front Range.

I think it is important that we not blow the rise in subprime credit problems out of proportion. Rising mortgage defaults and delinquencies certainly may slow the housing recovery and hold back consumer spending. But subprime problems have not had substantial spillover effects on the prime mortgage market or other major financial

markets. Subprime mortgages are still a fairly small share of outstanding mortgages, many subprime borrowers will continue to make their monthly payments, and the foreclosures that do occur will be spread over time. As a result, any depressing effect from the sale of foreclosed homes to home prices will likely not be large, and the wealth effects from any home price declines to other types of consumer spending will probably not be enough to have major macroeconomic consequences.

If you don't believe economic forecasters on the subject of subprime mortgages, I can't really blame you. No one has ever really asked me after a presentation like this the most basic question, "If you are so smart, why aren't you rich?" However, if you have ever been tempted to ask an economist that question, you might prefer to believe someone who is very rich, "the sage of Omaha." At his recent shareholders meeting, Warren Buffet said of the subprime mortgage problem, "You'll see plenty of misery in that field. You've already seen some. I don't see a big impact on the economy though."

I do not mean to say that we may not see further weakness in housing activity and prices, but at this point, the evidence that the housing market adjustment is unlikely to derail the broader economic expansion.

### The Colorado Housing Market

As is true at the national level, housing activity has softened in Colorado over the last year. Single-family housing permits in Colorado fell about 36 percent over the year ended in March, a little larger decline than for the nation. On the other hand, existing home sales increased 0.8 percent over the last year in Colorado, compared with a 6.6 percent decline nationally, according to statistics from the National Association of Realtors.

The OFHEO index shows Colorado home prices appreciated 3.3 percent from the fourth quarter of 2005 to the fourth quarter of 2006. This increase was below the 5.9 percent national rate. In fact, Colorado ranked 43<sup>rd</sup> among the 50 states in home price appreciation last year, and had below average price gains over a 5-year period as well. Thus, the state as a whole did not share in the recent boom in home prices.

But as they say, what matters in real estate is location, location, location. Home price gains have varied substantially across Colorado cities. Denver and Fort Collins had weak home price gains. But home prices appreciated solidly in Colorado Springs and surged 13 percent in Grand Junction.

Although the OFHEO index is a good one, there seems to be no perfect house price index. The OFHEO index does not include homes financed by subprime mortgages and also does not include very expensive homes financed by jumbo mortgages. In addition, the most recent OFHEO numbers cover the fourth quarter of 2006, and we will not get a report on the first quarter of 2007 until the end of this month.

As a result, it is worth looking at some alternative measures of home prices. These alternative measures generally paint a somewhat weaker picture of home prices in Colorado and the nation. Median existing home prices from the National Association of Realtors, for example, declined 2.0 percent from the first quarter of 2006 to the first quarter of 2007 in the Denver metropolitan area. This decline is about the same as the 1.8 percent decrease in existing home prices at the national level over this period. Even better news is that home prices rose moderately in Boulder and Colorado Springs over this period.

Another alternative measure is the S&P Case-Shiller home price index for Denver. This index uses a similar methodology to the OFHEO index, but includes the less expensive and more expensive homes missed by the OFHEO index. This index only covers 20 large cities around the country, however, which is a drawback when trying to assess national home price changes or home prices in Colorado cities other than Denver. This index does suggest somewhat larger home price declines than are seen in the OFHEO index for Denver. The S&P Case Shiller for index was still rising last fall, but has declined about 1.7 percent over the year ending in February.

Looking forward, I think Colorado's housing market is likely to fare better than many major metropolitan markets for several reasons. One is that Colorado is expected to have faster population growth than the nation. According to the Office of State Planning and Budgeting, Colorado's population is projected to rise at a 1.7 percent annual rate in 2007 to 2009. Although this growth rate is down slightly from last year, it exceeds national population growth projections, shown by the solid horizontal line.

In addition, even though employment growth is expected to moderate in 2007, Colorado should continue to add jobs faster than the nation as a whole. Moody's Economy.com, a private-sector consulting firm, projects year-over-year growth will slow to about 1.7 percent in 2007 before rising slightly to 1.8 percent in 2008.

Colorado should withstand the housing correction fairly well because it has not experienced the large home price gains seen in hotter real estate markets around the country. Going forward, home prices will likely be weakest in two kinds of markets. First, some parts of the country had rapid home price gains, which made homes

increasingly less affordable and fueled speculative purchases. Some of these overheated markets have slowed substantially and home prices are now declining.

Second, some areas are experiencing large home price declines even though they never really participated in the housing boom in the first place. These areas are facing weak local economies and the loss of jobs and population. Such areas include parts of the industrial Midwest, such as Michigan and Ohio, where the cutbacks in domestic auto production have hurt the local economies.

Colorado does not fit either of these cases. Employment and population are projected to grow faster than the national rate over the next few years, while home prices rose less than the national average over the last five years. All in all, the state seems well positioned to weather the housing correction.

But as a cautionary note, subprime mortgage problems may have localized effects. Subprime lending may concentrate in particular neighborhoods or cities, and rising subprime credit problems may put more downward pressure on home prices in such areas. Given the changes in mortgage and housing markets in recent years, there is considerable uncertainty about how these localized pressures might play out. But overall, I expect the state to fare better than the nation as a whole as the housing market adjusts.

### Conclusion

To summarize, Colorado's economy has outperformed the nation's over the last year. Employment growth has been stronger, and the unemployment rate is lower. Moreover, population and employment are projected to continue growing faster than national averages this year and next. Colorado also has high levels of education and personal income. Such factors should support the demand for housing.



In addition, Colorado's home prices have increased at a below-average pace in recent years, suggesting home values are closer to underlying values than in some of the hotter markets around the country. Although rising subprime credit problems introduce some uncertainties into the housing outlook, the economic effects of rising foreclosures and delinquencies should not be exaggerated. On net, Colorado appears well positioned to weather the housing market correction.

Unfortunately, we do not have Warren Buffet here to answer questions tonight. But an important part of Economic Forums is interacting with you through the Q&A, dinner conversations, and so forth. Many of you are truly more expert on the Colorado housing market than I am, so I would be pleased to get your questions and comments.