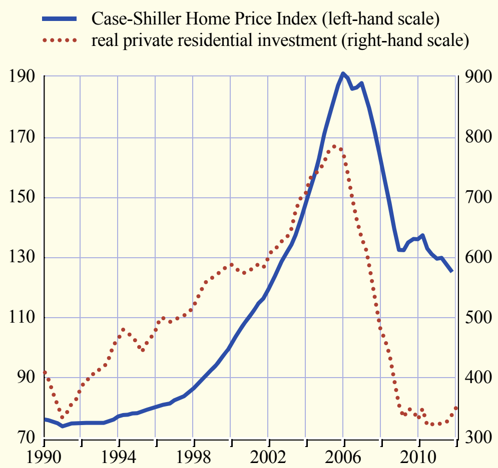
Box 1

RECENT DEVELOPMENTS IN THE US HOUSING MARKET

In recent years the US housing market has experienced its sharpest decline since the Second World War. House prices, as measured by the Case-Shiller index, have fallen by more than 30% since their peak in 2006 (see Chart A). Residential investment as a ratio to GDP now stands below 2.5%, compared with around 6% at its peak in 2005. More recently, however, some signs have emerged that the downturn in the US housing market is bottoming out. Home sales, housing starts and building permits have started to recover, albeit from historically low levels. Moreover, after collapsing in 2006, residential investment has been making a positive contribution to economic growth in the United States since the second quarter of 2011. The pace of the decline in house prices has moderated and house price futures suggest that house prices may be nearing a trough. However, the process of adjustment in the US housing market still faces a number of challenges which are constraining growth. This box briefly explains why a recovery in the housing sector is important for economic growth in the United States. It then reviews the main supply and demand factors that are impeding a strong pick-up in housing market activity. The box concludes with an overview of the policy measures taken to support the US housing market.

Chart A House prices and private residential investment

(index: Q1 2000 = 100, seasonally adjusted data; billions of chained 2005 US dollars, seasonally adjusted at an annual rate; quarterly data)



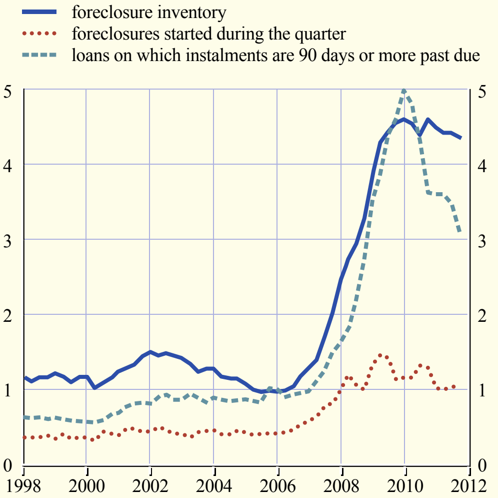
Sources: Bureau of Economic Analysis, Standard & Poor's, Fiserv and MacroMarkets LLC.
Note: The latest observation is for the fourth quarter of 2011.

The importance of the housing market for the US economic recovery

The weak housing market is hindering the economic recovery in the United States owing to several factors. First, the sharp drop in residential investment has had a direct impact on economic output. Since residential investment is much more cyclical than aggregate economic activity, its contribution to GDP growth is typically larger than its contribution to the level of GDP. The contribution of residential investment, which played an important role in the early phases of previous recoveries in the United States, has been subdued until recently. Second, many jobs depend on housing activity, both directly in the construction industry and also in industries producing complementary items, such as household items, or in related professional and skilled services. Third, declining housing wealth associated with falling house prices is dampening personal consumption expenditure because households assign less value to their housing assets which could affect their attitude towards current and future consumption.

Chart B Delinquencies and foreclosures

(percentages of the total number of mortgages outstanding, seasonally adjusted quarterly data)



Source: Mortgage Bankers Association.
Notes: Data on the foreclosure inventory are not seasonally adjusted. The latest observation is for the fourth quarter of 2011.

Supply factors

The persistent weakness in US house prices reflects continued imbalances between housing supply and demand. The excess supply of houses in the US market is the key factor limiting a pick-up in house prices and a stronger recovery in residential construction. The inventory of houses is currently at a historically high level; vacant housing units comprised around 14% of the total in 2011 and this percentage has not declined substantially since the peak in 2008. Foreclosures owing to default by borrowers have also added to the supply of homes on the market and continue to exert downward pressure on prices. The main causes of foreclosures are the deterioration in household income and the decline in house prices. In 2011 around one in four single-family homes with a mortgage were in negative equity (when the value of the house is less than the mortgage balance). This also constrains the ability of homeowners to sell or refinance, and they may be tempted to default as a result. The percentage of new foreclosures started in each quarter remained essentially unchanged in 2011, at around 1% of all loans (see Chart B). Moreover, the percentage of delinquent loans (where no payments have been made for 90 days or more) – a good indicator of future new foreclosures – decreased from its peak of 5.0% in early 2010, but remained very elevated at 3.1% at the end of 2011.

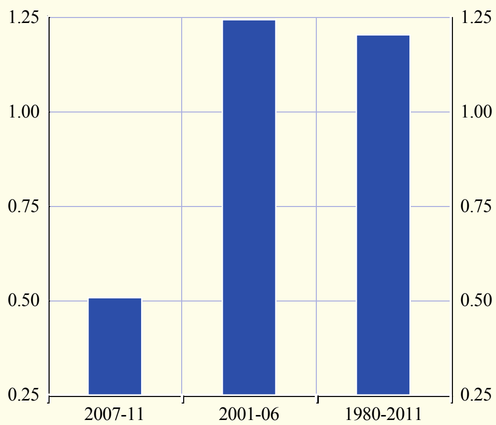
Demand factors

The main factor dampening demand for housing is the continued weakness in both employment and income growth. The US unemployment rate stood at 8.2% in March 2012, which is much higher than the 4.6% registered on average in 2007 before the crisis period. Despite the recent amelioration in the pace of employment growth, the US labour market remains structurally weak. The share of the long-term unemployed (defined as those out of work for six months or more) in total unemployment stood at the elevated level of around 43% in March 2012 – about twice the level seen after the 2001 recession. At the same time, those who are in employment are witnessing a decline in the purchasing power of their income, as inflation has been running higher than income growth. Indeed, the US Bureau for Labor Statistics reports that real average hourly earnings growth was negative in the first three months of 2012, and stood at a rate of -0.6% in March.

The weak US job market and poor income prospects have also affected household formation, which, in turn, has dampened demand for homes. Many school leavers who cannot find work continue to live at home with their parents rather than forming new households, while people who lose their jobs may also tend to move back in with their relatives. As a result, since 2007 the rate of growth in household formation in the United States has averaged around 0.5% per annum, which is substantially less than the annual average rate of 1.2% for the period since 1980 (see Chart C). It is also less than the population growth rate, including that of the age cohort usually associated with the formation of new households. The pace of household formation is expected to pick up once employment and income prospects improve further.

Chart C Number of households

(monthly averages of year-on-year growth rates as percentages)



Sources: Census Bureau and Haver Analytics.
Note: The latest observation is for December 2011.

A further factor constraining demand is the availability of mortgage credit. Despite historically low mortgage rates in the United States, broad access to new mortgage debt on reasonable terms is still limited. In an environment of declining house prices, banks are less willing to lend because the collateral is losing value. Consequently, residential mortgage lending standards tightened significantly during the crisis and have not eased substantially. For example, such restrictions take the form of higher fees, more stringent documentation requirements, the need for larger down payments, and stricter appraisal standards. Moreover, the prospect of a further decline in house prices, and thus a fall in collateral values, has deterred potential buyers. Reflecting the overall weak demand, in 2011 purchase mortgage originations were around 25% of the level recorded at their peak in 2003, while the volume of mortgage loan applications for purchase were around a third of the level at their peak in 2005.

Policy measures and considerations

The vicious circle of falling house prices leading to foreclosures and high supply on the market, which further depresses house prices, led the US authorities to take several measures to halt this spiral.

In September 2008 the government-sponsored enterprises (GSEs) Fannie Mae and Freddie Mac – which together hold around 60% of outstanding mortgages and play an important role in supporting a liquid mortgage market – were placed under government conservatorship and provided with a capital injection in view of their deteriorating solvency situation. In 2009 and 2010 the government provided a home-buyer tax credit programme which gave temporary financial assistance to first-time buyers and was intended to spur housing sales. The Home Affordable Modification Program (HAMP), which was launched in 2009, aimed to modify the mortgage loan conditions for those who are in default or at risk of default by lowering monthly mortgage payments to an affordable level. In addition, the Home Affordable Refinancing Program (HARP) aimed at reducing monthly mortgage payments for households not in default by helping them to refinance and thus to benefit from the low interest rates. Both HAMP and HARP are considered to have achieved only limited success as take-up rates have been lower than expected. In view of this, in the past few months both programmes have been expanded to widen their reach.[1] Early in 2012 the US administration increased incentives for both investors and GSEs to reduce the principal of loans for borrowers whose mortgages are significantly more than the value of their homes. This aims at avoiding further foreclosures and accelerating the pace of adjustment in the housing market.[2]

In conclusion, the huge imbalances in the US housing market that accumulated before the crisis have hindered the subsequent economic recovery and, despite several measures taken by the US authorities, the housing market remains weak and the pace of the adjustment process is slow. Nonetheless, recent data suggest that the housing market is gradually stabilising and, as the US labour market continues to improve, the pent-up demand for housing should eventually support a stronger recovery. The renewed policy efforts targeted towards the housing sector may accelerate the pace of the adjustment and the subsequent recovery.

1 For more details on each programme, see www.makinghomeaffordable.gov

2 For a recent discussion on US housing market policies see "The US Housing Market: Current Conditions and Policy Considerations", US Federal Reserve System, January 2012. See also *World Economic Outlook*, April 2012, Chapter 3, IMF, which, citing other case studies, suggested that targeted household debt restructuring policies, including write-downs of a part of the value of the mortgage, can deliver significant economic benefits at relatively low fiscal cost.