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2007's Housing Market

NOT YET RECOVERING FROM RECENT ILLS

ALAN CLAYTON-MATTHEWS

The Massachusetts economy is currently on a trajectory that is similar to that of the national economy, at least as measured in the aggregate. During the second quarter of the calendar year, the U.S. economy grew at an annualized rate of 3.4 percent. During the same period, the Massachusetts economy grew at 3.6 percent annual rate of growth, down from a strong 4.1 percent rate in the first quarter. The state's economy is being pulled in two directions. On the upside, strong demand for the state's technology, science, knowledge, and health-based goods and services is creating good job and income growth. On the downside, the housing market slump is restraining employment growth and consumer spending in related sectors. There is also growing concern about the spillover effects to the economy from the subprime mortgage sector collapse.

These two opposing forces are reflected in differences in recent employment trends by sector in Massachusetts. Employment in computer systems design; management, scientific, and technology consulting; scientific research and development; software; securities, commodity, and investment finance; and health care has been expanding at more than twice the overall payroll employment growth of 1.1 percent over the past year.

Employment in sectors related to housing, such as construction, and retail sales of furniture and building materials, have declined over the past year. Consumer spending tied to the wealth and credit that rising home prices provided has also weakened. This is reflected in June '06 to '07 declines in retail employment in general merchandise stores and motor vehicle and parts dealers, declines in motor vehicle sales taxes, and weak growth in other sales taxes.

The housing market pain is not over yet

The housing market, which began weakening in 2005, declined in 2006, with a sharp fall in sales and permits, modest price declines, and a large increase in inventories. Mortgage delinquencies and foreclosures rose. According to the Massachusetts Association of Realtors (MAR), sales in 2006 fell 12 percent for single-family homes and 10 percent for condominiums from the prior year, while



2006 median prices for single-family homes averaged 2.5 percent lower, and condos 0.1 percent lower, than in 2005. Meanwhile, active listings rose 27 percent in 2006, putting further downward pressure on prices. The U.S. Department of Housing and Urban Development's Office of Federal Housing Enterprise Oversight (OFHEO) new purchase-only house price index fell a moderate 0.8 percent in 2006.

The support that appreciation of housing values and low or falling interest rates gave to the economy during the recession and first years of expansion diminished with the housing slump. With credit tapped out, consumer spending, as indicated by regular sales tax revenues for use and services, barely kept up with inflation in 2006. Retail trade employment fell for the second straight year, by 0.3 percent. With declining residential building, construction employment fell for the first year since the expansion began, by 1.1 percent.

Recent trends in two alternative sources of information on the Massachusetts housing market give different signals for developments in the housing market near the end of last year and the beginning of this year. The OFHEO purchase-only house price index for the state shows that prices of single-family homes (on a seasonally adjusted basis) declined for the last four successive quarters (the data end in the first quarter of this year). According to this index, prices in the first quarter of 2007 were 4.0 percent below the peak in the first quarter of 2006.

According to the MAR's data, on the other hand, single-family home prices (on a seasonally adjusted basis) rose in the last quarter of 2006 and first quarter of 2007,

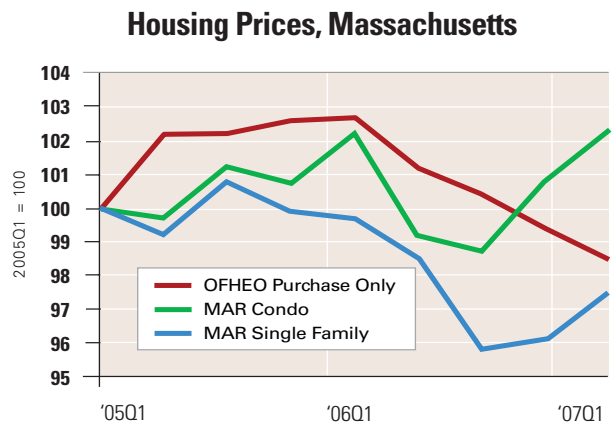
so that prices in the first quarter of this year were 1.8 percent higher than in the third quarter of 2006. According to the MAR data, single-family home prices — on a quarterly basis — fell 5.0 percent from the peak in the third quarter of 2005, before recovering 1.8 percent of that drop in the last two quarters.

Inventory has also improved, as measured by the MAR's active listings. In May, the latest month of available data, active listings of single-family houses and condominiums were down 21 percent from the prior year (they are no longer reported separately for single family and condos), and, on a seasonally adjusted basis, are about at the same level they were in mid 2005; still high, but much closer to "normal" levels than a year ago.

Does this mean that the housing market has hit bottom, and is now on its way back? Probably not. Even if the MAR data are "right" and the OFHEO data are "wrong," it's too early to tell if the corner has been turned, or if the recent improvement were simply a "dead cat bounce." The crucial months for the housing market are the summer months. In June, for example, single-family sales are typically 40 percent higher than in the average month, so the next few months will reveal whether or not conditions are improving.

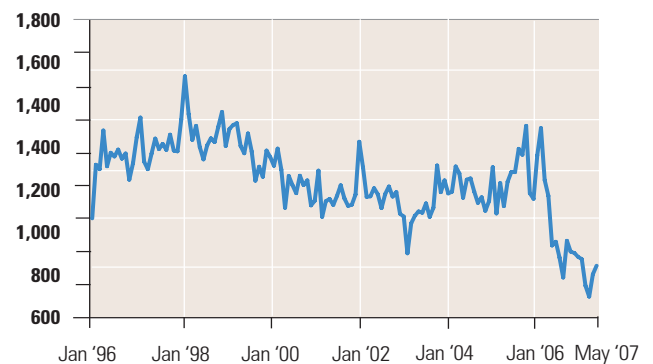
Moreover, several other factors suggest that the housing slump is not yet over, and will probably continue through the rest of this year and into the beginning of next. Most important, many householders are finding it increasingly difficult to hold onto their homes. The rise in delinquency and foreclosure rates has been especially steep for subprime mortgages, and these are likely to continue to rise this year as low-interest "teaser" rates expire and homeowners find they cannot afford to pay the mortgage. Massachusetts is about as exposed to the subprime market as the rest of the country. Nationally, the amount of adjustable rate mortgages that are resetting will continue to rise into the spring of next year.

Banks are tightening lending standards, and mortgage rates are rising — up nearly 60 basis points from the beginning of this year, making it more difficult for buyers to finance purchases, and therefore lowering hous-



Source: Office of Federal Housing Enterprise Oversight; Massachusetts Association of Realtors

Single-Family Housing Permits Number per month, seasonally adjusted



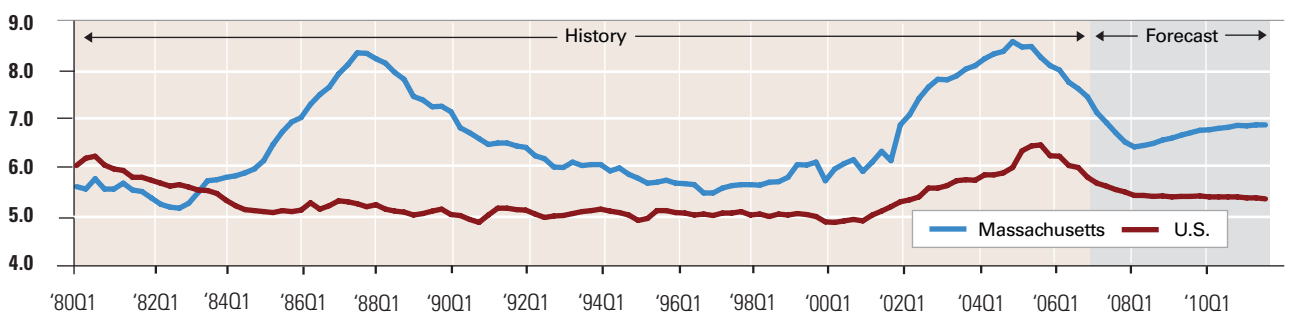
Source: U.S. Bureau of the Census, Seasonally adjusted by author

ing demand. Combined with an inventory of homes that is still large, the market has excess supply and therefore downward pressure on prices.

Home builders curtailed activity sharply last year, and are still reluctant to get back into the market. In the first five months of this year, on a seasonally adjusted basis, single-family housing permits averaged 22 percent below the average for 2006 and 32 percent below the average for 2005.

Finally, housing prices in Massachusetts are way out of line with the rest of the country. If households across the nation spent the same fraction of incomes on homes, then the house price to income ratio would be similar from

Ratio of Median House Price to Per Capita Personal Income



Source: New England Economic Project, Moody's Economy.com

State Data Section

state to state. The ratio of median single-family home prices to per capita personal income has fluctuated over the past few decades, with the ratio in Massachusetts twice diverging far above that of the nation. The first episode was in the mid 1980s, during the housing bubble near the end of the “Massachusetts miracle” years. The second episode began at the end of the tech bubble, and reached its peak at the beginning of 2005. The success of the state’s economy in the 1980s and 1990s allowed the run-up in prices, but it takes a strong local economy to maintain the disparity. The parity between Massachusetts and the nation was almost fully restored by the mid 1990s, as home prices in the state fell 14 percent over the course of almost five years between 1988 and 1993, and then grew very slowly for a couple more years. This time around, the price-to-income ratio in Massachusetts has already fallen from a high of 8.6 in the first quarter of 2005 to 7.6 in the last quarter of 2006. In the face of a relatively slow-growing state economy, the New England Economic Partnership is projecting the home price to income ratio to continue to decline to 6.4 by mid 2008 — versus a national ratio of 5.4. Falling house prices of 12 to 14 percent from peak are expected to account for the return to near parity.

Although many homeowners will feel the pain of this adjustment, in the long run it will cure the state’s economy, as the state’s cost of living disadvantage versus the rest of the country will be largely repaired, enabling Massachusetts to compete for households and grow its labor force. However, in the short run, negative spill-overs from the subprime mortgage sector collapse could spread the pain and delay the cure.

ALAN CLAYTON-MATTHEWS, *an associate professor and the director of quantitative methods in the Public Policy Program at the University of Massachusetts Boston, is co-editor of this journal.*

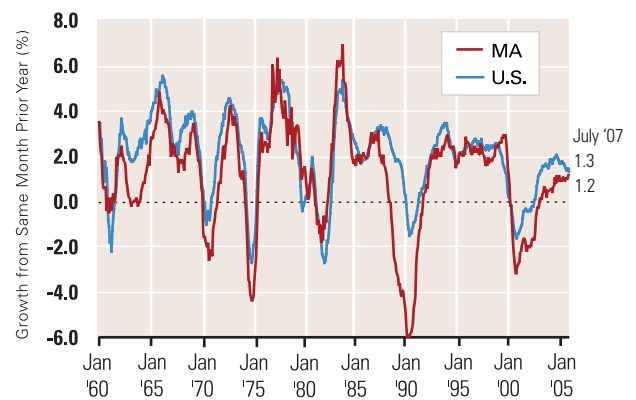
ENDNOTES

1. The data from both HUD and the MAR are seasonally adjusted by the author.
2. Henry, David & Goldstein, Matthew. (2007, July 23). “It’s just going to get worse: Many more borrowers could default when ARM rates rise.” *Business Week*, p. 29.

KEY INDICATORS: RECENT TRENDS

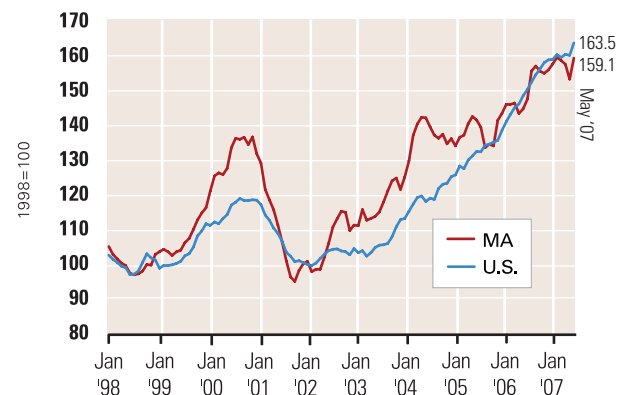
The data in the following figures provide a supplement to the analysis contained in “Economic Currents.” Recent trends in these key data series indicate fast-growing gross product, slow but steady employment growth and therefore fast-growing labor productivity.

PAYROLL EMPLOYMENT GROWTH Massachusetts and U.S.



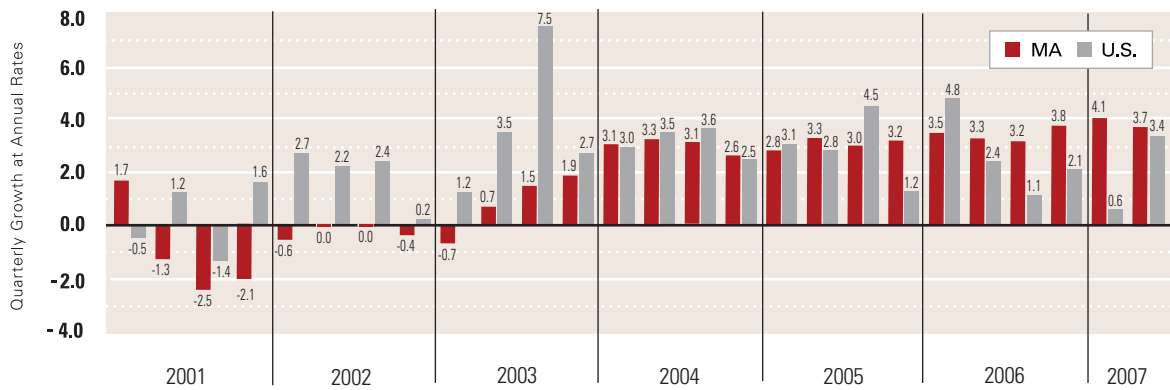
Source: U.S. Bureau of Labor Statistics

MERCHANDISE EXPORTS Seasonally adjusted 3-month moving average



Source: U.S. Department of Commerce, WISERTRADE; seasonally adjusted by author

GROWTH IN REAL PRODUCT • Massachusetts Current Economic Index vs. U.S. GDP



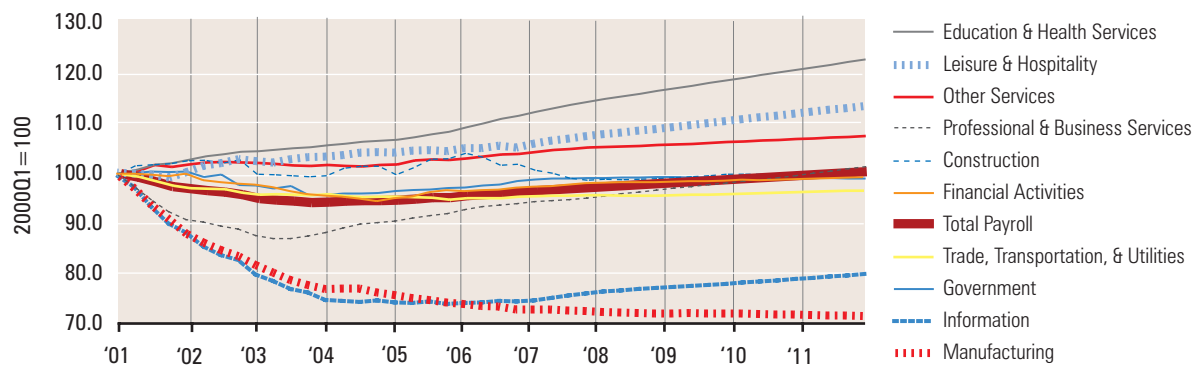
Source: U.S. Bureau of Economic Analysis; MassBenchmarks

MASSACHUSETTS PAYROLL EMPLOYMENT



Source: Massachusetts Division of Unemployment Assistance, CES-790 series, sa

PAYROLL EMPLOYMENT BY INDUSTRY SECTOR, MASSACHUSETTS



Source: New England Economic Partnership (NEEP)