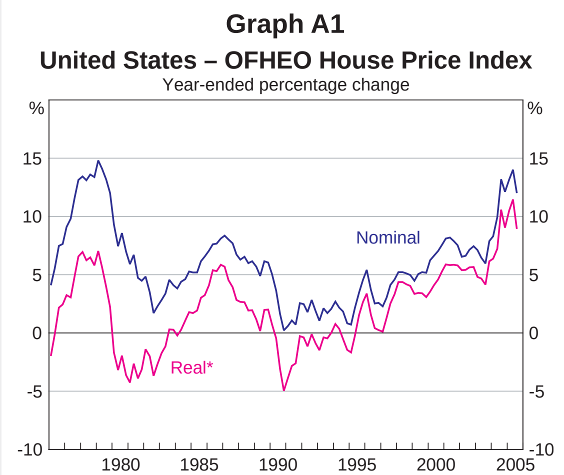
Box A: Developments in the US Housing Market

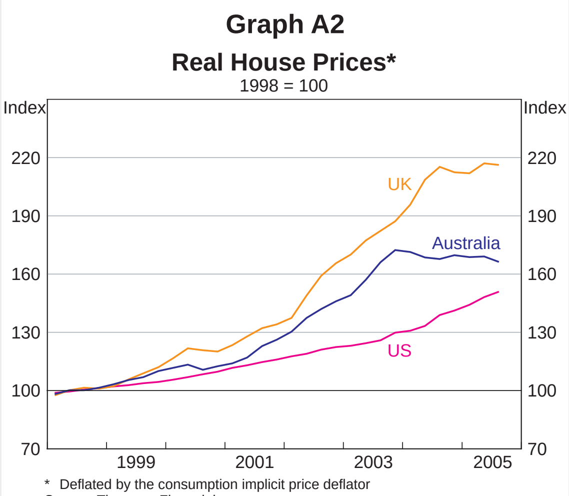
Like a number of other industrialised countries, the United States has experienced buoyant conditions in the housing market in recent years. Housing construction, sales and real price growth have all reached record levels. The house-building sector has made a large contribution to overall economic activity and employment, and the wealth effects of strong house price gains have supported consumption growth. However, the rapid growth in prices has raised concerns that housing may have become overvalued and that a slowing in the market would remove an important recent driver of economic growth. This box outlines some recent developments in the US housing sector.

US house prices have increased especially strongly over the past two years, with growth averaging around 13 per cent per annum according to the Office of Federal Housing Enterprise Oversight (OFHEO) house price index (Graph A1). In real terms, house price growth has been stronger than at any other time in the 30 years for which the OFHEO index is available, although the cumulative increase in prices since the late 1990s is not as large as the increases seen in Australia and the UK (Graph A2). The resultant rise in housing wealth is likely to have boosted US consumption growth in the last couple of years, with housing equity withdrawal increasing substantially and the saving rate declining.

The rapid house price appreciation has been accompanied by strong building activity. Annualised housing starts have averaged about 2 million



* Deflated by the consumption implicit price deflator
Source: Thomson Financial



* Deflated by the consumption implicit price deflator
Source: Thomson Financial

since late 2003, or about 1.6 per cent of the overall housing stock, well above the average of 1.3 per cent over the second half of the 1990s. Residential investment now stands at 6.2 per cent of GDP, the highest share for 50 years, up from 4.6 per cent at the start of the decade. Strong housing activity has also led to a boom in housing-related employment. Residential building employment increased by 26 per cent over the five years to January 2006, while overall employment increased by only 1½ per cent during this period.

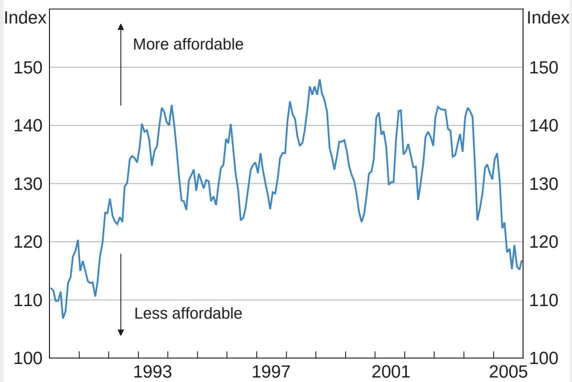
Conditions in the housing market have varied across the US. To some extent, the regional divergences in price growth have reflected divergences in underlying demand for housing due to different rates of population growth. For example, average annual price growth of more than 20 per cent over the past two years in California, Florida, Arizona and Nevada has been associated with strong population growth in these areas. More generally, the South and West have accounted for a disproportionate share of building activity in recent years, reflecting the relative shift in the population away from the Northeast and Midwest and the comparative availability of land. However, house price growth has also been rapid in a number of areas in the Northeast – such as New Jersey, New York and the District of Columbia – in which population growth has lagged behind the US average.

Although higher house prices and levels of borrowing have caused an increase in the US household debt-servicing ratio in recent years, it remains at the lower end of the range of the ratios in other English-speaking countries. Low mortgage rates have been an important factor. The nominal 30-year fixed mortgage rate, which applies to the bulk of US mortgages, is around the same level now as when the Federal Reserve began its tightening cycle in mid 2004. Furthermore, the development of new mortgage products, such as adjustable-rate and interest-only mortgages, has increased the capacity of households to borrow, as such mortgages typically entail smaller initial repayments than fixed-rate mortgages. In recent times, adjustable-rate mortgages have accounted for around one-third of new mortgages, although they remain a small share of the overall stock of mortgages.

Strong house price appreciation has led to a reduction in housing affordability over the past couple of years (Graph A3). However, with mortgage rates remaining at relatively low levels, the median family income has nonetheless remained sufficient to qualify for a mortgage for a median-price home (based on standardised loan qualification criteria), and the home ownership rate has increased from 65 per cent to 69 per cent over the past decade.

Graph A3

United States – Housing Affordability Index*



* A value of 100 indicates that a family with the median income has exactly enough income to qualify for a mortgage for a median-priced home, assuming a 20 per cent deposit and loan repayments equal to 25 per cent of the median family monthly income.

Sources: Thomson Financial; US National Association of Realtors

The strong pace of activity and house price inflation in the US has raised questions about their sustainability. However, the rate of new dwelling construction over recent years, while high, appears to have been broadly in line with estimates of underlying demand. Furthermore, the rise in the ratio of housing turnover to the housing stock can be partly explained by population movements, although increased investor activity and 'flipping', whereby investors buy properties with the intention of selling quickly to make capital gains, have also been important factors. With regard to prices, while it is difficult to be definitive, the house price-to-income ratio has increased to unprecedented levels in some areas (especially in parts of California) and former Federal Reserve Chairman Alan Greenspan referred to 'signs of froth in some local markets where home prices seem to have risen to unsustainable levels'.[1] Hence, it may not be surprising that there is some evidence house price growth in the US started to slow in late 2005, which most commentators expect will lead to a moderation in the pace of consumption growth.

1 *Greenspan A (2005), 'Testimony', Joint Economic Committee, United States Congress, 9 June.*