

# Study explores real factors behind declining housing prices

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Housing prices are likely to fall further, but not for the reasons usually cited, according to an "Economic Commentary" published by the Federal Reserve Bank of Cleveland and co-authored by University of Wisconsin-Madison business faculty.

The study, titled "What's Really Happening with Housing Prices," notes that most of the public concern about housing markets is based on claims that house prices have increased at historically atypical rates and that house prices have outpaced incomes. The first claim is based on inaccurate historical data, says the study, while the second claim is linked to relaxed credit constraints.

Although some observers claim that housing prices increased at historically atypical rates from 1998-2006, there is a precedent. Using a different source of data, the commentary's authors - Morris Davis and Francois Ortalo-Magne from the UW-Madison School of Business and Peter Rupert of the Cleveland Reserve Bank - found a similar boom in housing prices from 1970-1980.

The researchers also say that relaxed credit constraints could explain why house price appreciation has outpaced incomes. House prices can, and should be expected to, surge if credit constraints are unexpectedly relaxed for first-time homebuyers who are credit or down-payment constrained. As the demand for starter homes increases, the prices of those homes also increase. Owners of starter homes enjoy capital gains, enabling them to trade up to a more expensive house. The increased

demand for more expensive homes pushes up the prices of those homes.

As private mortgage originators tighten credit standards, the availability of subprime variable-rate mortgage programs will sharply curtail. This will reduce the demand for starter homes, causing their prices to fall. This, in turn, reduces the wealth of the current owners of starter homes, which triggers a chain-reaction decline in the price of trade-up homes.

The commentary is available online at [www.clevelandfed.org/research/...entary/2007/0707.cfm](http://www.clevelandfed.org/research/...entary/2007/0707.cfm)

Source: University of Wisconsin-Madison

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