Downward Stickiness in Prices

By Prof. Karl E. Case

In most markets when excess supply develops, prices fall quickly to clear the market. On the other hand, housing downturns have been characterized by "sticky prices." That is, sales and starts drop but prices are slow to respond. But during the current downturn, housing prices have fallen sharply and quickly. The question is: what is different today?

First, let's review the story behind sticky prices. Every housing downturn, national or regional, begins with an excess of supply, in most cases because demand has declined. Most downturns begin with rising interest rates, but demand can drop for any number of reasons: demographic pressures, a weak core economy with falling income or rising unemployment, house prices simply rising far faster than income, or a change in market psychology. On the other hand, there are clear instances of overbuilding with supply simply rising faster than demand. Of course, these causal factors can all be present and they always interact. A decline in a regional economy or a simple glut of condominiums can lead to a marked increase in the number of listings, newspaper articles and "for sale" signs, which can trigger a shift in consumer psychology, accelerating a demand decline.

In the past, when imbalances occurred in housing, prices were slow to respond. Since housing is heterogeneous, and comparable sales are not sales of identical units, sellers are uncertain of the actual worth of their property. Indeed, the value is determined in a stochastic process in which buyers and sellers search for exchange terms that will lead to a sale. Also, sellers see the worth of their property as embodied in comparable sales at the peak. "Sarah sold her house next door for $455,000 two years ago, and my house is identical except for the new kitchen I added. Mine must be worth at least as much as hers."

Bob Shiller and I have surveyed homebuyers for nearly two decades, and consistent evidence of this stickiness is found in the responses to survey questions. Buyers who sold properties prior to buying in the four metropolitan areas surveyed (Orange County and San Francisco in California, Boston and Milwaukee) were asked, "If you had been unable to sell your home for the price that you received, what would you have done?" The answers of the 254 respondents in the first survey have not materially changed over the years. Of the total, 95 (37%) said that they would have "left the price the same and waited for a buyer, knowing full well that it might take a long time." Another 70 (28%) answered that they would have taken the house off the market or rented it. In addition, 77 (30%) answered that they would have "lowered the price step by step hoping to find a buyer." Only 12 respondents (5%) answered that they would have "lowered the price until a buyer was found."

Downward stickiness has been most evident when demand declines are triggered by mortgage rate increases and most homeowners are sitting on fixed rate mortgages. The classic example was at the end of the California boom which lasted from mid-1975 to the 3rd quarter of 1980. During the boom, house prices in the state nearly tripled, increasing 170%. But in 1980, interest rates were on the rise and the average mortgage rate settled in between 16 and 18%. The double dip recession itself dampened demand in the state, but the combination of high interest rates and the recession caused the housing market to cool sharply. But prices in California never fell in the ensuing period.

The reason? If I sell I have to pay off my fixed rate mortgage.

Today, conditions are different. The S&P/Case-Shiller Indices are based essentially on all sales of property. Today a significant portion of the observed sales are purchases of property at foreclosure sales. While the indices exclude bank *purchases* usually made at the mortgage amount, they include bank *sales*. When a bank or other institution holding a property after foreclosure puts the home on the market, it wants to clear inventory and be out. There is little observed stickiness. In addition, most of the foreclosed property was financed with variable rate product, not fixed, and the downturn was not triggered by a rate spike.

As long as the foreclosure auctions continue to account for a significant portion of the observed transactions, prices will continue to fall until the market clears. When it does, the traditional stickiness will return and prices will eventually stabilize.

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