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SHOULD YOU BUY A HOME IN THE US?

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Robert j. Shiller, Nobel laureate in economics, Professor of Economics at Yale University and author

Even at currently elevated US home-price levels, buying still makes sense for those who are set on ownership. But buyers need to be sure that they can accept what could be a rather bumpy and disappointing long-term path for home values.

NEW HAVEN – A few days ago, I got an email from a man who chastised me for my scepticism about investing in housing today. He identified himself as a former US Air Force pilot during the Vietnam War who subsequently became a stockbroker and banker before retiring recently. "You, as an educated person," he wrote, "should be helping and promoting the ownership of real estate."

He was responding to my warning about a bubble in home prices in many places around the world. According to the latest S&P CoreLogic Case-Shiller Home Price Indices, US home prices rose at a record rate of 19.7% in the last year, and now look very unstable. They might increase further for a while, but that may be followed by serious declines.

Still, my correspondent was at least partly right about what I should say to the public about homeownership. In particular, we should recognize its big-picture effect on our lives, despite the recent extreme price volatility.

But investing in housing in booming locations may not be as safe a long-term bet as many seem to think. Prospective US home buyers might logically assume that their tenure in a house will outlast any interruption to an upward trend in home prices, enabling them eventually to benefit from new highs. After all, real home prices in the United States fell by 36% nationally from December 2005 to February 2012, because of the Great Recession, but then increased by 71% to a level 10% above their 2005 peak.

However, I have been arguing for years that the US housing market's performance since 2005 is not the only relevant example of long-term home-price trends. My historical data show that real US national home prices were sometimes lower in the 1990s than in the 1890s. Over that century, cities spread out to cheaper land, and building tools, technology, and transportation became more efficient.

Moreover, land itself is still cheap: the average cost today of one acre (0.4 hectares) of US farmland – onto which one can easily squeeze four or five houses – is only $3,380. Yes, farmland may be far away from cities, but history shows that cities start sprouting up in new places as the population increases.

Nevertheless, the Air Force pilot turned banker disagreed with my real-estate outlook. "In this country, like all developed countries, real estate is at the root of wealth as measured by money value," he wrote. "It has been that way for at least a thousand years, and there is no indication we are creating any more real estate."

So, let's imagine that, for the past 1,000 years, home prices had beaten the US stock market's average 7% annual return (after reinvesting dividends) in the twentieth century. During that time, these home prices, after compounding, would have increased by a factor of 24 followed by 28 zeroes.

But hardly any homes from a millennium ago remain today, and hardly anyone would want to live in those that have survived. Furthermore, the land they sat on is often no longer valuable. In Biblical times, for example, Ephesus in western Turkey was a coastal city with magnificent buildings. But its once-valuable harbor has since silted, so that the city's ruins are now miles from the sea.

It is mostly true that we are not creating any more real estate, if we consider land only in the strict sense of the term. Land creation, as in the case of Dubai's artificial archipelagos, is not a scalable solution. But we are essentially adding new space by developing high-rise apartments, creating virtual land in the form of online conference services and electronic storage, and improving transportation so that people can live in remote areas with cheap land.

The emailer then recounted his own experiences in the US housing market: "The first house we bought was in 1971 for $19,000, now worth over $300K, second house for $34K, now worth over $400K, third house for $130K, now worth over $450K, fourth house for $190K, now worth $435K, fifth house for $305K, sold for $800K three years later, the current house bought for $300K (downsizing in retirement) and worth $450K."

According to his numbers, the value of the first house has increased by a factor of 15.8 (300,000/19,000). But over that 50-year period, the US consumer price index has risen by a factor of 6.7, which means that the real value of the home did little more than double. And the compounded annual real price return over those five decades is only 1.7%.

Finally, he noted, "even the tax laws favor owning real estate." That is true. There is often a tax subsidy to homeownership; in most countries, imputed rent on owner-occupied housing is not subject to income tax. But this tax subsidy does not appear to be growing, and so does not justify continued increases in home prices.

But I take the emailer's moral imperative seriously. Even at currently elevated US home-price levels, buying still makes sense for those who are set on homeownership and want to get on with their lives. Homeownership can activate a predilection for community, long-term friendships with neighbors, and a sense of security and permanence.

Moreover, buying a house with a mortgage serves as a self-control mechanism that helps people to save more. The discipline imposed on young homeowners by regular amortizing mortgage payments is a key driver of retirement saving. And buyers can hedge some of their risk in the home price index futures market.

Make no mistake: homeownership clearly has its benefits. But people who really want to buy now need to be sure that they can accept what could be a rather bumpy and disappointing long-term path for home values.