Buyers' readiness to take risk is top cause for volatility in US house prices

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The cliché version of the American dream usually involves getting married, finding a good job, raising 2.5 kids and buying a home with a white picket fence.

But in recent times spiking prices can make home ownership impossible—or falling prices can trap homeowners in so-called "upside-down" mortgages, where debt dwarfs the shrinking value of a house.

"To determine the right price of a house, people need to make long-term projections of many uncertain economic variables, such as interest rate," said Shu Wu, associate professor of economics at the University of Kansas. "These projections can be subjective and are prone to big errors when people become either too optimistic or too pessimistic about the future."

According to new study to be published in the *Journal of Money Credit and Banking* by Wu and co-authors Joseph Fairchild at Bank of America and Jun Ma at the University of Alabama, consumer willingness to roll the dice in such a marketplace in large part triggers fluctuations in housing prices.

"We find that people's attitude toward risk plays the most important role in driving housing prices at both national and local market levels," Wu said. "People speculate in housing market just like they do in any other asset markets. People buy houses not because they need a place to live, but because they want to or believe they can sell the properties for a profit in near future."

The researchers used a dynamic factor model to boil down the price-rent ratios of 23 major housing markets into a national factor and independent local factors, then tied these to economic fundamentals of housing markets in the U.S. Thereby, they aimed to separate national factors that affect house prices from local factors distinct from the national housing market.

Nationally, Wu and his counterparts found three factors that influenced the price of houses most.

"The main drivers are interest rate, rent and people's willingness to take on risk," Wu said. "We found the swings in the last factor account for the most of the volatility in housing market nationwide."

Likewise, in local housing markets, consumer enthusiasm for taking chances in the face of uncertainty was the dominant influencer on prices. "We find a similar result in a local market, that is, changes in people's willingness to take on risk have the biggest impact on housing price," he said.

Other findings in the study showed that local price effects have fallen, especially since 1999. But, at the national level, lower interest rates have boosted housing prices and the volatility of prices. A reason for the increase in volatility is linked to potential homeowners' over-reaction to low interest rates and misinterpretation of these rates relative to inflation.

The effect is known as "money illusion" in investment models and translates into home ownership as well.

"'Money illusion' means people fail to recognize the effect of inflation and therefore make wrong forecasts of future economic variables such as interest rate," Wu said.

Based on his study, the economist believes that national factors have become more important in driving changes in housing prices today. He thinks would-be buyers should expect more volatility in housing prices going forward and make buying decisions based on long-term needs, rather than unfounded fear or unsustainable optimism.

"To many households in the U.S., the house they live in is also their biggest saving account," Wu said. "Changes in housing price have a direct impact on their personal wealth."