What Happens If Housing Goes Bust

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Five years ago, the bull market for stocks came crashing to a halt after a glorious run. Now, many worry that the roaring housing market may be headed for a train wreck as well.

What's the likelihood this could happen? For his part, Federal Reserve chairman Alan Greenspan said last week that a nationwide housing bubble was improbable, while warning of "froth in some local markets." He said a broad price decline in the housing market was unlikely to happen or to have much economic impact.

While house prices aren't likely to deflate as quickly as a hot Internet stock during the dot-com bust, the consequences have the potential to be far more devastating.

Here's how the stock and housing booms look similar -- but differ in several important respects.

The key difference is that stocks are purely financial investments. You can sell a stock on a whim, and you don't have to run out and buy another. By contrast, people live in houses, and if they sell they have to move -- which is both costly and time-consuming.

"How could you have a housing crash?" asks Ted Aronson, managing partner at Aronson Johnson Ortiz, a Philadelphia money manager. "We all just sell our houses and move into a trailer park?"

Houses are also much more expensive to sell. Mr. Greenspan says commission and other transaction costs approach 10% of the price of a home. By contrast, Mr. Aronson says big institutions typically incur transaction costs of 1% to 2% on their stock purchases.

The cost of moving is why homes change hands much less than stocks. Sales of new and existing homes in the U.S. in 2003 were equal to about 6% of total housing units in the U.S. By contrast, annual turnover on the New York Stock Exchange is about 100% of all shares outstanding. A home normally sits on the market for several weeks before selling; a stock usually sells in seconds.

Stocks also move as a single market more than houses do because they are subject to many of the same influences and often are bought and sold as part of a broad portfolio. Houses are more subject to local influences. Stocks can also be sold "short" by people who don't own them, or via derivatives. You can't bet on declining housing prices the same way. That means when houses appear overvalued, it's harder for contrarians to nudge them the other way.

For all these reasons, stocks show much bigger swings than housing values. Inflation-adjusted housing prices and inflation-adjusted stock prices have both declined about a third of the time since 1976, using quarterly averages compared to the same quarter a year earlier. (Stocks are represented by the Standard & Poor's 500-stock index and houses by the Office of Federal Housing Enterprise Oversight index.)

But the biggest decline in real housing prices was only 6% in 1980. Real stock prices have fallen more than 20% at least eight times, year over year, since 1976. The steepest was 29% in the third quarter of 2001.

So if history holds true, a housing crash is far less likely than a stock crash. But don't take too much comfort from that.

Since 1941, stocks had never declined three years in a row until 2000-2002. The fact they did reflected the magnitude of the preceding run-up. Housing prices have not seen a sharp drop in 30 years, but they've also never risen as much as they have since 1995.

If housing prices do fall, what would it mean for the economy? "A housing bust would be worse [than the stock bust]," says Kenneth Rogoff, an economics professor at Harvard University and former chief economist at the International Monetary Fund.

Why? Well, for one thing, housing is worth a lot more. According to the Fed, Americans' homes were worth the equivalent of 145% of gross domestic product in March; by comparison, their stocks and mutual funds were worth 130% at the market's peak in 2000, and just 82% now. Second, stock wealth is concentrated in the hands of the wealthiest Americans while housing is much more evenly distributed. A 2001 Fed survey found 68% of families own a home and the home's median value was $122,000. Just 52% owned stocks, either directly or through a mutual or pension fund, and the median value was $34,300. That disparity has since widened.

Families are also better able to tap into the value of their homes to finance the purchase of new homes and other items. Homes are collateral for about $7.7 trillion in mortgage and home-equity debt, whereas total margin debt in investors' stock brokerage accounts is only $194 billion. For the same reason, a decline in housing prices would put more bank loans at risk; mortgages make up 40% of the assets of U.S. commercial banks, mortgage-backed securities another 16% and stocks less than 1%.

Some economists dispute the notion that housing has a bigger impact on spending than stocks. "The evidence is consistent with sizable 'wealth effects' from both sources," says Dean Maki, chief economist at Barclays Capital. The rich do own most of the stocks, but they also do most of the spending. That means they have a disproportionate impact on the economy.

But Mr. Greenspan thinks homes have a bigger "wealth effect." Mr. Rogoff agrees, citing IMF research that from 1984 to 2000 in the U.S. and similar economies, a dollar reduction in stock wealth cuts household spending by four cents, but a dollar lost in housing wealth reduces it by seven cents. Mr. Rogoff says the effect may have since grown because home buyers are more leveraged.

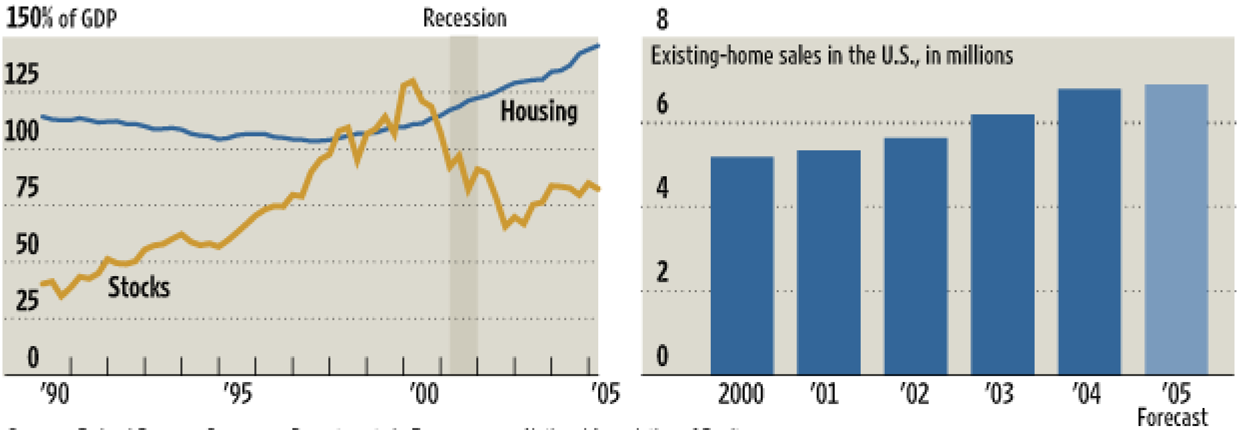
The IMF found after studying housing cycles world-wide that "private consumption fell sharply and immediately in the case of housing price busts while the decline was smaller and more gradual after equity price busts." That's even though housing price declines were usually smaller at 30%, adjusted for inflation, compared with 45% for stocks. The U.S. had never experienced a decline of such a size in the period the IMF studied, so it's unclear how much the global experience would apply to the U.S.

There could be other major consequences. The stock bubble did speed up the adoption of new technologies and business models such as Internet commerce, and those benefits have persisted even after the tech bubble burst.

The housing boom has not unleashed any similar revolutionary forces. Sure, more people now own their homes instead of rent, and that might have spinoff benefits in lower crime and greater civic involvement. But if it turns out many new homeowners stretched to buy and eventually will have to give up their homes, those kinds of benefits may prove fleeting.

Back on Top

Housing once again is a greater part of Americans' wealth than stocks. Homes were worth the equivalent of 145% of gross domestic product in March (left chart), while stocks represent 82%. Meanwhile, home sales (right chart) have kept rising in recent years.



Sources: Federal Reserve, Commerce Department via Economy.com; National Association of Realtors