Going Down? Some Predict Housing Market Free-Fall Will Send Economy into a Tailspin
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"Bubble, bubble, Toll's in Trouble." That is how economist Paul Krugman starts his August 25 *New York Times* column headed, "Housing Gets Ugly." The blog from Nouriel Roubini referred to in Krugman's column is headlined, "The Biggest Slump in U.S. Housing in the Last 40 Years… or 53 Years?" The reported drop in new and existing home sales excites Roubini, as he believes it will lead to a free fall in housing prices. He believes the price drops will usher in a deluge of foreclosures on homes purchased with interest-only loans. Roubini predicts that by 2007, this chain of events will tip the U.S. economy into recession as:

- Residential investment drops from 6.2 percent of GDP to under 4 percent.
- The wealth effect of rising prices that has enabled consumers to obtain spending money by borrowing on their homes operates in reverse, dragging down the consumption underpinnings of the economy.
- The employment effect of job cuts in the industries that build, supply and finance housing wrecks the incomes of many.

I am sanguine about single-family home prices in most of the regions that have seen great price escalations in recent years. I believe the single-family price cuts that do take place will be relatively small and only rarely in double digits. Condo prices, however, likely will fall significantly in some formerly "hot" markets, and drop like Newton's apple in a few. The demographic fundamentals of an expanding population with a strong desire for home ownership and improvement in the quality of their housing will enable the current backlog of new single-family homes to be sold with relatively slight explicit and implicit cuts. A leveling or slight drop in single-family housing prices that is maintained in the future can forestall major cuts in annual housing production. This would be a very good thing for the country's economy and the welfare of its citizens.

However, if we do weather the current storm of concern about the three effects spelled out in Roubini's blog, and return to the overly-liberal financing that constantly pushes housing prices ever higher in regions with restrictive land use practices, we will have dodged the bullet of a housing melt down only temporarily. If we go back to making it tough and expensive to be allowed to develop greenfields and infill sites, prices will inevitably rise to the point where they fall and ignite just the kind of disaster scenario forecast to occur in 2007, according to Roubini and others.

The housing price escalation we have seen in recent years is caused by over-lending and under-zoning. Our ever-helpful friends on Wall Street have devised a new lending technology that facilitates lending at subprime rates with loans that provide the kind of interest-only terms that helped push the United States into the Great Depression of the 1930s. Over-lending alone, however, would not give birth to the super housing price increases recently seen in many fast-growing, economically healthy regions. As shown in studies including, most recently, the excellent "Superstar Cities" by Joseph Gyourko, Christopher Mayer and Todd Sinai of the Wharton School, housing prices go up when locations constrict the supply of building sites so that the housing supply becomes inelastic. When the local housing supply is inelastic, it takes a lot of price growth to induce a lesser growth in the housing inventory.

The zoning and other policies that cause supply inelasticity are most frequently the result of what has become a powerful, if irrational, fervor to stop sprawl -- which leads me to discuss and recommend a recent book entitled *Sprawl – A Compact History.* Professor Robert Bruegmann, who teaches at the University of Illinois at Chicago, has written a brilliant, easy to read history of sprawl that exposes the misconceptions that underlie the beliefs of the anti-sprawls. Bruegmann defines sprawl as "low-density scattered, urban development without systematic large-scale or regional public land-use planning." He demonstrates that the characteristics associated with sprawl have been visible at some point in the development of all prosperous cities throughout history. The density gradient that falls as one moves from the center city is shown to be flattening. Over time, scattered low density development is filled in with higher density uses.

Bruegmann writes, "The density of the Los Angeles urbanized area, as calculated in the 2000 census, was just over 7,000 people per square mile, nearly twice that of the Chicago urbanized area and significantly denser than the New York area." Among the myths shattered by his book is the oft told tale that as housing quality and size increases, urban folks are chewing up more land per person. Bruegmann cites evidence that proves, "actually, since 1970 American city and suburban dwellers are using less land per capita."

Bruegmann explains that zoning gave to most Americans the power that once only had been wielded by the capitalist elite. All who attend city council and planning commission meetings know that neighborhood activists have become masterful in their use of this weapon and the panoply of growth limiting tools delivered by the environmental movement. Bruegmann refers to these activists as the incumbents whose self-interests are well served by making it difficult and expensive to add to the inventory of housing in greenfields and on infill sites. He also uses deductive logic to consider and defend sprawl against the charges that arise when discussing new development in the suburbs.

If the lesson of history presented by Bruegmann's book is heeded, so that in the future housing can be supplied at prices that go up little faster than construction costs, the current slowdown in housing sales and leveling of prices will be remembered as "the pause that refreshes." If the current warnings about dangers to local and national economies fail to motive changes in the policies that cause housing prices to grow at a much faster rate than housing inventories, we will see a day when the worst of what is predicted will become a reality.

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