

Crossroads

ECONOMIC TRENDS IN THE DESERT SOUTHWEST

Housing Market Trends in El Paso

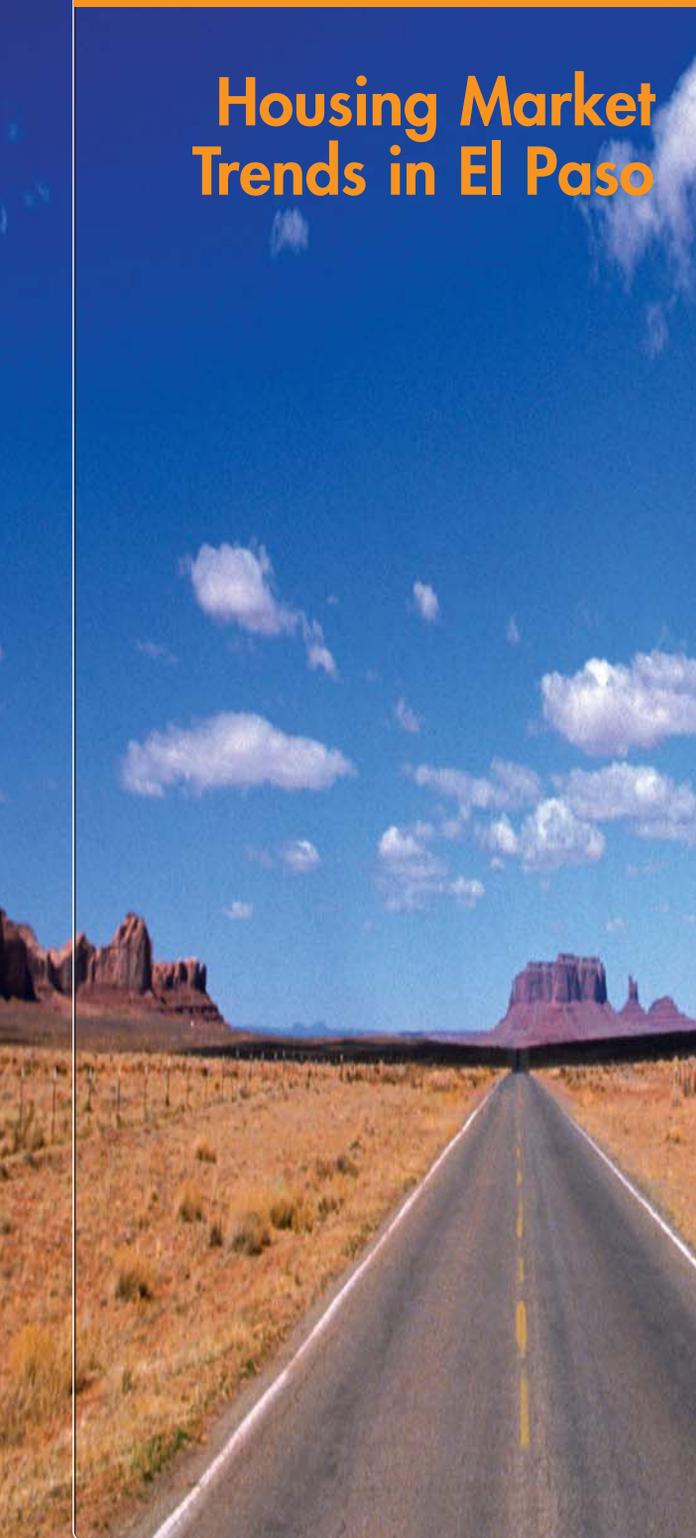
Housing prices have received considerable attention in recent years as concerns over potential excess appreciation have emerged for both national and regional markets. In general, moderate increases in house prices often reflect and contribute to a region's economic and financial health. In fact, the strong U.S. housing market has been a key factor in sustaining consumer spending in recent years. Home prices can be too high or too low, but if a market becomes misaligned with excessively high prices, the resulting correction can reduce perceived wealth and leave homeowners saddled with high payments.

As in many other areas, price increases in the El Paso housing market have raised questions about whether local real estate prices are still in line with regional economic conditions. Since 2003, home prices in El Paso have risen 39.8 percent, exceeding the 24.8 percent increase for the U.S. but falling short of the hottest markets, such as Honolulu (67.1 percent), Miami (64 percent) and Los Angeles suburbs such as Riverside (84.6 percent). Some argue the El Paso increases are a correction in a historically underpriced market; others say restrictions on local development are artificially inflating prices.¹

This article is a brief look at recent conditions in El Paso's housing market. We will not resolve the question of whether home prices are too high or too low, but we can look closely at the forces driving El Paso's recent price increases. A surge in demand driven by recent employment gains and the expansion of Fort Bliss is probably the major factor pushing prices up—and El Paso's ability to develop new lots and to meet this surge in demand may be the key to whether a growing bubble lies ahead.

Home Prices in the Local Economy

Households tend to benefit from strengthening housing markets. It has been argued that gains in housing wealth were largely responsible for the strength in consumer expenditures observed in the United States during the 2001 recession.²



Much of that strength is attributable to mortgage refinancing and subsequent household equity withdrawals. Not all cash-out refinancing is used for personal consumption, but survey evidence confirms that a substantial percentage of it does support retail purchases.³ Robust consumer expenditures have helped improve overall business conditions in the U.S., as well as in the El Paso region.

Recent mortgage innovations and other developments have contributed to higher household liquidity. Moreover, those innovations include loan options that make it easier for first-time buyers to qualify for mortgages, with smaller down payments than those historically required by lenders. These changes probably increase effective demand and can lift overall house prices. Consequently, if a bubble existed and burst, home prices would fall and an important support for consumption would be gone. Such a development would reduce retail activity around the country, including in El Paso.

A “bubble” generally describes a substantially overvalued asset price (often 20 percent or more above historical norms) that is in danger of collapsing.⁴ A house price bubble can also be defined as an upward deviation of the market price from the true value of the house. The term also refers to situations in which excessive public expectations of future price increases cause prices to become temporarily elevated.

During housing market bubbles, homebuyer behavior changes. Structures that prospective buyers would normally consider too expensive are frequently regarded as acceptable purchases. That occurs because investors believe they will be compensated by significant future price appreciation. In addition, first-time homebuyers may worry that

if they don’t buy now, they won’t be able to afford a house later.

Housing Bubbles

There are two basic categories of housing bubbles: price bubbles and supply bubbles. Price bubbles generally occur in expensive, supply-constrained markets. These are regions with a tight supply of new homes resulting from tough and often artificial restrictions on development, such as zoning or a limited supply of vacant land. On the other hand, supply bubbles generally occur in the inexpensive, supply-abundant markets when builders expand too rapidly, eventually leading to housing surpluses. Both conditions have been argued to exist in El Paso. Real estate agents have complained that El Paso is underpriced, while builders have argued that the supply of available lots is too small for a fast-growing market of more than 725,000 people.

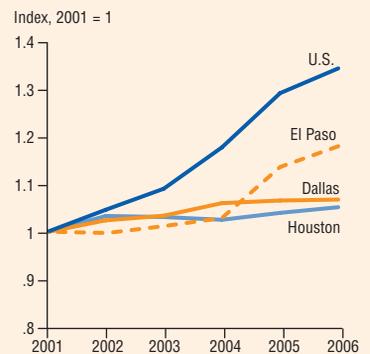
In general, key characteristics of a price bubble include price levels that have been bid up beyond what is consistent with underlying fundamentals plus sustainable buyer expectations of future price increases. As we have seen, housing prices have risen substantially in El Paso since 2003, but price increases alone don’t provide conclusive evidence of a housing bubble. Two measures have been widely used to examine the purported existence of housing bubbles: (1) home prices relative to rents, and (2) affordability.

One widely used indicator of housing market health is the ratio of single-family home prices to implicit rents.⁵ Implicit rent, or owner’s equivalent rent, is defined as the amount a homeowner would have to pay to rent a housing unit. Accordingly, the ratio of home prices to rents should reflect the future benefits of ownership, through either

rental income earned by a landlord or implicit rent saved by an owner-occupier. Because it uses data from owner occupancy and rental markets, the price-to-rent ratio helps signal whether supply-and-demand market imbalances are temporarily inflating single-family prices beyond reasonable levels. Large and long deviations in the price-to-rent ratio from its historical average may be seen as the onset of a bubble.⁶

Unfortunately, we do not have a long series on implicit rents for El Paso. Chart 1 illustrates the relationship between housing prices and rents in the U.S. and El Paso from 2001 to the present. Comparisons are also included for Houston and Dallas, two rapidly growing markets for single-family homes that both have the capacity for rapid development. The El Paso ratio turns around later and grows more slowly than the U.S. ratio, but it also grows much faster than the other Texas cities’ ratios over the past two years. While we don’t know to what extent this is a deviation from historical norms, it is clear that during the past two years single-

Chart 1
Ratio of Single-Family Home Prices to Rents in U.S. and Texas Cities



NOTE: 2006 is through September.

SOURCES: Office of Federal Housing Enterprise Oversight; Bureau of Labor Statistics; Texas A&M Real Estate Center.

family housing in El Paso was subject to a shock not shared by the local cost of lodging.

Another frequently used measure of overpriced housing is its long-term affordability in the local market, comparing the median family income in El Paso to the income required to qualify for a conventional mortgage on the median-priced El Paso home. If this ratio is relatively low, down payments and monthly mortgage payments are more difficult to meet. From a financial institution's perspective, this reduces the pool of qualified borrowers in the credit market. Such conditions would naturally lessen demand and place downward pressure on home prices. Higher mortgage interest rates would exert similar effects on housing markets.

Chart 2 shows this affordability index for a conventional mortgage in El Paso annually from 1990 to 2006. The largest values indicate the most affordable markets, and low values indicate diminished affordability.⁷ The least affordable year is 1990, when interest rates stood at 9.9 percent. The most affordable year is 2004, the end of a period of low and declining interest rates and stagnant growth in El Paso.

The sharp recent decline in affordability was due to a combination of rising interest rates (from 5.9 percent to 6.5 percent) and substantial increases in local home prices. Chart 3, for example, shows how affordability declined quarterly from 2004Q3 to 2006Q2 and how it would have declined if interest rates had remained constant at 2004Q3 levels. Clearly, home price increases dominated interest rates in this movement.

The current affordability index is low but within ranges visited in the not-distant past. Part of the steep slide in affordability was attributable to a desirable

Chart 2
Affordability Index for El Paso Declines in Recent Years



NOTE: 2006 is through September.

SOURCES: Texas A&M Real Estate Center; Department of Housing and Urban Development; authors' calculations.

correction after a period of low mortgage rates and poor economic performance. Comparing El Paso's affordability with other Texas cities, El Paso ranks very near the bottom of the list. However, the fact that it is accompanied at the bottom by Brownsville and McAllen suggests that very low median family income on the border plays a significant role in determining the level of these indexes relative to other areas.

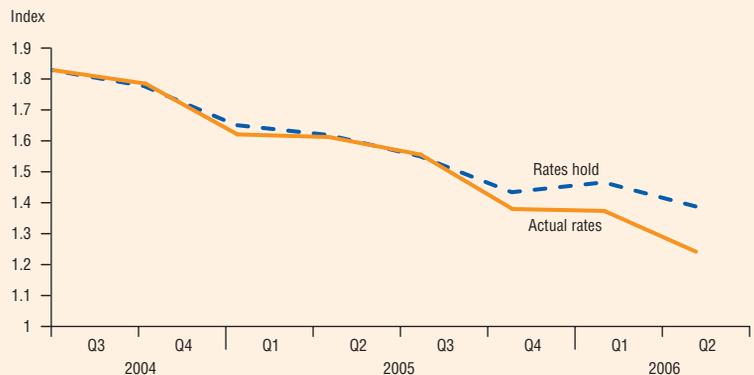
Why Higher Home Prices?

The sharp appreciation in home prices since 2004 is partly

due to local job growth, as U.S. industrial production rebounded and as Mexico's economy and the maquiladora industry began to grow strongly. However, more relevant is the resetting of expectations about the current and future demand for these houses due to the 2005 decision to double the size of El Paso's largest employer—Fort Bliss.

The Base Realignment and Closure Commission made this event a high probability in 2004, and Congress and the president approved it in 2005. It will bring as many as 21,000 new troops and their families to the city,

Chart 3
Interest Rates Versus Affordability



SOURCES: Texas A&M Real Estate Center; Department of Housing and Urban Development; authors' calculations.

with about half seeking housing off base. About 4,000 troops have already arrived, and the remainder will be in El Paso by 2012. The demand curve for El Paso's housing shifted quickly and sharply to the right, with the local stock of single-family homes unable to catch up to demand in a short period. Prices responded accordingly.

If the recent price increases have a solid basis in underlying demand growth, the question of a housing bubble emerging depends on the city's ability to deliver new homes to market in a timely way. Barriers or delays will simply push prices higher as demand grows and could create (or add to) a speculative atmosphere in local housing.

During the first nine months of this year, El Paso issued the lowest number of permits for single-family houses since 2002 (Chart 4). The slow pace seems to be the result of a shortage of developed lots in the city. Although several large master-planned developments are under way in El Paso, including a 3,500-acre development near Fort Bliss in northeast El Paso, these projects have yet to impact the market. Meanwhile, lot prices have soared.

There is a clear need to prudently expedite the development of new land and lots, and especially not to allow it to be delayed by the kind of artificial land-use controls—often coming under various smart-growth and new urbanism labels—that have created the bubbles we now see imploding on both coasts.

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Notes

¹ Home-price appreciation figures are from the National Association of Realtors, annual 2003 through 2006Q3.

² "House Price Bubbles," by John Krainer, Federal Reserve Bank of San Francisco *Economic Letter*, March 7, 2003.

³ "Mortgage Refinancing in 2001 and Early 2002," by Glenn Canner, Karen Dynan and Wayne Passmore, *Federal Reserve Bulletin*, December 2002, pp. 469–81.

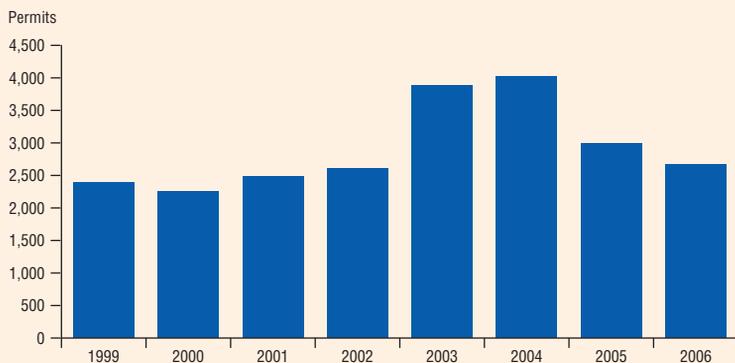
⁴ "Making Sense of Elevated Housing Prices," by John V. Duca, Federal Reserve Bank of Dallas *Southwest Economy*, September/October 2005.

⁵ The implicit rent measure used here for the United States, Houston and Dallas is from the consumer price index for the respective area. The consumer price index is not collected in El Paso, and an index of rental values for zero- to five-bedroom apartments is used in its place.

⁶ "House Prices and Fundamental Value," by John Krainer and Chishen Wei, Federal Reserve Bank of San Francisco *Economic Letter*, Oct. 1, 2004.

⁷ These calculations follow the methodology of the Texas Affordability Index of the Real Estate Center at Texas A&M University, available at <http://recenter.tamu.edu/data/dataaffd.html>.

Chart 4
Pace Slows for Single-Family Permits Issued in El Paso



NOTE: 2006 is through September.

SOURCE: Texas A&M Real Estate Center.

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