



STATEMENT OF

**PATRICK J. LAWLER
ASSOCIATE DIRECTOR AND CHIEF ECONOMIST
OFFICE OF FEDERAL HOUSING ENTERPRISE OVERSIGHT
(OFHEO)**

ON THE

**“THE HOUSING BUBBLE AND ITS
IMPLICATIONS FOR THE ECONOMY”**

**BEFORE THE COMMITTEE ON BANKING, HOUSING, URBAN
AFFAIRS**

**SUBCOMMITTEE ON HOUSING AND TRANSPORTATION
AND SUBCOMMITTEE ON ECONOMIC POLICY**

**UNITED STATES SENATE
SEPTEMBER 13, 2006**

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I am pleased to be here, where I worked as a Committee staff member some years ago, to testify on housing market developments and prospects. The Office of Federal Housing Enterprise Oversight, OFHEO, has a strong interest in housing markets and particularly in house prices because they have a powerful effect on the credit quality of mortgage loans owned or guaranteed by Fannie Mae and Freddie Mac, the Enterprises we regulate.

Over the past five years, we have witnessed an extraordinary change in the relative price of houses. The general level of house prices soared 56 percent from the Spring of 2001 to the Spring of 2006. The prices of other goods and services rose much less, so that inflation-adjusted house prices are now 38 percent higher than 5 years ago. That exceeds the inflation-adjusted increase in the previous 26 years, going back to the beginning of OFHEO’s data.

A number of factors have contributed to these price gains. Long-term mortgage interest rates fell from about 8 percent in mid-2000 to generally less than 6 percent in the period from early 2003 to mid-2005. Short-term rates declined by more, and borrowers took advantage, as more of them took out adjustable-rate loans. Interest-only and negative

amortization loans provided even lower monthly payments. The spread of these products helped stimulate demand, as did the rapid growth of subprime lending. In 2001, less than 10 percent of new mortgage securities were backed by subprime loans. In each of the past two years, subprime lending has amounted to more than 20 percent of that market.

Demographics have also been favorable. Aging boomers are reaching their peak earning and investing years, with many interested in second homes for vacations or future retirement, and immigration has accelerated household formation. Supply constraints have made it difficult to meet the increased demand. Land use restrictions, environmental and economic impact studies, natural barriers, and existing high densities in some areas have lengthened the time necessary for builders to bring new houses on the market and raised the premiums paid for prime house locations.

Finally, there is some evidence of speculation, as the share of loans made to investors has risen and turnover rates have been high, with anecdotes of property flipping becoming common. Certainly, the poor performance of the stock market early in this decade made an obvious contrast with the investment performance of houses, and that may have encouraged some to shift their investment focus.

House price increases have been uneven across the nation, though. While homeowners in Indiana, Ohio, and Michigan have seen their house values over the past 5 years hardly budge in constant dollars, residents of Florida, California, and here in the District of Columbia have watched prices virtually double, even after adjusting for inflation. The coastal areas have generally had more vibrant economies, more immigration, and more supply constraints.

Over the past year, the pace of house price inflation over most of the country has moderated dramatically. The sharpest decelerations have come in some of the most

superheated markets of a year ago, including Arizona, Nevada, California, and Hawaii in the West and DC, Delaware, Maryland, and Virginia in this area. Nationally, prices rose roughly 1.2 percent in the second quarter of this year, less than the inflation rate for other goods and services in the economy. For comparison, the appreciation rate in the second quarter of last year was approximately 3.6 percent.

Housing markets in New England and the Midwest are showing some of the most significant regional weakness. The relatively anemic New England market has been cooling for the last two years. While Massachusetts, New Hampshire, and Maine saw some of the largest gains in the nation in the late 1990s and early 2000s, rates of price increase have dropped sharply since. Our latest data suggest that prices in those states were virtually unchanged in the second quarter of this year.

Although appreciation rates in the Midwest were only slightly above baseline inflation levels throughout the latest boom, the rates have declined somewhat. Price performance in Indiana, Ohio, and Michigan, in particular, appears weak. Appreciation over the last year was less than three percent in all three states, and, in the latest quarter, prices actually declined.

We are seeing continued price strength in select areas of the country. The areas affected by Hurricane Katrina, for example, have shown strong increases, presumably a result of the loss of housing stock. Prices in Louisiana, for example, rose nearly 12.5 percent between the second quarter of 2005 and the second quarter of 2006. Price appreciation in the second quarter of this year was more than double the national rate in that state. Over the past year, gains in several Katrina-affected cities, including Gulfport-Biloxi and Mobile, were between 15 and 18 percent, the largest one-year increases we have ever recorded for these cities.

Select areas in Texas, as well as parts of the Pacific Northwest, also seem to have fared relatively well. At more than 3.6 percent, quarterly appreciation rates in Oregon, Idaho, and Washington state were more than three times the national average. Appreciation in oil-rich Texas areas like Odessa and Midland, also appears to have been strong.

Other market indicators confirm the general chilling of housing markets across the nation. Particularly noteworthy is the swelling inventory of unsold houses on the market, which has risen to 4.5 million from levels generally below 3 million in 2003 and 2004. As sales rates have fallen at the same time, inventories are now more than 7 times monthly sales, the highest since the early 1990s.

Historical patterns of price behavior in housing markets may provide some guidance about potential future developments. OFHEO's national House Price Index has never fallen over a period of a year or more, but it has come very close, and inflation-adjusted prices have fallen significantly, by 11 percent in the early 1980s and by 9 percent in the early 1990s. In the first instance, it took nearly 8 years for inflation-adjusted prices to regain the past peak and in the second case, almost 10 years. Certainly, a similar event is quite possible now.

Cycles in inflation-adjusted home prices have occurred in a much more pronounced way in some cities, such as Boston and Los Angeles. The cycles stem from the effects of local business cycles, the delays in the response of supply to increased prices, and to some extent from speculation. Over much of the country, fundamental factors have pushed up demand and accounted for at least a large portion of the price increases in recent years. However, increasing supply, higher interest rates, and a turn in investor market psychology may cause prices in some markets to fall. In the past, significant nominal price declines

generally have been associated with local or regional economic recession, but the exceptional size of some of the recent increases could make them vulnerable without a recession, especially if interest rates continue to rise.

In the long run, I expect housing markets to perform well, especially if immigration continues at recent rates. An important caveat, though, is that healthy housing markets could soften seriously from an unexpected disruption in the ability of Fannie Mae and Freddie Mac to function effectively in secondary mortgage markets. OFHEO is currently focused on correcting the significant accounting, internal control, management, and corporate governance weaknesses identified at both companies through OFHEO examinations. While both companies have made progress, much more needs to be done. It is apparent that in order to ensure the long-run safety of these two GSEs, the regulatory framework must also be strengthened. OFHEO supports the enactment this year of legislation, currently before the full Committee, that will create a new regulator with adequate funding, bank-like regulatory and enforcement authorities and encompassing not only safety and soundness, but also mission regulation.

Research and OFHEO's House Price Index

I now would like to talk briefly about some of OFHEO's research activities related to measuring home price trends. OFHEO's work has been focused on our House Price Index (HPI), which we publish quarterly. We estimate quarterly price changes for single-family houses at the national level and for census divisions, states, and metropolitan statistical areas. We use data obtained from Fannie Mae and Freddie Mac on values of houses in repeat mortgage transactions.

OFHEO is working hard to ensure that our house price index remains an accurate and reliable indicator for both internal and external use. Precise measurement of historical

price movements is extremely important in measuring the credit exposure at Fannie Mae and Freddie Mac, a critical part of OFHEO's regulatory duty. It is also important because mismeasurement may obscure indications of any accelerations or reversals in the housing cycle. Such information is valuable not just to OFHEO, but also to the other disparate entities and individuals that use our data. Government and private policy analysts, risk modelers at Wall Street firms, and even individual homeowners interested in tracking their home values all employ our data. Our historical index data, as well as related market commentary, are all available on OFHEO's website.

Accurately measuring house price movements is quite challenging. One of the fundamental difficulties stems from the fact that houses do not sell frequently. At best, sporadic measurements of home values are usually available. Also, homes obviously differ substantially in their size and quality. This heterogeneity means that the average sales price of properties reflect not only trends in house prices, but also changes in the mix of houses transacting.

A final challenge is that home valuation measures are not always perfect indicators of true home values. For example, much of OFHEO's home value information is derived from appraisals produced in the home refinancing process. Such appraisals, for a variety of reasons, may not always accurately reflect true home values.

OFHEO in fact is actively researching the issue of appraisal bias. The underlying research question to be addressed is: "How can appraisal bias be stripped from the OFHEO index without having to remove all appraisal data from OFHEO's calculations?" Although home price appraisals may systematically differ from purchase price information, their inclusion can provide valuable information about price trends, particularly for small cities where the availability of price data is at a premium. More

fundamentally, to the extent that refinanced homes may have different attributes than other homes, the inclusion of refinance-related appraisals provides our models with a potentially broader sampling of appreciation patterns.

Preliminary research suggests that a refined methodology that aims to remove appraisal bias from the HPI may reflect long-run historical price patterns that are quite similar to what has been observed in the usual HPI. Despite the similarity, however, OFHEO may pursue such a refinement because changes in the mix of refinance and purchase valuations can affect measured short-term price change patterns.

Another issue of broad research and policy significance is the effect of home improvements on measured price trends. Some observers have wondered whether a significant share of the dramatic appreciation reflected in the OFHEO HPI has been caused by home remodeling activity as opposed to fundamental price increases. The concern has been motivated in part by a divergence between appreciation shown in the OFHEO index and house price growth reflected in a “constant-quality” index produced by the Census Bureau.

Although the OFHEO index is generically classified as a constant-quality index, some recent appreciation may indeed reflect net quality improvements in the housing stock. Outside research coupled with as-yet unpublished internal OFHEO work nevertheless suggests that, even under generous assumptions concerning the impact of remodeling on home valuations, a relatively modest amount of appreciation is accounted for by what might be described as “quality drift.” In short, the recent price run-ups are not mere illusions caused by the fact that Americans are buying bigger and better homes.

While OFHEO does not publish home price forecasts, it maintains a strong interest in available information concerning future expectations. One potentially useful

development in this area is the introduction of real estate futures exchanges. Such exchanges, at least in theory, may one day provide a meaningful summary of the market's best guess for the future price trends. Unfortunately, trading volumes on these nascent futures exchanges are relatively low. Thus, although some futures markets currently point to small home price declines through the Spring of 2007, the implied price trajectories may not reliably reflect aggregate expectations concerning future prices.

Conclusion

Although the future direction of home prices is the subject of great speculation, there is little doubt that several factors may constrain appreciation rates in the near future. First and most fundamentally, home prices are at historically high levels and have already started to stretch past many traditional affordability boundaries. Home affordability is at very low levels in places like California and the New England states, for example. Barring very significant increases in average incomes or interest rate declines, these price levels will weigh heavily against major price increases in the near term.

The second constraint on appreciation rates is rising housing inventories. The number of homes available for sale has increased substantially over the last year, giving homebuyers much more bargaining power than they have had in recent periods. Such bargaining power can lead sellers to reduce prices.

The third and final factor involves market psychology. Although it has been difficult to accurately quantify the effect of speculative activity on recent appreciation patterns, anecdotal evidence suggests that its effect may have been material in select markets in California, Nevada, Arizona, and other states. To the extent that the recent slowdown in appreciation rates may sour some potential investors on real estate investments, home demand may decline somewhat.

Despite the presence of various factors that may act to constrain price appreciation in the near term, I would like to stress that housing markets and price appreciation are affected by some very basic economic and demographic patterns. For example, migration patterns (both domestic and international) affect the demand for housing and thus influence price movements. Also, the extent to which retiring baby boomers opt to increase or decrease their demand for second homes may also play a role in determining the direction of prices in the future. Finally, the cost of constructing new homes clearly can play a role in affecting supply and thus home prices. As is the case in other markets, the future trajectory of prices will be determined through a netting out of these factors, in addition to the short-term demand and supply determinants that have already been discussed. Thank you, and I'd be happy to answer any questions.



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HOUSE PRICE APPRECIATION SLOWS **OFHEO House Price Index Shows Largest Deceleration** **in Three Decades**

WASHINGTON, D.C. – U.S. home prices continued to rise in the second quarter of this year but the rate of increase fell sharply. Home prices were **10.06 percent** higher in the second quarter of 2006 than they were one year earlier. Appreciation for the most recent quarter was **1.17 percent**, or an annualized rate of 4.68 percent. The quarterly rate reflects a sharp decline of more than one percentage point from the previous quarter and is the lowest rate of appreciation since the fourth quarter of 1999. The decline in the quarterly rate over the past year is the sharpest since the beginning of OFHEO's House Price Index (HPI) in 1975. The figures were released today by OFHEO Director James B. Lockhart, as part of the HPI, a quarterly report analyzing housing price appreciation trends.

"These data are a strong indication that the housing market is cooling in a very significant way," said Lockhart. "Indeed, the deceleration appears in almost every region of the country."

Possible causes of the decrease in appreciation rates include higher interest rates, a drop in speculative activity, and rising inventories of homes. "The very high appreciation rates we've seen in recent years spurred increased construction," said OFHEO Chief Economist Patrick Lawler. "That coupled with slower sales has led to higher inventories and these inventories will continue to constrain future appreciation rates," Lawler said.

House prices grew faster over the past year than did prices of non-housing goods and services reflected in the Consumer Price Index. While house prices rose 10.06 percent, prices of other goods and services rose only 4.41 percent. The pace of house price appreciation in the most recent quarter more closely resembles the non-housing inflation rate.

Significant findings in the HPI:

1. All states show four-quarter appreciation, but five Midwestern and New England states had small price decreases in the second quarter.
2. Price appreciation remains relatively robust in the two states hardest hit by Hurricane Katrina one year ago—Louisiana and Mississippi. Four-quarter appreciation rates were well above the national average in several cities in the area including: New Orleans-Metairie-Kenner,

- Gulfport-Biloxi, Baton Rouge, and Pascagoula. Gulfport-Biloxi and Pascagoula in fact logged their highest appreciation rates since the beginning of OFHEO's Index.
3. The South Atlantic Census Division including Florida, Delaware, the District of Columbia, Virginia and Maryland experienced its most significant price deceleration since at least the early 1980s. Its four-quarter appreciation rate fell from 17.43 percent to 13.74 percent.
 4. New England's four-quarter appreciation rate fell from 8.71 percent to 5.68 percent. While appreciation rates in Massachusetts were consistently amid the 10 highest between mid-1997 and mid-2003, its four-quarter appreciation rate now ranks 48th among the states and the District of Columbia.
 5. Despite a nine percentage point decline in its four-quarter appreciation rate, Arizona's housing market still exhibits the highest appreciation rate among the 50 states. Prices were up roughly 24 percent compared to the second quarter of 2005 but grew only 2.94 percent in the most recent quarter.
 6. While the 20 Metropolitan Statistical Areas (MSAs) with the highest appreciation included nine cities in Florida, the representation of other states continues to increase. MSAs in North Carolina, South Carolina, and Washington State have now entered the list of fastest appreciating markets.
 7. Michigan had the greatest numbers of price decreases among ranked MSAs. Thirteen of Michigan's 16 ranked metropolitan areas exhibited quarterly price decreases.

One of the more striking elements of the new HPI data is that four-quarter appreciation rates fell sharply in four of the five states that had fastest appreciation in last quarter's HPI release. This subject is discussed in greater detail in the Highlights section of this report on page 8.

Changes in the mix of data from refinancings and house purchase transactions can affect HPI results. An index using only purchase price data indicates somewhat less price appreciation for U.S. houses between the second quarter of 2005 and the second quarter of 2006. That index increased 8.27 percent, compared with 10.06 percent for the HPI.

OFHEO's House Price Index is published on a quarterly basis and tracks average house price changes in repeat sales or refinancings of the same single-family properties. OFHEO's index is based on analysis of data obtained from Fannie Mae and Freddie Mac from more than 31 million repeat transactions over the past 31 years. OFHEO analyzes the combined mortgage records of Fannie Mae and Freddie Mac, which form the nation's largest database of conventional, conforming mortgage transactions. The conforming loan limit for mortgages purchased in 2006 is \$417,000.

This HPI report contains four tables: 1) A ranking of the 50 States and Washington, D.C. by House Price Appreciation; 2) Percentage Changes in House Price Appreciation by Census Division; 3) A ranking of 275 Metropolitan Statistical Areas (MSAs) and Metropolitan Divisions by House Price Appreciation; and 4) A list of one-year and five-year House Price Appreciation rates for MSAs not ranked.

OFHEO's HPI report in PDF form is accessible at www.ofheo.gov. Also, be sure to visit www.ofheo.gov to use the OFHEO House Price calculator. The next HPI report will be posted December 1, 2006. Please e-mail ofheoinquiries@ofheo.gov for a printed copy of the report.

House Price Appreciation by State

Percent Change in House Prices

Period Ended June 30, 2006

State	Rank*	1-Yr.	Qtr.	5-Yr.	Since 1980
Arizona, (AZ)	1	24.05	2.94	96.71	323.30
Florida, (FL)	2	21.28	2.51	112.59	377.53
Idaho, (ID)	3	20.14	3.78	55.27	229.24
Oregon, (OR)	4	19.47	3.99	63.79	333.68
Hawaii, (HI)	5	18.09	0.43	111.21	427.63
Washington, (WA)	6	17.39	3.67	60.21	363.59
Maryland, (MD)	7	16.21	2.31	102.68	422.09
District of Columbia, (DC)	8	15.86	1.28	119.97	534.93
New Mexico, (NM)	9	15.54	4.22	50.30	215.40
Utah, (UT)	10	15.17	3.75	33.39	229.32
California, (CA)	11	14.35	1.25	111.93	543.28
Virginia, (VA)	12	14.24	2.01	83.38	360.29
Wyoming, (WY)	13	13.97	2.94	55.61	149.60
Alaska, (AK)	14	12.90	2.82	53.01	169.33
Montana, (MT)	15	12.66	3.12	55.84	254.28
Louisiana, (LA)	16	12.48	2.71	37.92	134.09
New Jersey, (NJ)	17	12.43	1.85	84.98	475.25
Delaware, (DE)	18	11.78	0.63	70.75	392.00
Nevada, (NV)	19	11.44	0.26	104.77	312.02
Vermont, (VT)	20	11.28	2.45	65.97	350.98
Pennsylvania, (PA)	21	10.69	1.61	55.57	299.17
United States **	.	10.06	1.17	56.49	298.85
New York, (NY)	22	9.89	0.90	72.76	554.65
Mississippi, (MS)	23	9.59	2.85	27.62	138.56
North Carolina, (NC)	24	9.32	1.93	28.41	221.47
South Carolina, (SC)	25	8.93	1.67	31.48	205.02

*Note: Ranking based on one-year appreciation.

**Note: United States figures based on weighted Census Division average.

House Price Appreciation by State

Percent Change in House Prices

Period Ended June 30, 2006

State	Rank*	1-Yr.	Qtr.	5-Yr.	Since 1980
Alabama, (AL)	26	8.91	1.88	30.18	174.32
North Dakota, (ND)	27	8.88	3.00	39.64	140.99
Connecticut, (CT)	28	8.46	0.83	62.98	376.96
Tennessee, (TN)	29	8.10	1.96	28.06	191.09
Arkansas, (AR)	30	8.01	1.98	32.31	153.66
Illinois, (IL)	31	7.82	1.12	42.76	270.57
Rhode Island, (RI)	32	7.43	1.18	94.00	513.89
West Virginia, (WV)	33	7.40	0.15	34.73	127.04
Oklahoma, (OK)	34	6.50	1.78	26.75	97.79
Texas, (TX)	35	6.45	1.93	22.64	111.87
Maine, (ME)	36	6.25	-0.20	61.74	405.84
Georgia, (GA)	37	6.14	1.05	28.02	230.46
New Hampshire, (NH)	38	5.97	0.04	61.03	404.18
South Dakota, (SD)	39	5.96	2.05	31.18	175.99
Missouri, (MO)	40	5.77	0.45	33.29	196.36
Wisconsin, (WI)	41	5.58	0.31	36.00	226.57
Kentucky, (KY)	42	5.27	1.21	24.94	183.51
Minnesota, (MN)	43	4.94	0.28	46.61	271.41
Iowa, (IA)	44	4.30	1.26	23.61	146.78
Colorado, (CO)	45	4.20	0.96	23.68	263.10
Kansas, (KS)	46	4.15	1.04	24.10	138.93
Nebraska, (NE)	47	3.63	0.95	21.57	155.27
Massachusetts, (MA)	48	3.40	-0.44	56.98	631.67
Indiana, (IN)	49	2.76	-0.04	17.00	154.65
Ohio, (OH)	50	2.14	-0.05	18.40	172.34
Michigan, (MI)	51	1.01	-0.72	18.95	222.11

*Note: Ranking based on one-year appreciation.

**Note: United States figures based on weighted Census Division average.

House Price Appreciation Slowing Rapidly



OFHEO HOUSE PRICE INDEX FOR USA
Quarterly House Price Appreciation--Annualized
1997 - 2006 Second Quarter

