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Home Prices Must Fall Far To Be In Sync With Rents

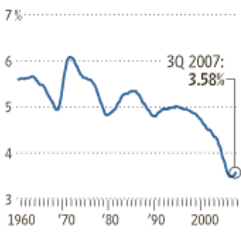
By GREG IP January 3, 2008; Page A2

U.S. house prices "likely would have to fall considerably" to return to a normal relationship with rents, says a study by one former and two current Federal Reserve economists.

The study, which doesn't necessarily reflect the views of Fed policy makers, suggests prices would have to fall 15% over five years, assuming rents rose 4% a year. House prices would have to fall further if the adjustment took place more quickly.

Homes vs. Rentals

Average annual rent as a percentage of average home price



Source: Morris Davis, Andreas Lehnert & Robert Martin

The study tracks rents and home prices back to 1960 and found annual rents fluctuated at around 5% to 5.25% of home prices until 1995. At the end of that year, the average monthly rent was about \$553 (or about \$6,600 a year) and the average home price was about \$134,000.

But starting in 1996, home prices started to grow much more rapidly than rents. By the end of 2006, they had more than doubled to an average of \$282,000, while the average rent had risen 48% to \$818. That drove the annual rent/price ratio down to 3.48%.

That means the rent/price ratio is about a third below its long-term average. To return to normal would require some combination of falling prices and rising rents. The paper suggests house prices would need to fall about 3% a year, if rents grew in

line with their 4% average annual growth this decade.

Of course, the link between house prices and rents can remain out of whack for years.

The U.S. study is by Morris Davis, an economist at the University of Wisconsin-Madison and until 2006 a staff economist at the Fed; and Andreas Lehnert and Robert F. Martin, staff economists at the Fed.

The authors' methodology was based in part on previously published work by Fed economist Joshua Gallin. The same approach is used by many other analysts, including the Congressional Budget Office, which arrived at similar conclusions.

In an interview, Mr. Davis said lower long-term interest rates can explain only a small part of the drop in the ratio. "To justify current price levels, you need rapid growth in rents." But it's hard to imagine the scenario that would justify such rapid growth in rents, he added. Indeed, it's possible rents will grow more slowly than 4%, reflecting the overhang of unsold homes that might be rented out.

Mr. Davis said the authors postulated a five-year horizon for the rent/price ratio to return to normal by looking at previous downturns. "When a downturn begins, it will last for a while."

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