The Double Whammy of Foreclosures

BY CHARLES GERENA

"The Impact of Foreclosures on the Housing Market." Daniel Hartley, Federal Reserve Bank of Cleveland Economic Commentary 2010-15, October 2010.

If a foreclosure notice is tacked onto the door of your neighbor's house, there's a good chance the value of your house will be affected as well. There are two reasons for this, and research by Cleveland Fed economist Daniel Hartley suggests that local housing markets may determine which one is more important for owners, lenders, and policymakers to address.

One way that foreclosures can decrease property values is by suddenly increasing the supply of available homes in a given market. This supply shock may lower prices and/or increase the time that houses remain on sale. At the same time, the people who lose their homes may not be in the market for another house. They are less creditworthy and prohibited for several years from getting certain mortgages like FHA loans.

"This means that the former homeowner will most likely rent or move in with family for a number of years," notes Hartley. "This is important because unless the foreclosed home is converted to a rental property, the foreclosure will result in an additional home on the market, but no addition to the pool of potential buyers."

Another way that foreclosures reduce neighboring home prices is by making a community less desirable. A foreclosed home may not be maintained as well as surrounding properties or sit unoccupied, attracting criminal activity. This is known as a "disamenity," the opposite of amenities like good schools that boost a neighborhood's home values.

But which mechanism is more important, the supply shock or the disamenity effect of foreclosures? Hartley tackled this question by studying a decade's worth of housing transactions and foreclosures in Chicago. He found that in neighborhoods with a low vacancy rate, foreclosures lowered property values by way of the supply effect while the disamenity effect was near zero. The opposite was true in neighborhoods with high vacancy rates — foreclosures lowered prices by way of the disamenity effect and the supply effect was almost nonexistent.

Hartley's finding suggests different policies might be necessary to stem the negative effects of the foreclosure wave. "In low-vacancy-rate neighborhoods ... the best strategy may be to meter out the foreclosed properties at a rate slow enough to avoid flooding the market," he notes. "In contrast, in high-vacancy-rate neighborhoods ... the most important issue is making sure that properties are kept up and do not sit vacant."

"Improving Survey Measures of Household Inflation Expectations." Wändi Bruine de Bruin et al., Federal Reserve Bank of New York *Current Issues in Economics and Finance*, vol. 16, no. 7, August/September 2010.

Whether you decide to go shopping or keep your savings in the bank is likely dependent on what you expect the value of your money to be in the future. That's one reason why many economists — especially those at the Federal Reserve — try to estimate inflation expectations.

One approach is to find out what people think about future prices through consumer surveys. Four years ago, the New York Fed joined researchers at the Cleveland Fed and other institutions to analyze and hopefully improve existing surveys of consumers' inflation and wage expectations. Details of the project were published by the New York Fed.

The survey, administered since November 2007, has, among other things, confirmed earlier findings of differences in inflation expectations across demographic groups. Furthermore, it has revealed a decline in the uncertainty of consumers' expectations since mid-2008 and a persistent expectation that real wages will decline. The researchers plan future work to help predict "how consumers respond to specific price changes and other new information as well as to economic and financial developments."

"The State of State and Local Government Finance." Ronald C. Fisher, Federal Reserve Bank of St. Louis *Regional Economic Development*, October 2010, vol. 6, no. 1, pp. 4-22.

The public sector was hit hard by the recent recession and will face major challenges in managing its budgets during the next decade. "In the short run, taxes may be increased to restore fiscal stability as the economy recovers," noted Ronald Fisher, an economist at Michigan State University, during his keynote address at an April 2010 conference co-hosted by the St. Louis Fed. His remarks were published in a special issue of one of the Bank's journals, *Regional Economic Development*.

Fisher continued: "Of course, tax increases alone will not be enough. Several options have been widely discussed, including redesigning corrections systems, reconsidering public employee pension and benefit plans, broadening tax bases, building more substantial fiscal reserves ... and even reorganizing local government structure."

As for the long run, municipalities and states may have to reconsider how they spend money on things such as health care, education, and criminal justice as well as how to reform their sales and income tax systems. **RF**