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INTEREST IN INTEREST

RISING RATES AND HOME SALES

BY JACK C. HARRIS

Even economists would agree that when interest rates go up, home sales decline. After all, for most buyers, the interest rate represents a significant part of the price, translating into higher or lower monthly payments.

Interest rates have a potent effect on affordability, and declining rates have been a major factor in the record number of home sales over the last several years. But the seemingly simple relationship between interest rates and cost is more complicated than it seems.

If the home is a principal residence, much of the monthly payment is tax-deductible. Within generous limits, money spent on mortgage interest can be claimed as an itemized deduction on federal income taxes. This means that part of the cost of higher interest rates may be offset by lower taxes.

As interest rates rise, more homebuyers resort to adjustable rate loans, which offer lower initial interest rates. True, these buyers take a chance that the rate will rise in the future, but the lower current rate makes the purchase more affordable.

Buyers may see higher interest rates as signaling inflation that will be reflected in the value of the home and increase the resale price in the future. An increase in inflation expectations may actually make real property more desirable because of its reputation as a hedge against inflation.

Higher interest rates often coincide with an improving economy, bringing more employment, higher incomes and added economic security, all of which tend to expand the demand for housing. The initial stage of a rate increase may cause people looking for a home to accelerate the process, thus raising sales temporarily.

The market has benefited in recent years from unusually low mortgage interest rates. Current expectations are for a gradual increase in rates over the next year or so, largely through the actions of the Federal Reserve Bank. The Fed is expected to raise interest rate targets to slow the growth of the money supply and counter any inflationary pressures now that the economy appears to be expanding.

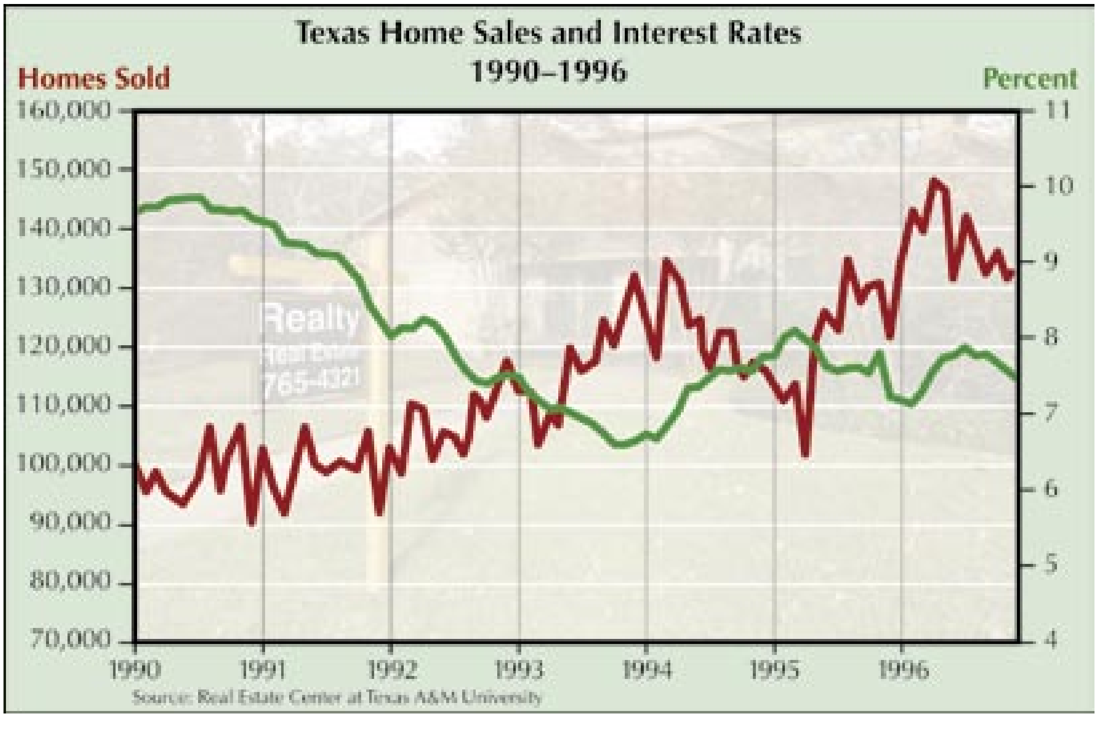
While no one is predicting a return to double-digit rates, the days of rates below 6 percent are probably history. Will this increase kill the housing boom? Perhaps not, if the market continues to behave as it has over the past eight years.

The Recent Past

By far, the predominant trend for interest rates over the past 15 years has been downward. The trend began in the early 1980s as the Federal Reserve whittled away at inflation expectations that had pushed mortgage rates into the upper teens. The 1990s began with mortgage rates close to the two-digit level but headed downward.

Along the way, the descent has been punctuated by bounces of 50 or more basis points (100 basis points equal one percentage point). These interruptions in trend provide opportunities to examine how housing markets react to both periods of rising and falling credit costs.

To make it easier to see movements in the interest rate and housing markets, monthly (rather than annual) rate and sales data are portrayed in the charts and used to delimit the periods of rising and falling rates. Home sales are indicated by the total of all single-family sales as reported by local Realtor® boards and associations throughout Texas. The raw data can be found on the Center's website (recenter.tamu.edu).


Texas Home Sales and Interest Rates
1990–1996

Source: Real Estate Center at Texas A&M University

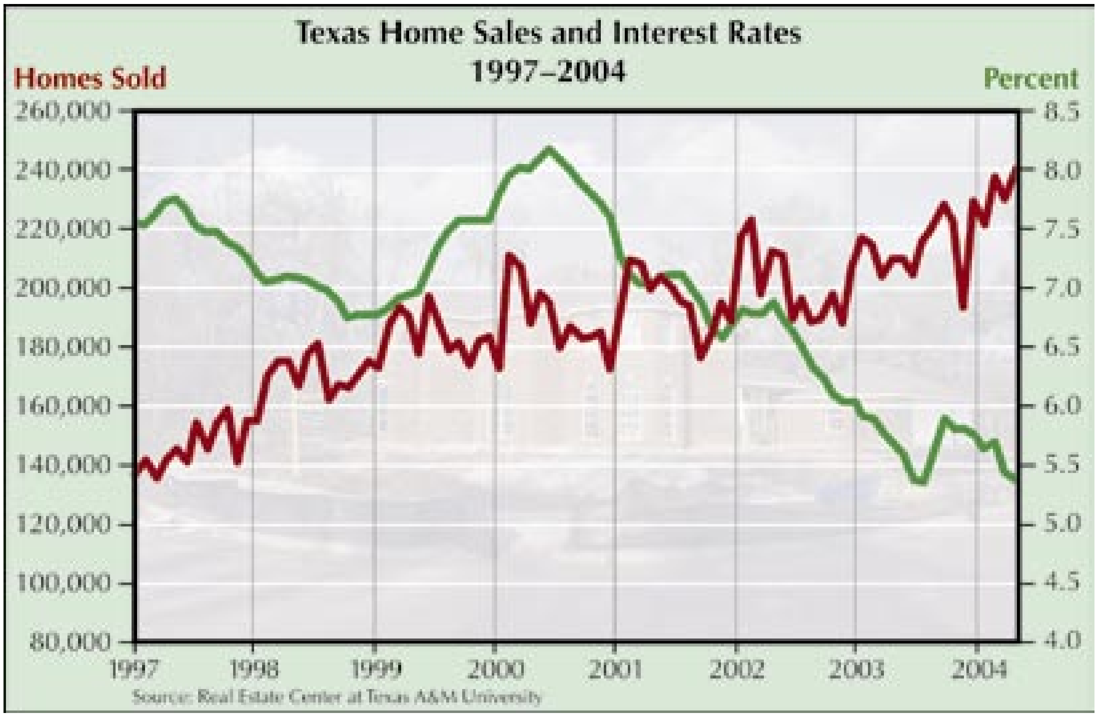
Seasonally adjusted annual totals are estimated from the raw monthly sales figures (basically a 12-month projection based on monthly totals). Because monthly sales figures are based on closed sales, they are advanced two months to approximate the period when the sales contract was executed.

For the first half of the 1990s, housing markets were sensitive to interest rate changes. The decade began with the economy coming out of the Gulf War recession. Consequently, the growth in Texas employment was slow.

Contract mortgage interest rates fell from 9.85 percent to a low of 6.59 percent in late 1993. Much of this decline was caused by lower inflation, but even "real" rates (the nominal rate minus the inflation rate) declined 160 basis points. Despite the slow economy, seasonally adjusted sales grew by 6.5 percent per year during the period.

As the recovery matured, the Fed grew wary of inflationary pressures and tightened throughout 1994. Mortgage rates responded with a 148 basis point climb, peaking at over 8 percent in early 1995. Real rates returned to their 1990 level. Texas home sales dropped 18.5 percent from spring 1994 to spring 1995.

Rates resumed their fall through the remainder of 1995, hitting a low of 7.13 percent in early 1996. Texas housing markets celebrated with a surge equal to a 22 percent annual growth rate. During the next five months, interest rates reversed course again and spiked up to 7.87 percent in July. Sales during this time slid by almost 11 percent (26 percent on an annualized basis).


Texas Home Sales and Interest Rates 1997–2004

Source: Real Estate Center at Texas A&M University

Era of Easy Mortgage Credit

The sensitivity of housing sales to interest rate swings all but disappeared in the mid-1990s. Starting in mid-1996, interest rates fell for the next two years to a low of 6.74 percent. While sales went up, the annual growth rate was a little over 12 percent — not remarkable considering the severe contraction of the previous period and the fact that employment grew by 4 percent per year during the interval.

Late in 1998, the Fed began a series of rate hikes that eventually sent mortgage interest rates back over 8 percent — in total, an increase of 143 basis points. The rise did manage to slow the raging economy, but had minimal effect on the housing market. Sales grew by an annual rate of almost 4 percent and median sales prices went up by more than 8 percent.

After 2000, interest rates declined and home sales continued to grow by almost 9 percent per year. Prices grew by 4 percent per year. All this occurred despite stagnant employment figures. Predictions are for rates to go higher. Most observers feel that the low rates of recent years will not be seen again in the near future.

Will home sales volume continue to grow if rates increase from here? Recent history suggests that any pullback will be negligible even if rates rise by a full percentage point. The experience of recent years supports this outlook. However, if the market reverts to its early 1990s mode, a more drastic pullback could be in store.

The main difference between the earlier period and the last eight years is mortgage lenders' attitudes toward risk. In 1989, the Federal Institutions Reform, Recovery and Enforcement Act was passed. This was the law that created the Recovery Trust Corporation to clean up after the failed savings and loan associations across the country. During this time, mortgage lenders and insurers, even the FHA, raised the bar on loans they made and insured, effectively cutting off the entry level of the housing market.

By the mid-'90s, mortgage markets were in much better shape, and the federal government began a push to extend homeownership to lower-income and minority households. Lending criteria were loosened and down payment requirements reduced at the same time interest rates were mostly falling. In an environment of easily-acquired financing, the occasional rate increase had much less effect than during the earlier tight credit period.

Most likely, higher interest rates will not kill the housing boom. Contraction in lenders' willingness to extend credit would be a more serious threat.

Fortunately, the only sign that such a contraction might be imminent is the currently high delinquency rate on FHA loans. With the economy in recovery, the delinquency rate may recede, but it does bear watching by all who value a robust housing market.

Dr. Harris (j-harris@tamu.edu) is a research economist with the Real Estate Center at Texas A&M University.

MAYS BUSINESS SCHOOL

Texas A&M University
2115 TAMU
College Station, TX 77843-2115

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