



## Oversupply of U.S. Housing— A Sustained Headwind

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**This is the first postwar recovery that hasn't been led by a pickup in housing. That is because this was the first postwar recession that was not caused by tightening monetary policy to fight inflation. There was no inflation in sight, except in house prices, and that was because of easy money, record-low interest rates and the ability of banks to ignore prudent credit standards. With no housing rebound, the recovery remains subpar and job creation lags. This, of course, only exacerbates the housing overhang and so the beat goes on.**

The continued weakness in U.S. housing, evident in this week's 5% decline in June housing starts, is reflective of and partly caused by the continued weakness in labour markets. As the average duration of unemployment continues to rise, people continue to make impecunious lifestyle decisions, which add to the headwinds facing the economy. Despite the recent decline in the jobless rate to 9.5%, 27 states reported a drop in payroll employment in June. While 21 states notched increases, there still is a long way to go before employment returns to pre-recession levels. The Fed predicts that even by the end of 2012, the jobless rate will still have a 7-handle, compared to an average rate of only 4.5% in the first half of 2007. Twenty-four states still have a jobless rate above year-ago levels, and many discouraged workers will restart their job search when conditions improve, mitigating the fall in unemployment.

Moreover, the combination of job loss, real wage declines and the fall in household wealth—both from house- and stock-price declines—has a social impact on the U.S. that may last (as the Fed says) for an extended period. One of the most profound repercussions of long-term unemployment and declining wealth is the effect on household formation. Jobless university grads are moving in with their parents instead of finding a place of their own. Couples are postponing having a(nother) child. Unhappy couples are postponing divorce, 'separating' within the confines of their own home. Even middle-aged job seekers are moving into shared living arrangements. Stumbling stock markets and falling home equity have caused many to delay or cut short their retirement.

Household formation has fallen sharply to an average annual rate of only 0.5 million since 2005 compared to an annual average of 1.2 million in the preceding decade. The national homeownership rate has declined from a peak of 69.2% in 2004 to 67.1% as of the end of Q1 this year, with homeownership rates for some minority groups falling by an even greater extent. The U.S. has lost over 1 million households since the recession began as units merge and new formation is delayed.

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According to a recent Fed study,<sup>1</sup> researchers found that the median borrower who purchased a home in 2006 using a subprime mortgage with 100% financing does not strategically default until equity falls to -62% of their home's value. And when negative equity falls below -50%, half of defaults are driven purely by strategic decisions rather than job loss. There was something that could trigger underwater borrowers to default much, much earlier—and that something was a mortgage rate rise. In fact, higher interest rates were even more significant in triggering defaults than higher unemployment.

With a quarter of U.S. mortgages underwater, the Fed must heed the advice of its own research if it wants to prevent a cascade of defaults and the consequent repercussions on the financial system and the economy. **Hence, expect U.S. interest rates to remain low for an extended period.**

Even with low mortgage rates, the oversupply of housing units will take years to clear. Net new housing units<sup>2</sup> created in the U.S. surged between 2002 and 2006, as homebuilders went on a construction binge, building 9.1 million new homes while the number of households went up by just 5.6 million. Even though housing starts have fallen sharply to roughly 0.6 million new homes annually, with household formation running at about a 1.0 million annual rate, only about 0.4 million of the oversupply will be absorbed each year.

The total value of the U.S. housing stock (single- and multi-family) fell from \$23 trillion in 2006 to about \$16 trillion since then. Judging from historical ratios of mortgage debt as a percent of the value of housing collateral, which for many years averaged roughly 40%, there is an overhang of mortgages that are insufficiently collateralized. In other words, given today's value of housing collateral, mortgages outstanding should be roughly \$6.4 trillion, about \$4 trillion lower than the actual level of just over \$10 trillion.

**Bottom Line:** Perhaps homeowners are patiently expecting house prices to rise again. Human psychology suggests people naturally anchor on the price they paid, or what something was worth in the past, and are reluctant to sell below this level. But if so, they may be in for a long wait.

Prices are likely to be weighed down for some time by a massive oversupply of homes relative to underlying demographic demand. The faster the jobless rate declines, the faster the workoff of the oversupply as household formations rise. Unfortunately, the labour market is not expected to improve quickly.

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<sup>1</sup> Bhutta, Neil, Dokko, Jane K. and Shan, Hui, *The Depth of Negative Equity and Mortgage Default Decisions* (May 18, 2010). FEDS Working Paper No. 2010-35. Available at SSRN: <http://ssrn.com/abstract=1626969>

<sup>2</sup> A **housing unit** is a house, an apartment, a mobile home, a group of rooms, or a single room that is occupied (or if vacant, is intended for occupancy) as separate living quarters.

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