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Housing Market – An Overview of Volume and Price Adjustments

A bit of background information before looking at how home prices and volumes have behaved in the past three decades or so. Chairman Greenspan has officially noted that there is a housing market boom. Here are the remarks Greenspan made on August 27:

“Nearer term, the housing boom will inevitably simmer down. As part of that process, house turnover will decline from currently historic levels, while home price increases will slow and prices could even decrease. As a consequence, home equity extraction will ease and with it some of the strength in personal consumption expenditures. The estimates of how much differ widely.”

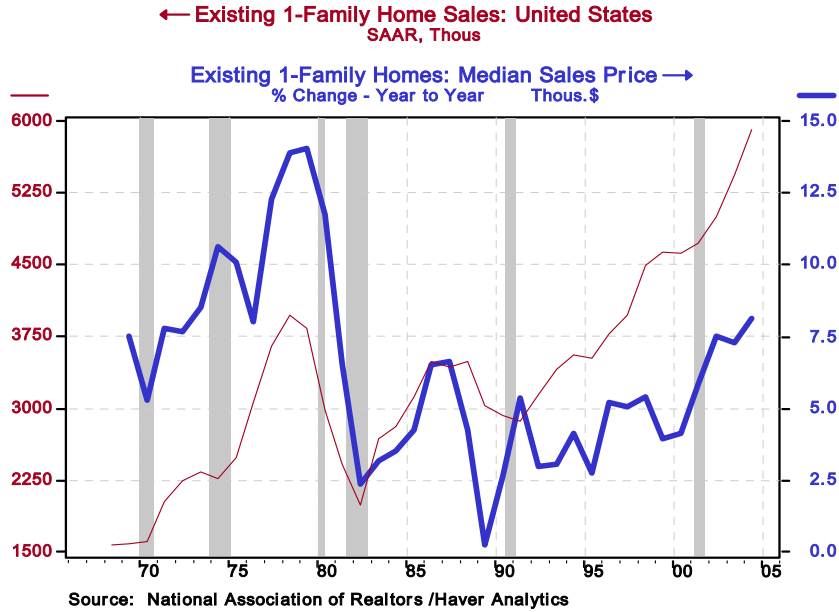
“The surprisingly high correlation between increases in home equity extraction and the current account deficit suggests that an end to the housing boom could induce a significant rise in the personal saving rate, a decline in imports, and a corresponding improvement in the current account deficit. Whether those adjustments are wrenching will depend, as I suggested yesterday, on the degree of economic flexibility that we and our trading partners maintain, and I hope enhance, in the years ahead.”

Translation – Home prices will decline, pace of adjustment unknown. The drop in home prices should bring down consumer spending because households have supported their expenditures from home equity extraction in addition to income. The large increase in the current account deficit is a reflection of this extravagance. The expectation is that households will feel less wealthy, spend less, and save more when the boom “simmer” down. An improvement in the current account deficit should follow. Greenspan adds that the nature of this adjustment is unknown and is tied to the degree of flexibility of the U.S. economy and its trading partners. How smooth and orderly the adjustment will be is a matter of opinion. Krugman, one of Greenspan’s critics, has his prognosis in today’s New York Times (<http://www.nytimes.com/2005/08/29/opinion/29krugman.html>).

Let us see what lessons the history of home sales and prices has to offer. From chart 1 and chart 2 it is clear that housing market peaks preceded overall economic recessions, with the exception of the 2001 recession when the housing market missed a serious downswing. Historical data for existing homes goes back to 1968. The 1978 peak in sales of existing homes (see chart 1) represented a 75.4% increase in volume from the previous low reading in 1974. In this period, the median price of an existing home rose 38.4%. By 1982, the volume of existing homes had dropped 50.1% and prices posted a marked deceleration. Prices of existing homes (on an annual average basis) have never dropped. In the 1982-88 period, the volume of existing homes rose 75.0% and price gains ranged between 6.0% and 7.0%. Between 1988 and 1991, sales of existing homes fell 17.6% and prices were creeping in the 2%-5% range. In more recent times, with the exception of significantly soft existing home sales in the 1994-95 and 2000 periods, sales of existing homes have risen 123% between 1991 and June 2005 (the recent peak). The median price of an existing home has risen between 2.7% and 8.1% during the 1991-2004 time span. The double digit gains in prices of existing homes is a story of the past six months, with the median price advancing 14.6% on a year-to-year basis in July.

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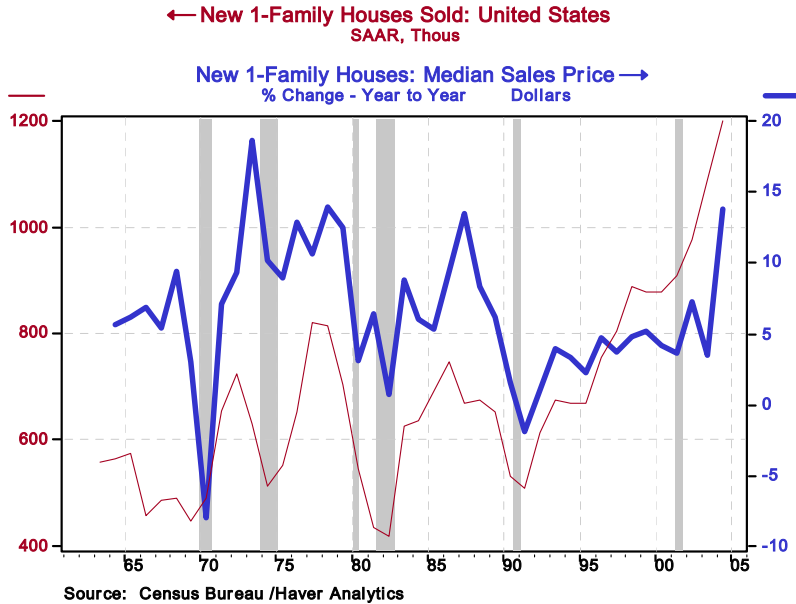
Chart 1



Shaded regions denote recessions

Data for new single-family home show that the 1977 peak of new home sales represented a 60.0% increase in sales volume and the median price of a single-family home posted a 36.0% increase during this time period. Sales of new homes fell 49.0% in the five years ending 1982. The next turnaround in sales of new single-family homes resulted in a peak in 1986, with the sales volume registering a 78.5% increase during 1982-86. Purchases of single-family homes continued to drop until 1991 from their peak in 1986, with a cumulative decline of 32.0%. With the exception of soft market conditions when the Fed was tightening in 1994 and 1999, sales of new single-family homes have risen 177.0% between 1991 and July 2005. Although the median price of a new single-family fell 4.1% on a year-to-year basis in July, it follows a 13.3% jump in 2004, the largest annual increase since 1987.

Chart 2

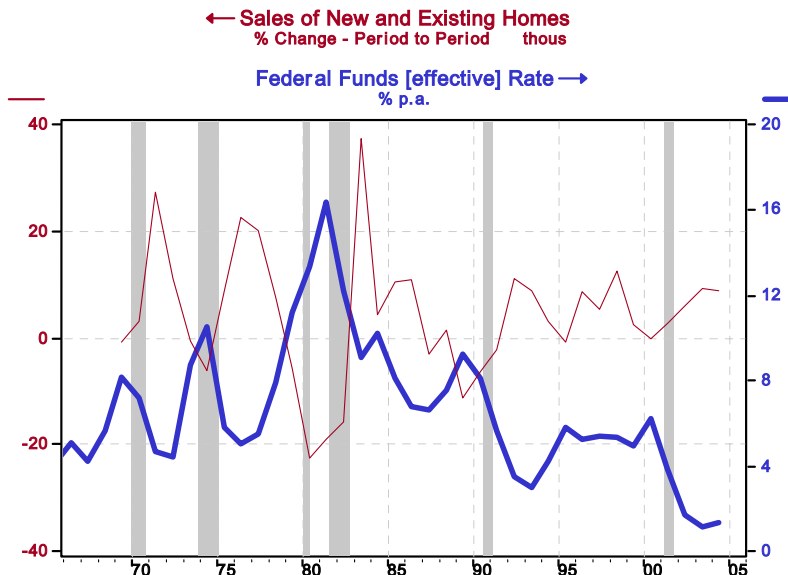


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What lessons can we draw from historical data? (1) The most obvious and well known fact is that the housing market takes an early hit when the Fed begins to tighten monetary policy, but it survived the 2001 recession.

Chart 3



(2) The size of the expansion of housing activity is large this time around and therefore a setback could be fairly large based on historical information mentioned above. (3) Unlike previous downswings in housing activity, this time around a downswing will have serious repercussions in terms trimming down consumption expenditure and thereby reducing economic momentum not only in the U.S. but also in the rest of world because the U.S. economic expansion is the engine of economic growth in the world. U.S. imports have grown from 8.5% of real GDP in 1991 to 16.2% in the second quarter of 2005. (4) Over 40.0% of payroll employment in the current expansion is tied to the housing sector, a disruption in this market will have serious ripple effects in the rest of the economy. (5) This is what Trichet, the head of the European Central Bank, had to say about housing price booms on June 5, based on a IMF study: "Historically, housing price booms have been followed by busts about 40% of the time, while equity price booms are followed by busts only in 25% of the cases. Housing price peak-to-trough periods are longer on average and, despite the fact that the decline in prices is somewhat smaller, the associated output losses are notably bigger. The output losses incurred during a typical housing price bust amount to 8% of GDP, which is double the average loss during an equity price bust. The reason is a different exposure of the banking system to mortgages than to shares. In this respect, bank-based financial systems incur larger losses than more market-based financial systems during housing price busts, while the opposite is true for equity price busts. This finding is corroborated by the fact that all major banking crises in industrial countries during the post-war period coincided with housing price busts." U.S. banking system is exposed to mortgage products to a significant extent (see discussion related to chart 12 of Paul Kasriel's commentary of August 25. http://www.northerntrust.com/library/econ_research/weekly/). There is downside to the boom in the housing market, when it will occur is the unknown. Data and the entanglements of the housing market with the rest of economy raise the probability of a serious setback to the economy.

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