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**ECONOMIC FUNDAMENTALS IN LOCAL HOUSING MARKETS:
EVIDENCE FROM U.S. METROPOLITAN REGIONS**

By

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**Economic Fundamentals in Local Housing Markets:
Evidence from U. S. Metropolitan Regions**

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Min Hwang* and John M. Quigley**

Abstract

This paper investigates the effects of national and regional economic conditions on housing market outcomes: the prices of owner-occupied housing, vacancies, and residential construction activity. Our three-equation model confirms the importance of changes in regional economic conditions, income and employment on local housing markets. The results provide the first detailed evidence on the importance of vacancies in the owner-occupied housing market in affecting housing prices and supplier activities. The results also document the importance of variations in materials, labor and capital costs and regulation in affecting new supply. Simulation exercises, using standard impulse response models, document the lags in market responses to endogenous shocks and the variations arising from differences in local parameters. The results also suggest the importance of local regulation in affecting the pattern of market responses to regional income shocks.

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I. Introduction

Housing markets are local, and housing market outcomes reflect local economic conditions. Housing prices are bid up as a result of better employment opportunities and higher incomes enjoyed by residents in an expanding metropolitan market. Changes in the distribution of income are reflected in the distribution of prices and housing amenities. Similarly, housing vacancy rates can be expected to decline as the local economy improves and as the demand for housing increases. Finally, residential construction and building activity are responsive to housing prices, vacancy rates and the health of the local economy. As higher incomes increase the demand for housing, prices are bid up; new construction becomes more profitable, inducing supplier activity. Dwellings that would otherwise become vacant remain occupied, and some dwellings that would otherwise leave the housing stock are renovated for continued use. Government regulation mediates all these interactions.

This paper considers the inter-relationship among these three forms of economic behavior in the context of local housing markets. We model the relationship among the prices of owner-occupied housing, vacancy rates, and housing supplier activity in response to the exogenous factors which affect the fortunes of the regional economy. We also recognize explicitly the importance of local land use and building regulations in affecting the operation of the owner-occupied housing market.

Our analysis uses U. S. metropolitan areas (MSAs) as units of observation, and we follow a panel of 74 MSAs over the thirteen year period, 1987-1999. The panel includes all U.S. metropolitan areas for which annual data are available on the prices of owner-occupied housing, on the vacancy rates in single family housing, and on supplier

activity (i.e., the number of permits issued for construction of new single family housing).

Figure 1 illustrates the course of housing prices during 1975-2000 for nine of the MSAs in the sample we analyze below. Note the enormous variation in the course of house prices. For the three California housing markets depicted, prices increased eight to twelve hundred percent between 1975 and 1999. For the least volatile markets in the sample (Houston, Albany, and Oklahoma City), nominal housing prices doubled during the past quarter century. Real housing prices in these latter markets were stagnant. What causes this enormous variation?

Figures 2, 3, and 4 illustrate some key relationships explored in this paper. Figure 2 investigates the predictability of housing price changes using our panel of MSAs covering 1987-1999. It presents the current annual price change in each of the 74 markets as a function of its lagged value. There is clearly a strong positive relationship, suggesting that lags and slow adjustment to market conditions are crucial to understanding the course of prices.

Figure 3 indicates the bivariate relationship between annual changes in vacancy rates for single family dwellings and changes in their prices, while Figure 4 illustrates the relationship between annual changes in house prices and the number of building permits issued for new construction of single family housing in these same metropolitan areas. These two figures provide little evidence of the systematic relationships postulated by economic theory. In particular, there is *no evidence* in the simple diagram that vacancy rates decline as house prices increase. There is also *no evidence* that supplier activity,

measured by building permits, increases in response to increases in housing prices. Is there *no empirical link* between vacancies, new supply and housing prices?

In this paper, we develop a model relating exogenous changes in regional employment and incomes, construction costs and macro economic conditions to these measures of the health of housing markets -- prices, vacancies, and housebuilding. The model is estimated in several variants, and we simulate the responsiveness of the housing market to local economic conditions. The model indicates the strong interdependency between the state of the macro economy, the state of the regional economy, and outcomes in the housing market. The results also suggest the key role of local regulation in affecting housing outcomes.

In Section II below, we relate our work to previous attempts to develop regional models of the housing market. Section III presents an overview of the data and the methodology we use, as well as the relationships among the various measures of the housing market. Section IV presents our statistical results and the simulations based upon them. Section V is a brief conclusion.

II. Antecedents

A simple model of supply and demand at the regional level motivates the choice of variables to explain outcomes in the housing market over time. Housing demand is a function of prices and incomes and perhaps demographic variables as well. Housing supply is a function of profitability which depends upon housing prices and input prices, including the costs of labor, materials, financing and regulations inhibiting new

construction. Vacancy rates in existing housing reflect the difference between aggregate supply and demand in the market in any period.

Several early papers (following Reid, 1962, and Muth, 1960, 1968) analyzed variations in housing prices across metropolitan areas, focusing on the reduced form relationship between the prices of owner-occupied housing and metropolitan characteristics. Using these models, it is easy to describe the development of house prices, but it is quite difficult to make inferences about structural parameters or about causation¹.

In contrast, a few more recent studies have investigated structural relationships among housing market outcomes. Poterba (1984) analyzed the interaction between movements in prices and housing stocks, modeled as a two-equation system. The growth of housing prices is represented as a function of the difference between current prices and imputed rentals, while the growth of the housing stock is related to real housing prices (as a proxy for profitability) and to the size of the current stock. In this simple stock-flow model, there are no leads or lags. Vacancies in the housing stock are ignored.

DiPasquale and Wheaton (1994) specified a model for housing demand in which the price of owner-occupied housing within a given housing market is a function of the current stock of single family housing relative to the number of households, their age-expected homeownership rate,² the price of renting relative to owning in the market, and the average household income within the market. In a second equation, the authors modeled housing starts as a function of current prices, costs, and the stock of housing, as

¹ Tests of the efficient functioning of housing markets based on these reduced form models are in fact joint tests of the efficiency of the housing market together with the underlying structural models used to derive reduced form relationships (Follain and Velz, 1995).

² The age-expected homeownership rate is a simple transformation of the age distribution of adults in the housing market.

well as employment and time on the market for new units. Most of supplier behavior in this model is explained by exogenous changes in interest rates, employment levels, and time on the market. The authors interpret this latter variable as evidence of slow adjustment in housing markets.

Follain and Velz (1995) developed a structural model of housing markets at the metropolitan level, in part to reflect the importance of turnover (the inverse of time on the market) in housing markets. Their structural model consists of four equations predicting the turnover rate, housing size, housing prices and household formation, respectively. Follain and Velz found that housing prices and turnover are negatively related; they attribute this to the reduced importance of down payment constraints since the mid-1980s. However, their estimates of some key structural parameters are quite implausible (e.g., the estimated price elasticity of housing supply is about six).

In assessing this previous work on the determinants of housing price variations, several factors are worth noting. First, none of these empirical models consider that trends in house prices or new construction might be mitigated by changes in vacancy rates for owner-occupied housing. This is in contrast to extensive empirical analyses of the rental market (e.g., Rosen and Smith, 1983, Igarashi, 1992, Read, 1993, Gabriel and Nothaft, 1988, 2001, Hendershott *et al.*, 2000) which emphasize the inverse relationship between rents and vacancy rates across markets. Second, equations explaining variations in housing supply are often unsatisfactory, in contrast to demand equations, which tend to fit the data reasonably well. The estimated supply elasticity often has a negative sign, an insignificant effect, or an implausibly large magnitude. Third, with one exception, these systems of structural equations applied to housing markets are tested on national data

despite the local nature of housing markets. This limitation is, in part, due to difficulties of data assembly at the metropolitan level.

III. Overview of Model

Our model of regional housing markets is based upon a panel of U.S. metropolitan areas, including all markets for which annual data on housing prices, vacancies, and construction activity are available for owner-occupied housing. Of the 220 metropolitan housing markets (MSAs) in the U.S., consistent measures of house prices are available for 120, beginning in 1975. Annual measures of the stock of owner-occupied housing, vacancy rates, and supplier activity (i.e., building permits) are available for only 75 MSAs and only for the period 1987-1999. Our analysis is based upon 962 observations reporting a panel of 74 MSAs observed annually during the period 1987-1999.³

Some of the key bivariate relationships in this panel of housing markets are reported in the introduction. Figures 5, 6 and 7 present additional descriptive information. Figure 5 suggests that there is a strong positive relationship between price appreciation in these markets and a measure of the restrictiveness of regulations governing new construction⁴. Figure 6 reports a positive, but rather weak, relationship between price appreciation and income growth, while Figure 7 reports the absence of any simple relationships between house price appreciation and employment growth. These puzzles and suggestive relationships motivate our systematic research.

³ For one MSA (Scranton, PA) house prices are not available, but vacancy rates, supplier activity, and housing stock measures are.

⁴ Glaeser et al (2003) attributes substantial difference between price and cost of Manhattan condominiums to land use regulations.

Our empirical model consists of three equations describing the movement of housing prices, housing supply, and vacancies in the market for owner-occupied housing. In this section, we describe the key features of the model, deferring issues related to data, measurement, and estimation technique to Section IV.

A. Housing Prices

Our analysis of housing prices is based upon an extension of the work of DiPasquale and Wheaton (1994) which considers the distinction between the number of households in the housing market and their individual demands for owner occupancy. We extend the model to include vacancies:

$$(1) \quad H_t \cdot D_t = OC_t = S_t - V_t = S_{t-1} + N_t - V_t,$$

where H_t is the total number of households in a metropolitan market at the time t , D_t is the proportionate demand for owner occupancy, OC_t is the number of occupied units of owner housing, S_t is the total stock of owner-occupied housing, V_t is the number of vacancies, and N_t is the number of newly constructed owner-occupied units. The subscript i distinguishing metropolitan area is suppressed for ease of presentation. Following DiPasquale and Wheaton (1994), individual demand for owner-occupied housing is

$$(2) \quad D_t = D(P_t^*, UC_t, R_t, X_t^D),$$

where P_t^* is the market clearing price of owner-occupied housing, UC_t is its annual user cost, R_t is the cost of renting, and X_t^D represents other demand shifters (e.g., income, demographics).

As asset prices and annual user costs for owner-occupied housing increase, individual households are less likely to choose owner-occupancy; as the cost of renting increases, households are more likely to choose owner-occupancy. Changes in rent can affect house price in two different ways. First, in the context of tenure choice, as the cost of renting increases, households are more likely to choose owner-occupancy, raising the price. Second, in the context of asset pricing models, rent is a dividend from owning a house and price will be a discounted sum of future rents. If rents are correlated over time, changes in current rent imply changes in future rents, which in turn affect the asset price. Since rents are more likely to exhibit positive serial correlation, a rise in current rent implies a rise in housing prices.⁵ When rents and prices are non-stationary, it is easy to show that rent-price ratio can predict future growth rate of rents, using present value relations. Similarly, in financial markets, the dividend yield (dividend-price ratio) has long been used as a predictor of long run returns in stock prices. (Campbell and Shiller (1988) and Fama and French (1988))

The probability of owner-occupancy times the number of households in the market equals the number of units of owner-occupied housing in the local market.

Assuming log linearity in D_t using the approximation in the Appendix A, solving for the market clearing price of housing, and taking first differences yields:

$$(3) \quad p_t^* = \alpha_1 s_t + \alpha_2 v_t + \alpha_3 uc_t + \alpha_4 r_t + \alpha_5 h_t + \alpha_6 x_t^p,$$

where lower case letters represent logarithmic differences, Greek letters represent parameters, and x_t^p represents a set of demand shifters.

⁵ In fact, extensive research [Shiller (1981), LeRoy and Porter (1981), West (1988), Campbell and Shiller (1987, 1988)] provides only mixed support for the present value model. For empirical testing of present value model of housing, see Meese and Wallace (1994).

If we further assume partial adjustment in asset prices of owner-occupied housing

$$(4) \quad \log P_t - \log P_{t-1} = \delta[\log P_t^* - \log P_{t-1}],$$

the pricing relationship can be expressed in observables

$$(5) \quad p_t = \alpha_1 s_t + \alpha_2 v_t + \alpha_3 uc_t + \alpha_4 r_t + \alpha_5 h_t + \alpha_6 x_t^p + \alpha_7 p_{t-1}.$$

B. New Housing Supply

In contrast to the analysis of housing demand and price formation, less is known about the behavior of housing supply. In part, this reflects limitations in available data and in conceptual models (Rosenthal, 1999). DiPasquale (1999) has summarized three empirical difficulties in the housing supply literature. First, housing supply estimates vary widely. Second, price does not seem to be a sufficient statistic, and other market indicators are quite important in explaining housing supply. Third, construction levels seem to respond quite sluggishly to construction costs and output prices. Furthermore, there are disagreements about the appropriate specification of models of housing supply. In early research, new housing supply, measured by either housing starts or by permits, is specified as a function of the *level* of price and the *level* of construction cost (Porterba, 1984, Topel and Rosen, 1988, DiPasquale and Wheaton, 1994). More recently, however, Mayer and Somerville (2000) developed an empirical model linking new housing supply to *changes* in prices and costs. They argue that the equilibrium level of housing price matches the stock of housing supplied with the total demand for housing space, which implies that new construction and other changes in stock will be a function of changes in housing price, as well as changes in other variables, such as construction costs.

We follow Mayer and Somerville, modeling new housing supply as a function of changes in prices and input costs, as well as local and national macroeconomic conditions. Our model is

$$(6) \quad s_t = \beta_1 p_t + \beta_2 v_t + \beta_3 c_t + \beta_4 f_t + \beta_5 REG_t + \beta_6 x_t^s + \beta_7 p_{t-1},$$

where s_t is new housing supply, v_t represents vacancies, c_t is input costs for labor and materials, f_t is financing costs, REG_t is the restrictiveness of local regulation, and x_t^s represents other supply shifters. We measure new supply as the annual difference in the stock of housing; the stock is constructed by adding building permits to the stock in the previous year⁶. Again, lower case letters indicate logarithmic differences. Note that this specification of the supply equation includes two endogenous variables, changes in housing prices and changes in vacancies. We expect that increases in housing prices will lead to an increase in supplier activity, increases in input costs (labor, materials or financial costs) will reduce supplier activity, and increases in vacancies will also reduce supplier activity.

Finally, as noted above, there is ample evidence that supply adjustment to changes in price is sluggish and slow. We recognize this by including a variable measuring the lagged change in housing prices in the empirical model.

C. Vacancies in Owner-Occupied Housing

The early literature on vacancy in the rental housing market analyzed the empirical relationship between some “natural” rate of vacancy and housing rents, based on reduced form models (Eubank and Sirmans, 1979, Rosen and Smith, 1983).

⁶ Housing stock at the beginning of the sample period has been estimated by using number of households, ownership rates and vacancy rates.

Theoretical explanations of vacancy focus on the frictions of search, given the idiosyncratic preferences of households and the heterogeneity of housing units (Arnott, 1989, Wheaton, 1990, Read, 1997). In these models, some level of vacancy facilitates the search process by housing demanders; sellers charge higher prices to cover the cost of maintaining vacancies. These search models provide insights on the unique aspects of housing markets, and they provide a rationale for housing vacancies in market equilibrium. More recently, Gabriel and Nothhaft (2001) distinguished two components of vacancy, incidence and duration, arguing that the incidence component is affected by population mobility and the duration component by search costs and the heterogeneity of housing stock. Their empirical results suggest that residential rents are more responsive to the incidence component than the duration component.

If a homeowner chooses to keep a unit vacant rather than selling in response to an offer, this is the decision to hold a real option. That is, when the owner of a vacant unit decides to keep a unit vacant rather than selling it at the current market price, this is because she believes that waiting is worthwhile. Waiting is more worthwhile if prices are expected to increase and if the volatility of housing investment returns is larger.

We thus specify the vacancy relationship as

$$(7) \quad v_t = \gamma_1 p_t + \gamma_2 N_t + \gamma_3 E(p_{t+1}) + \gamma_4 V(p_{t+1}) + \gamma_5 x_t^V$$

where $E(p_{t+1})$ and $V(p_{t+1})$ are the mean and variance of expected price changes respectively and x_t^V represents other exogenous shifters in vacancies. Again, lowercase letters represent logarithmic differences. We expect that higher current housing prices will lead to fewer vacancies. Higher expected price changes and a higher variance in

housing prices will lead to higher current vacancies, and increased supply will lead to higher vacancies.

IV. Data and Methodology

A. Data

The econometric evidence presented in the following section is based data pieced together from a variety of sources. With one exception, the data series are publicly available, and most are available online. As noted above, we analyze three dependent variables: prices, vacancies, and supplier activity.

Single family housing prices are measured using metropolitan housing price indices published by the U.S. Office of Federal Housing Enterprise Oversight (OFHEO)⁷. The index is defined by the weighted repeat sales method using all single-family houses whose mortgages have been purchased or securitized by Freddie Mac or Fannie Mae since 1975.

Homeowner vacancy rates by MSA are available annually from the U.S. Bureau of the Census.⁸

We measure supplier activity by the number of building permits issued for single family housing in each MSA. Most prior research on housing supply is based upon aggregate housing starts (Topel and Rosen, 1988, DiPasquale and Wheaton, 1994, Mayer and Somerville, 2000). Information on housing starts is simply unavailable at the metropolitan level. However, it is well known that the aggregate series on permits tracks

⁷ <http://www.ofheo.gov/house/faq.html>

⁸ <http://www.census.gov>

housing starts very closely (Somerville, 2001, Evenson, 2001).⁹ Other studies analyzing metropolitan data (e.g., Poterba, 1991, Dreiman and Follain, 2000, and Mayer and Somerville, 1998) also rely upon building permits. Data on building permits for single family houses by MSA are recorded by the U.S. Bureau of the Census and are available online from the Real Estate Center at Texas A&M University.¹⁰

The equation for housing prices (5) includes structural variables measuring the user cost of housing capital and rents. Following many others (e.g., Kearl, 1979, Dougherty and Van Order, 1982, Mankiw and Weil, 1989), we specify the user cost of capital as

$$(8) \quad UC_t = M_t(1 - T_p)(1 - T_y) + DM - E(p_{t+1})$$

where M_t is the mortgage interest rate, T_p is the property tax on housing, T_y is the marginal tax rate on income DM is the depreciation and maintenance rate, and the last term is the expected capital gain on housing, assumed tax free. The mortgage interest rate (for a 30-year fixed-rate contract) is reported by Freddie Mac.¹¹ In computing the user cost of capital in each metropolitan area in each year, we use the 1990 median tax rate as a percentage of house values,¹² assume constant depreciation rates, and we estimate capital gains as an AR-GARCH processes for each individual MSA (as explained in the Appendix A).

Annual rents, R_t in each metropolitan area are obtained directly from the U.S. Department of Housing and Urban Development's measurement of rent at the fortieth

⁹ At the national level, the correlation between housing starts and building permits is 0.95 from 1959 through 2000, and 0.99 during our sample period, 1987 thru 1999.

¹⁰ <http://recenter.tamu.edu/data/bpm>

¹¹ www.freddiemac.com

¹² <http://www.bus.wisc.edu/realestate/resources/resdownl.htm>

percentile of the distribution, so called, “Fair Market Rents.”¹³ In addition, we also include a lagged price-rent ratio, PD_{t-1} , to measure expected implicit rent growth in housing, following the present value literature in finance¹⁴.

The estimated supply equation includes structural variables measuring input costs for labor and materials as well as financing costs. We also measure the regulatory stringency of each metropolitan area, that is, the stringency of regulations inhibiting new construction. Labor costs, LC_t , are measured by average earnings per worker in the construction industry by MSA and year as reported in the Regional Economic Information System database maintained by the Bureau of Economic Analysis (REIS).¹⁵

Proprietary metropolitan data on material costs for residential construction by year were obtained from the firm of Marshall and Swift. The data include separate cost estimates for structural steel columns and beams, reinforced concrete, masonry or concrete load bearing, wood or steel studs and metal bents, columns and girders. Rather than using all five series, we use the first two principal components of these costs, MC_t^1 and MC_t^2 , which together explain 99 percent of total variation in the five series.

We measure the financing costs for housing suppliers by the prime interest rate f_t obtained from the DRI database.¹⁶

The impact of regulations inhibiting new housing construction, REG , is measured using the results reported in Malpezzi (1996) and Malpezzi *et al.* (1996).¹⁷ REG_t is an index of the stringency of regulation which varies by metropolitan area.

¹³ <http://www.huduser.org>

¹⁴ Using the standard present value relation, one can show that current dividend yield predicts future dividend growth. For more detailed review, see Cochrane (1991).

¹⁵ <http://www.bea.doc.gov>

¹⁶ DRI is now called Global Insight. The data is located at <http://www.globalinsight.com>.

We also employ several other exogenous variables in the three equations to measure the importance of the local economy. These include per capita income, Y_t , employment, EM_t , and per capita transfer payments for unemployment, UN_t . These data are all available from the REIS database.

A complete listing of variables, definitions and symbols is presented in Table 1. The subscripts i and t designate variables which vary by MSA and year.

V. Empirical Results

A. Housing Prices

Alternative estimates for Equation (5) are reported in Table 2. All coefficients are estimated by error-component 2 SLS (Baltagi, 1981, Hsiao, 1986) allowing for MSA-idiosyncratic shocks and national shocks. The coefficients on the changes in housing stock are significantly negative as expected. The magnitude of the estimated coefficients are unaffected when the vacancy variable is eliminated (Model V), suggesting independent roles for prices and vacancies in the equilibrium price determination in metropolitan housing markets. The vacancy variable is negative as expected. (Increases in vacancies imply increases in housing units available for sale, which leads to decreases in prices.) The estimated coefficient for the rent variable is positive as expected, but is insignificantly different from zero. As anticipated, the coefficient for the user cost measure is negative; it is highly significant in all five models. The estimated coefficients on dividend yields are small but significant for all specifications. This is consistent with present value models (especially Meese and Wallace, 1992), which suggest that lower dividend yields today imply high dividend (rent) growth in the future. Homeowners

¹⁷ See also <http://www.bus.wisc.edu/realestate/resources/resdownl.htm>.

expect house prices to go up when they anticipate rent growth in the future. The coefficients on the lagged endogenous variables are also all significant. The coefficient on the lagged price variables is around 0.5, implying that half of the discrepancy between the market clearing price and the observed price is eliminated in the following year. Past increases in vacancies tends to decrease housing prices; homeowners expect lower prices this year when vacancies were higher last year.

Metropolitan macroeconomic conditions, household income and employment affect housing prices. These effects are sizable in magnitude and significant in most cases. One exception is the growth of employment (see Model III), in which both household growth and employment growth are included. Given household growth, employment growth has only a limited effect on housing demand.

Overall, the equations predicting housing prices appear to perform reasonably well at the metropolitan levels. Coefficients are precisely estimated and the magnitudes are reasonable.

B. New Housing Supply

Table 3 reports the results for the housing supply models. The contemporaneous supply elasticities are small but highly significant, ranging from 0.01 to 0.09. Differences in elasticity estimates in housing supply across the five models imply that the supply elasticity depends on local macroeconomic variables. Once the effects of local macroeconomic variables are controlled for, in Models IV and V, the elasticity is substantially decreased. This suggests that the local business cycle might be as informative for developers as housing market variables are. In Models III through V, vacancy is included. The estimated coefficients on the vacancy variable are small, but of

course, price is already controlled for in those models. The coefficients on vacancy may act as an indicator for price volatility. If current vacancies are correlated with the future volatility of housing prices, then housing suppliers, observing high vacancies now, will delay new construction, anticipating future volatility. In contrast to previous studies, the cost variables have the expected negative signs and are highly significant. The variables measuring materials costs are clearly important; the measure of labor cost has the expected sign, but is insignificant.¹⁸ Capital cost, as measured by the prime interest rate, also has the expected sign, and is significant in two of the three specifications. The regulation index has the predicted sign and t-ratios are large; more stringent regulation acts to depress building activities. Housing price volatility is significant in Model V, suggesting that the options perspective might be important in explaining suppliers' decisions.¹⁹

C. Vacancies in Owner-Occupied Housing

Table 4 reports the estimates of the equation predicting vacancies in single family housing. The coefficient on price is negative - higher prices mean that it is expensive to keep houses vacant. In all the cases, the coefficients for housing prices are significant and negative. The coefficient on supply is significant and positive, as expected. The sign on the lagged vacancies is expected to be positive due to the same sluggish response observed in movements in price and new construction. On the contrary, however, the sign on the past vacancies is negative and significant, implying that building and vacancies tend to overshoot. The regional macroeconomic variables have negative signs,

¹⁸ This may reflect the fact that the labor cost used is not the hourly wage, but rather per capita labor income in the construction industry, which includes both hourly wage and hours worked.

¹⁹ In computing conditional variances of house prices, we assume that the quarterly prices follow AR-GARCH processes. Annual conditional expectations and variances are computed by aggregating quarterly counterparts. For details, see the Appendix B.

i.e., adverse shocks tend to increase vacancies, but they are statistically unimportant (except for employment growth in Model IV, which has a p-value of 0.06). Model V contains the conditional variances and expected returns to test for real option element in homeowner's decisions to keep houses vacant. The results are mixed. Overall, the vacancy equations have much higher error variances for all three components, indicating that the course of vacancies is relatively more difficult to predict using these economic variables.

D. Simulation

Another way to measure the implications of the model is to simulate the effect of exogenous shocks on the endogenous variables. We use estimates of Model II, III and IV as the basis for simulation. Conventional simulation exercises postulate a one standard deviation change in some endogenous variable and trace the changes in one or more endogenous variables. In this case, given the high correlation of local macroeconomic variables, we vary MSA income and employment growth jointly²⁰. We select three metropolitan areas, San Jose, Tucson and Houston whose extreme patterns of house price development are depicted in Figure 1. In each case, we expose the local economy to an unexpected income shock of one standard deviation and we trace out the subsequent effects.

Figure 8 shows that the macroeconomic developments caused by an unexpected income shocks appear to be qualitatively similar among three MSAs. The magnitudes of initial income shocks range from 2.62 percent to 3.86 percent and subsequent income shocks become smaller. It does take a considerable time for these income shocks to be

²⁰ To accomplish this, we estimate a two-variable VAR model of income and employment by MSA and use the results to trace through the responses over time to a one standard deviation increase in MSA income.

completely dissipated. Note that even though San Jose does not have the highest initial income shock, but nevertheless, the shock is the most persistent to affecting subsequent income development.

Figure 9 shows the impact of this unexpected income shock on housing prices in these three markets. The initial price increase in Houston, one of cities with the lowest housing return reported in Figure 1, is actually higher than that of San Jose and Tucson, but price increases dissipate rapidly. In response to an exogenous increase in income, housing prices in San Jose and Tucson keep rising for extended period of time; peaks in housing price appreciation take about five years to reach. In the case of San Jose, the housing prices never return to the initial equilibrium during the subsequent thirty year period. This simulation exercise with housing prices suggests that the higher appreciation in housing prices in the last three decades may arise as much from the persistence of price appreciation as from the timing of initial shocks. Overall, the predicted housing price developments from the same model are quite distinctive among the three MSAs.

Figure 10 shows the response of construction activity to an unexpected income shock in these housing markets. Even though most of response is dissipated in three years, the timing and magnitudes of the responses are remarkably different. Houston, the market with the lowest price appreciation, has an initial increase of about 3,500 permits, while Tucson (with medium price appreciation) has only 1,200 permits. San Jose issues merely 600 permits. Within the econometric model, a major reason for these large differences is the importance of regulation²¹. As noted in Figure 5, the relationship

²¹ Houston has regulation index of 18.21, 6th lowest among 74 MSAs, and Tucson has 19.45, 35th lowest, while San Jose has 25.81, 7th highest.

between housing returns and regulation is positive. This simulation exercise shows that this probably reflects the strong relationship between building activities and regulation. It also helps to understand the variations in housing price appreciation in Figure 9. A housing market with the more stringent regulation has a more persistent price appreciation arising from an endogenous shock. Recently, Glaeser, *et al.* (2003) provide complementary evidence from a single housing market: high condominium prices in Manhattan, estimated to be roughly twice supply costs, arise from regulatory constraints restricting new housing construction.

A second simulation may illustrate more clearly the importance of local regulation in affecting housing adjustment paths in metropolitan markets in general. In this simulation, we present the adjustment paths for housing prices, building permits, and vacancy rates for Denver, the metropolitan area with the lowest level of regulation in our sample. This simulation is conducted in the same manner as those reported for Houston, Tucson and San Jose. We also report a second simulation for Denver, but with one counterfactual. In this second simulation, we assume that Denver's regulation of new construction is as stringent as that observed in San Francisco, the market with the most stringent building regulations in our sample.

Figure 11 compares the effects of an exogenous increase in income on house prices. In Denver, there is a gradual, but minimal price impact. Five years after the shock, housing prices have increased by about a tenth of a percent. However, with the regulations in force in San Francisco, the impact on housing prices would be substantial and persistent. Under the counterfactual, housing prices increase, and prices continue to rise subsequently. The differential impact on new construction is also substantial (See

Figure 12). The general pattern appears to be similar; building permits rise upon impact, and return quickly to previous levels. However, under its own regulation, the new supply of housing in Denver is larger by ten percent than it would be if the more stringent regulation in effect in San Francisco were in force. Vacancies fall more rapidly with more stringent building regulation. With a lower level of new construction, vacancy rates will be more responsive to increase in demand. Moreover, as price increases under more stringent regulations, homeowners find it more expensive to keep houses vacant.

VI. Conclusion

This paper estimates the effects of national and regional economic conditions on local housing markets using a panel of U.S. metropolitan areas over a fourteen-year period. We estimate the effects of exogenous conditions on the prices and vacancy rates for owner-occupied single-family housing and on building permits issued for new supply of single family housing. The model is framed in an error components framework, and the parameters are estimated by two stage least squares.

The empirical models proposed here provide a coherent set of empirical and simulation results. The results confirm the importance of changes in regional economic conditions, income and employment, upon local housing markets, and they confirm the importance of lagged adjustment process on both the demand and supply sides of the market. The results also provide the first detailed evidence on the importance of vacancies in the owner-occupied housing market on housing prices and supplier activity. The results also document the importance of new supply and the factors – variations in materials, labor and capital costs and regulation – affecting building permits issues for new single family construction.

Simulation exercises, using standard impulse response analyses, document the lags in market responses to endogenous shocks and the variations in response predicted from a common model depending upon local parameters. Finally, the results suggest the importance of local regulation in affecting the pattern of market responses to regional economic conditions. Patterns of housing prices are much higher in response to endogenous shocks in highly regulated housing markets, and the price increases arising from local economic booms are far more persistent over time.

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Figure 1

Course of Housing Prices in Nine Metropolitan Areas.
1975-2000

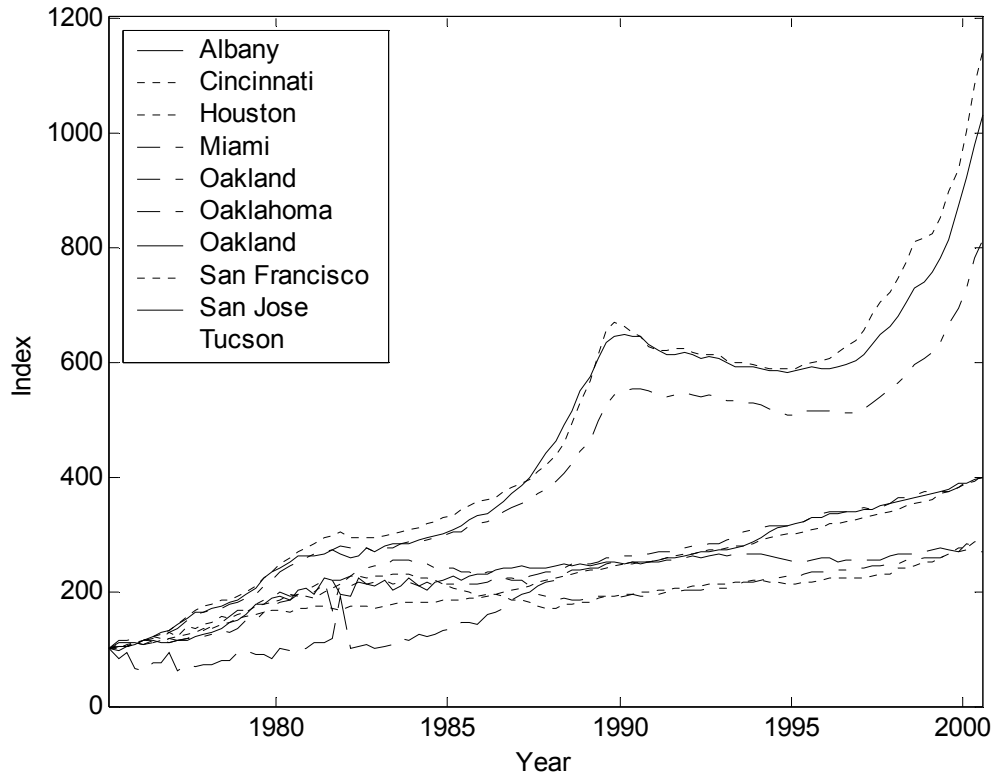
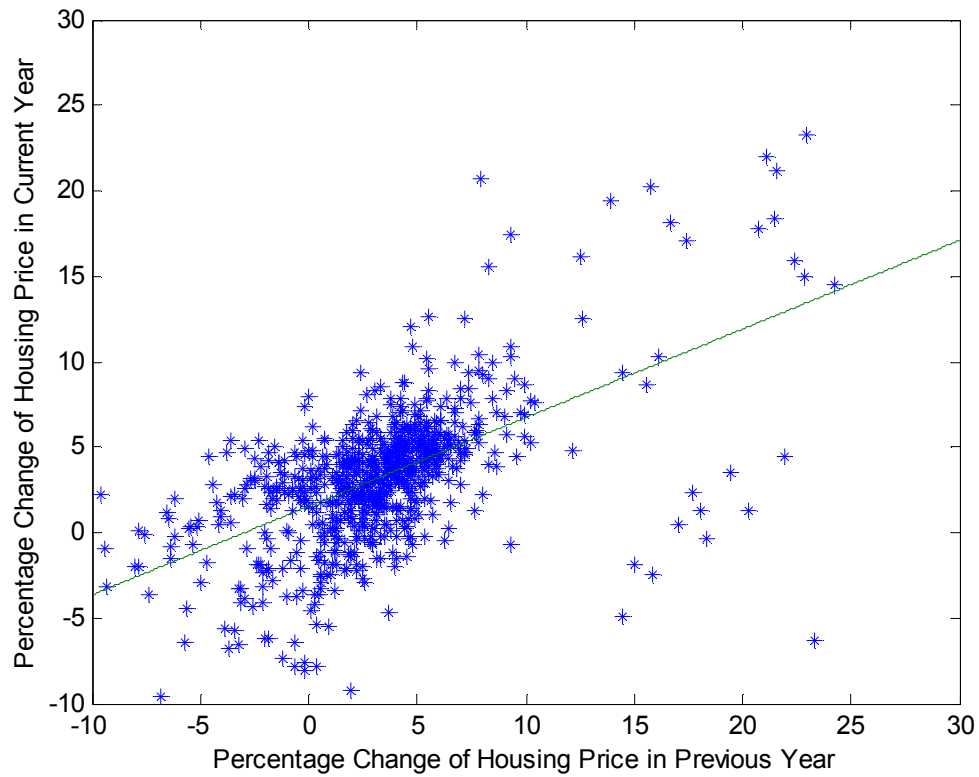


Figure 2

Current Annual House Price Changes vs. Lagged House Price Changes
1987-1999*
(74 metropolitan areas)



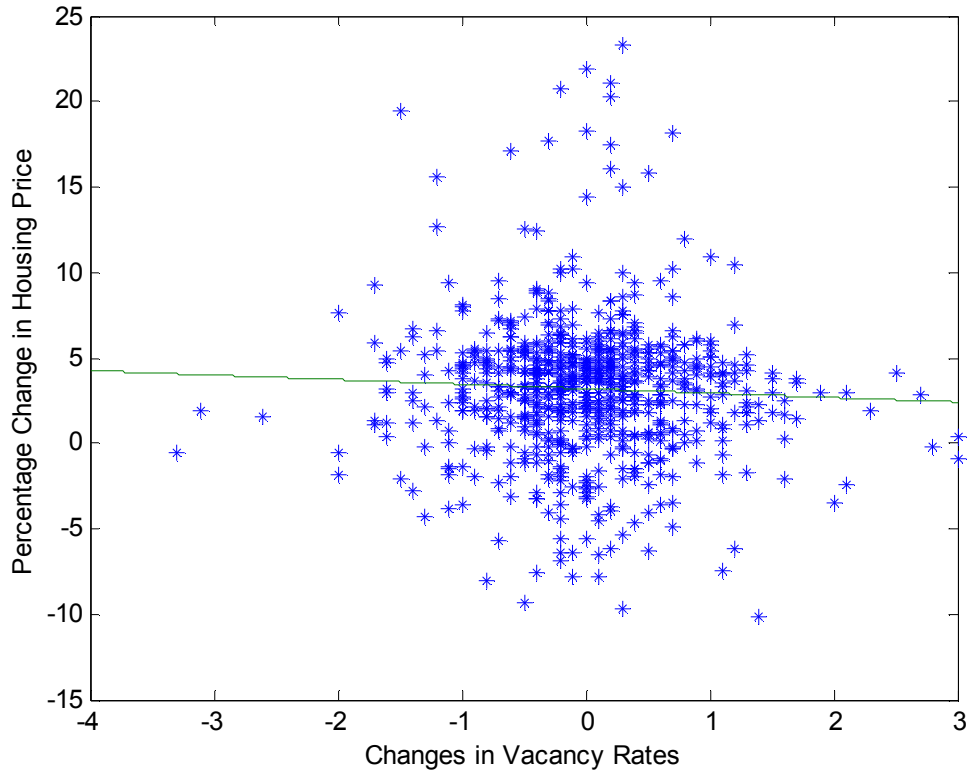
* Regression of percentage changes of housing price in current year on previous years is based on

$$P_{t-1} = 1.5166 + 0.5186P_t$$

(10.23) (19.45) $R^2 = 0.339$.

Figure 3

Changes in House Prices vs. Changes in Vacancy Rates
1987-1999*
(74 metropolitan areas)



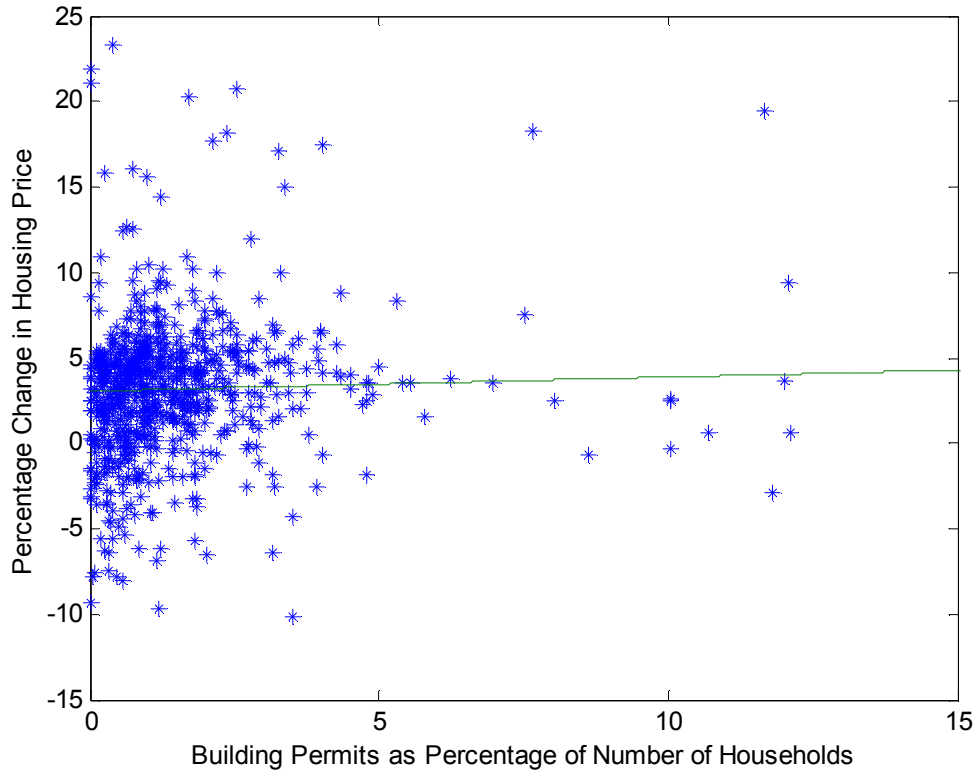
* Regression of percentage changes of housing price in current year on vacancy rate is based on

$$P_t = 3.2029 - 0.2627V_t$$

(21.69) (1.302) $R^2 = 0.002.$

Figure 4

Changes in House Prices vs. Building Permits
1987-1999*
(74 metropolitan areas)



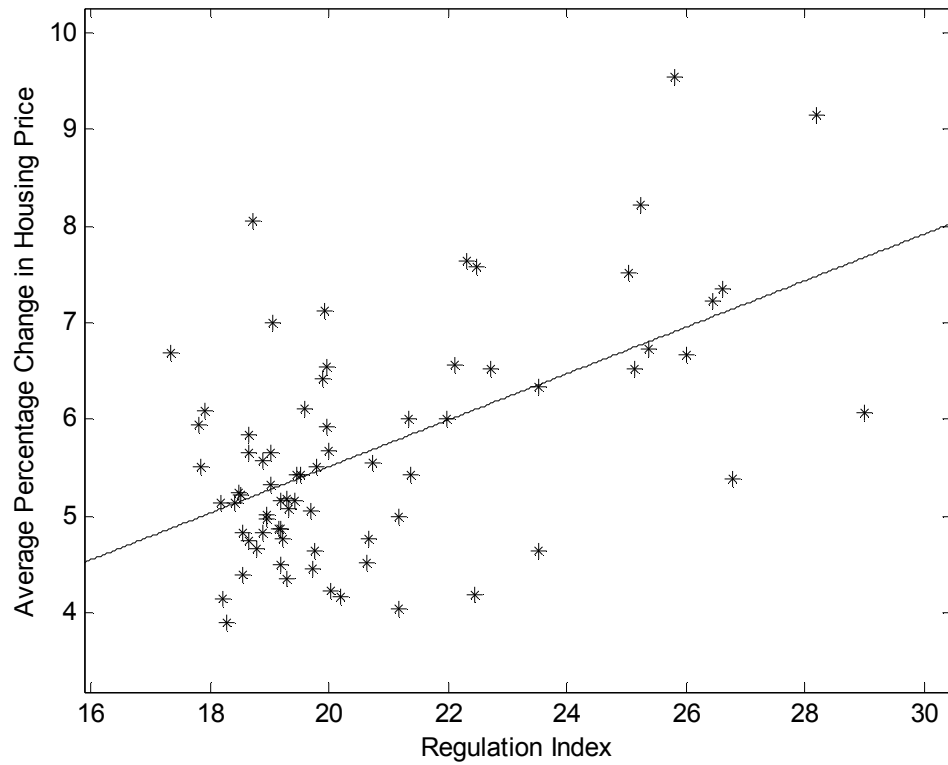
* Regression of percentage changes of housing price in current year on permit is based on

$$P_t = 3.0536 + 0.0820S_t$$

(18.59) (0.206) $R^2 = 0.006$.

Figure 5

Average House Price Appreciation vs. Regulation Index*



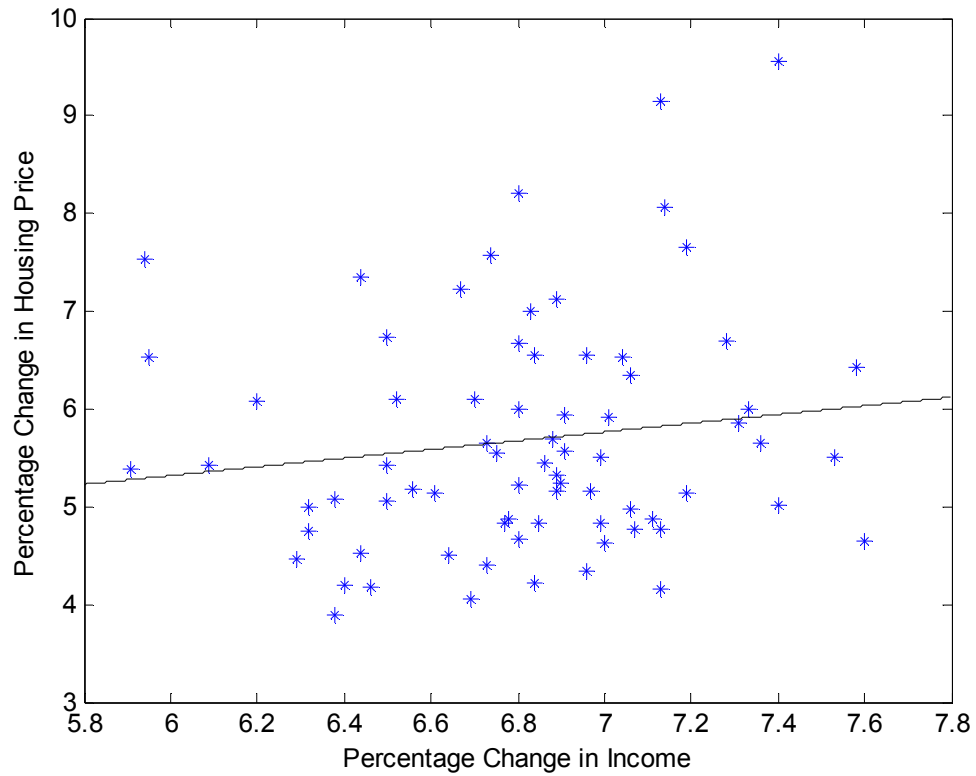
* Regression of percentage changes of housing price in current year on regulation is based on

$$P_t = 0.0018 + 0.0006R_t$$

(0.799) (5.688) $R^2 = 0.310$.

Figure 6

Average House Price Appreciation vs. Income Growth*



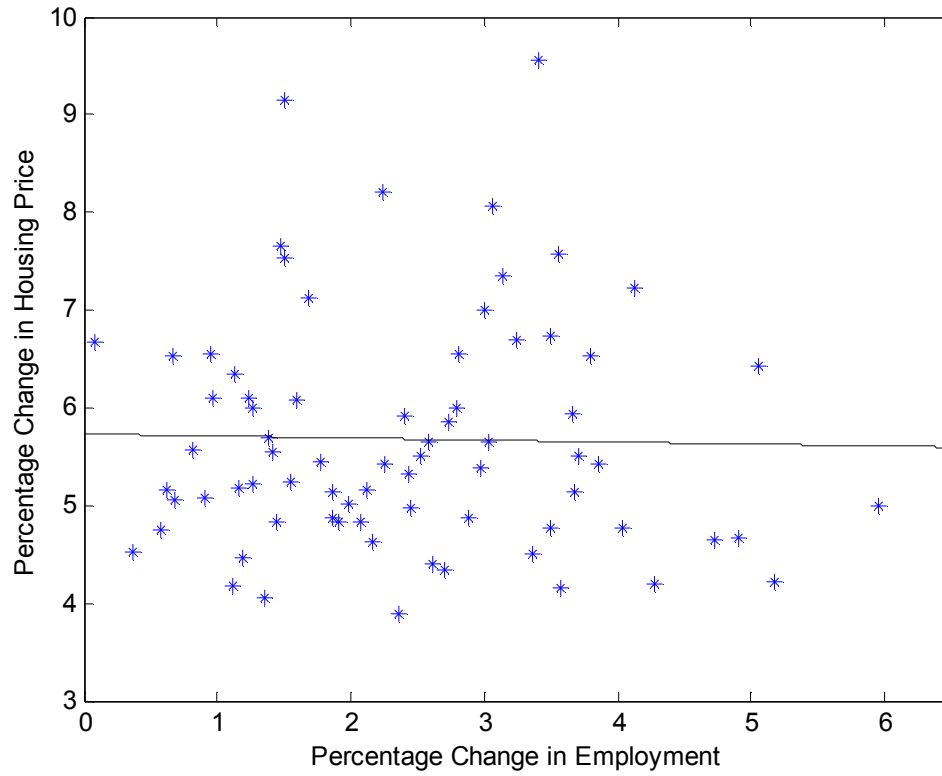
* Regression of percentage changes of housing price in current year on percentage changes in income is based on

$$P_t = 2.6410 + 0.4461R_t$$

(1.047) (1.207) $R^2 = 0.020$.

Figure 7

Average House Price Appreciation vs. Employment Growth*



* Regression of percentage changes of housing price in current year on percentage changes in income is based on

$$P_t = 5.7309 - 0.0206R_t$$

(19.27) (0.188) $R^2 = 0.0005$.

Figure 8.
Impulse Responses of Income to an Unexpected
Income Shock in Houston, Tucson and San Jose

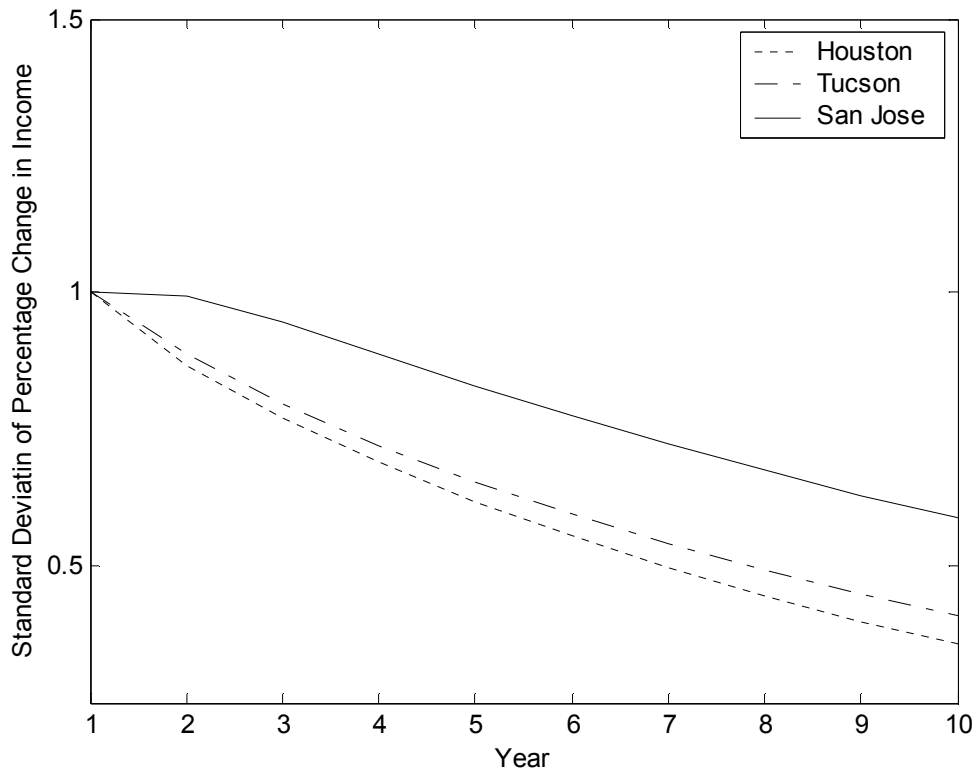


Figure 9.
Housing Price Responses to Income Shock
for Houston, Tucson and San Jose

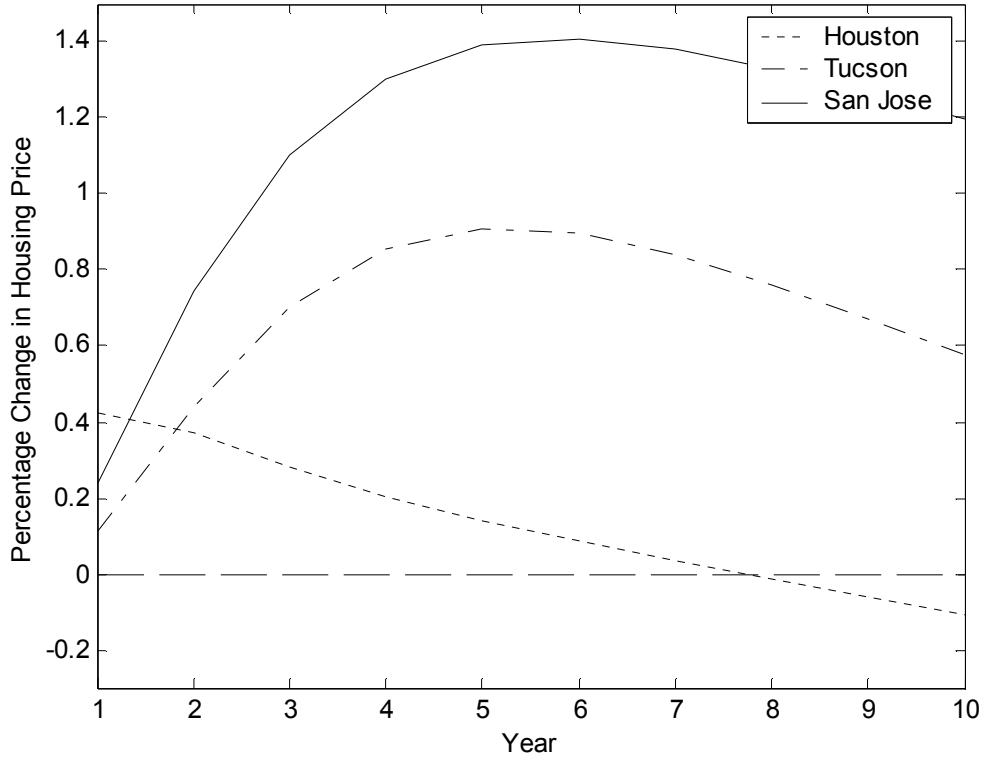


Figure 10.
Construction Responses to Income Shock
for Houston, Tucson and San Jose

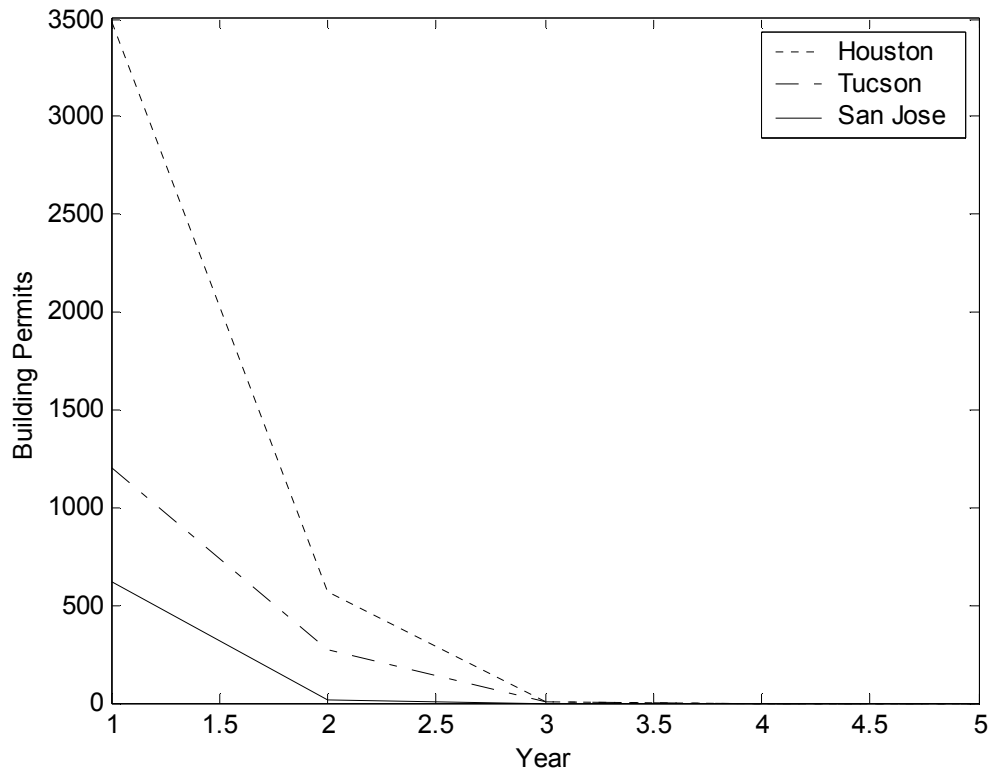


Figure 11.
The Effects of Regulation in Housing Market: Denver MSA
Housing Prices

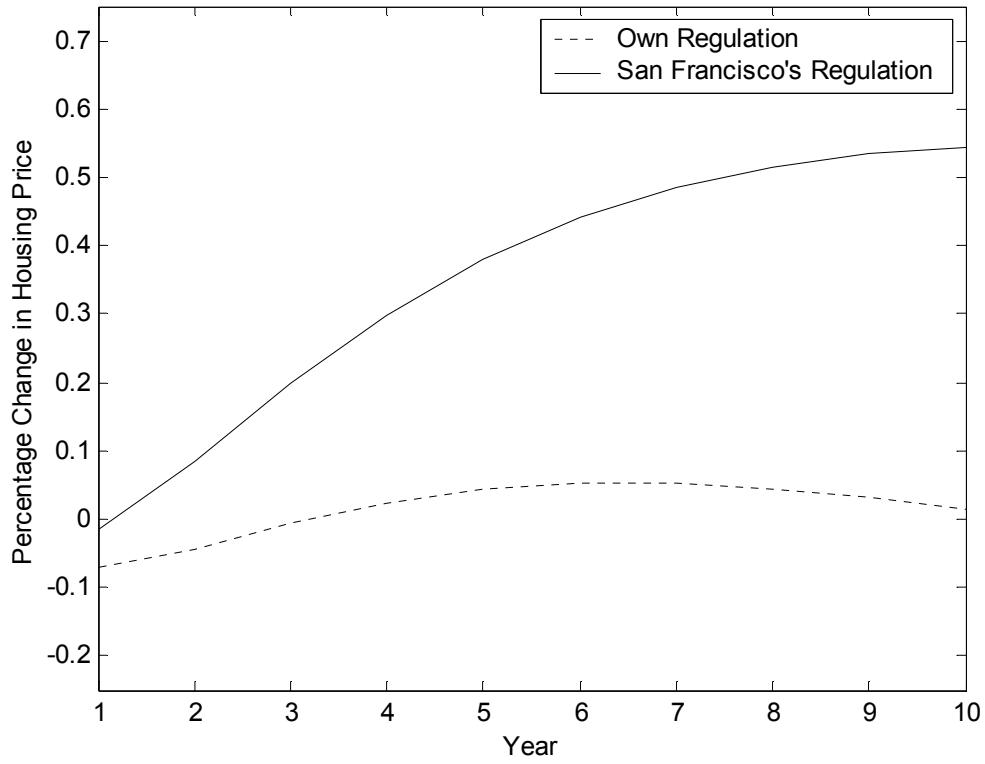


Figure 12.
The Effects of Regulation in Housing Market: Denver MSA
Building Permits

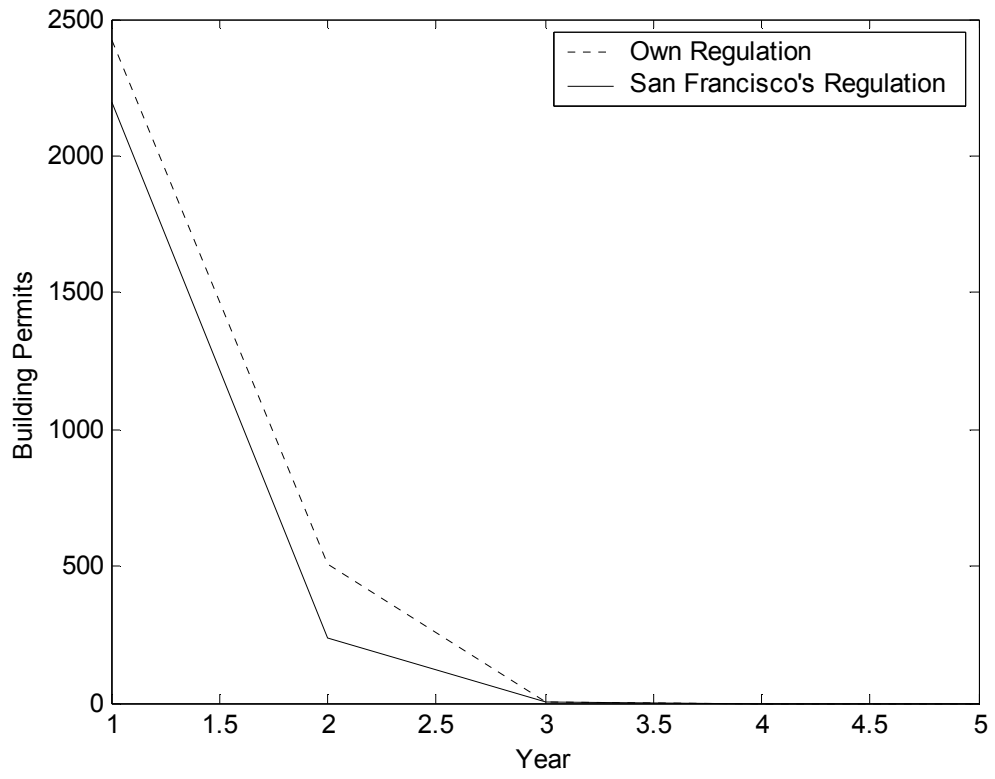


Figure 13.
The Effects of Regulation in Housing Market: Denver MSA
Vacancy Rates

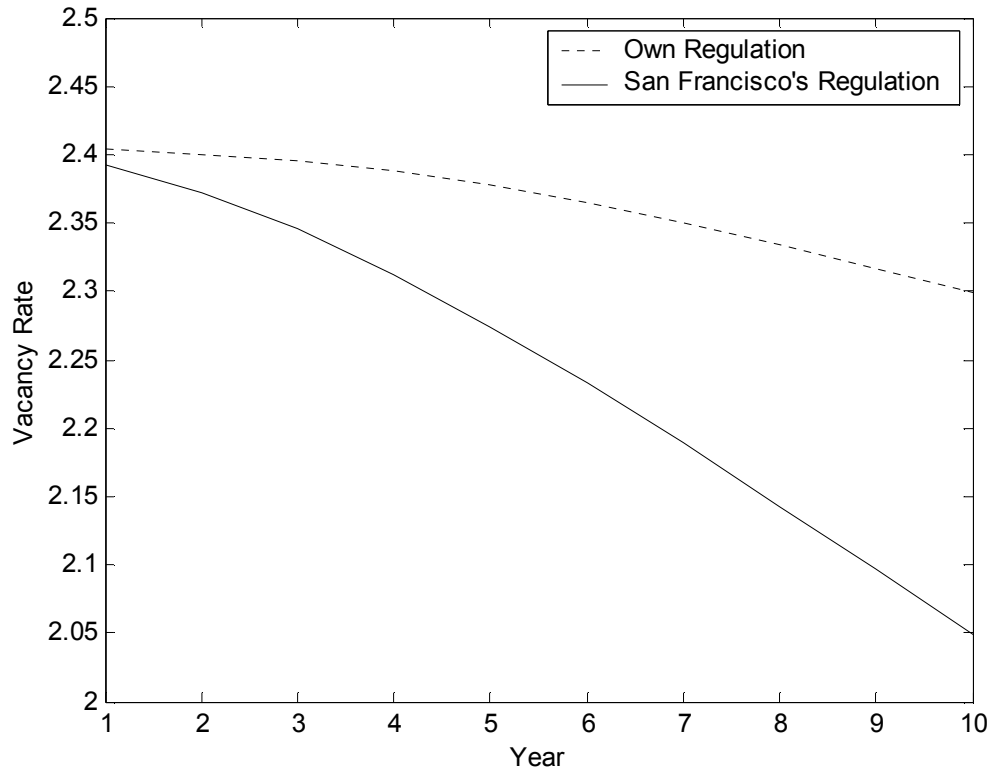


Table 1. Description of Variables and Symbols

| <i>Symbol</i> | <i>Description</i> |
|-----------------------------------|--|
| <u>Dependent Variables</u> | |
| p_{it} | Difference in log of housing price in MSA i at time t |
| s_{it} | Difference in log of housing stock in MSA |
| v_{it} | Difference in log of vacancies |
| <u>Other Endogenous Variables</u> | |
| h_{it} | Difference in log of number of households |
| uc_{it} | Difference in log of user cost |
| r_{it} | Difference in log of rent |
| $E(p_{it})$ | Expected rate of change in log of housing price |
| $Var(p_{it})$ | Conditional Variance of rate of change in log of housing price |
| <u>Exogenous Variables</u> | |
| c_{it} : | Input Costs |
| mc^1_{it}, mc^2_{it} | Difference in log of material cost measure 1 and 2 |
| lc_{it} | Difference in log of labor cost |
| f_t | Difference in log of prime interest rate |
| REG_i | Regulation index |
| $x_{it}^{P,S,V}$: | Price, Supply, Vacancy Shifters |
| y_{it} | Difference in log of personal income |
| em_{it} | Difference in log of employment |
| $x_{it}^{P,V}$: | Price, Vacancy Shifters |
| un_{it} | Difference in log of unemployment compensation |
| x_{it}^P : | Price Shifter |
| $PD_{i,t-1}$ | Log of price-to-rent ratio |

Table 2.

Estimates of Price Equation
(t-ratios in parentheses)

| | <i>Model I</i> | <i>Model II</i> | <i>Model III</i> | <i>Model IV</i> | <i>Model V</i> |
|-----------------|-------------------|------------------|-------------------|-------------------|------------------|
| s_{it} | -0.224 (1.60) | -0.316 (6.13) | -0.399 (8.20) | -0.120 (2.90) | -0.315 (7.13) |
| v_{it} | -0.004 (0.77) | -0.031 (8.68) | -0.024 (6.93) | -0.043 (10.49) | |
| r_{it} | 0.030 (0.44) | | | | |
| uc_{it} | -0.509 (11.58) | -0.231 (6.74) | -0.185 (5.61) | -0.098 (2.63) | -0.219 (6.52) |
| $PD_{i,t-1}$ | -0.034 (6.48) | -0.019 (9.88) | -0.021 (11.43) | -0.020 (11.43) | -0.015 (7.76) |
| p_{it-1} | | 0.570 (29.07) | 0.480 (25.33) | 0.515 (25.93) | 0.481 (25.14) |
| v_{it-1} | | | | -0.019 (8.86) | |
| h_{it} | 0.999 (6.38) | 0.622 (10.26) | 0.634 (7.73) | | |
| y_{it} | | | 0.515 (11.29) | 0.355 (8.24) | 0.267 (5.58) |
| em_{it} | | | 0.085 (1.41) | 0.325 (7.99) | 0.546 (12.50) |
| σ_{it}^2 | 0.037 | 0.029 | 0.028 | 0.032 | 0.028 |
| σ_i^2 | 0.130 | 0.156 | 0.037 | 0.034 | 0.064 |
| σ_t^2 | 0.033 | 0.008 | 0.007 | 0.003 | 0.006 |

Note: Estimates are based upon annual observations on 74 MSAs during the period 1987-1999. Models are estimated by 2SLS in an error component framework. σ_i^2 and σ_t^2 represent the variance of time and MSA components of the error, and σ_{it}^2 is the variance of the white noise component.

Table 3

Estimates of Supply Equation
(t-ratios in parentheses)

| | <i>Model I</i> | <i>Model II</i> | <i>Model III</i> | <i>Model IV</i> | <i>Model V</i> |
|-----------------|--------------------|------------------|------------------|------------------|-------------------|
| p_{it} | 0.094 (13.57) | 0.042 (8.00) | 0.021 (4.65) | 0.009 (2.12) | 0.011 (2.26) |
| v_{it} | | | -0.002 (4.16) | -0.001 (2.87) | -0.001 (1.18) |
| mc^1_{it} | -0.00003 (0.10) | -0.001 (5.34) | -0.001 (8.35) | -0.001 (8.19) | -0.001 (5.70) |
| mc^2_{it} | -0.001 (2.14) | -0.000 (2.55) | -0.001 (4.48) | -0.000 (1.54) | |
| lc_{it} | -0.001 (0.17) | | | | |
| f_t | -0.054 (2.65) | -0.021 (2.06) | -0.003 (0.45) | | |
| REG_i | -0.015 (1.63) | -0.004 (3.61) | -0.005 (3.68) | -0.004 (4.08) | -0.004 (3.27) |
| s_{it-1} | | 0.818 (82.76) | 0.790 (75.44) | 0.806 (91.90) | 0.802 (89.967) |
| p_{it-1} | | -0.026 (7.44) | -0.009 (2.93) | -0.018 (6.30) | -0.021 (6.702) |
| y_{it} | | | | 0.001 (0.12) | -0.004 (0.61) |
| em_{it} | | | | 0.077 (10.58) | 0.096 (12.08) |
| $Var(p_{it})$ | | | | | -0.088 (2.70) |
| σ_{it}^2 | 0.006 | 0.003 | 0.003 | 0.003 | 0.003 |
| σ_i^2 | 0.011 | 0.005 | 0.003 | 0.003 | 0.004 |
| σ_t^2 | 0.033 | 0.004 | 0.005 | 0.003 | 0.003 |

Note: Estimates are based upon annual observations on 74 MSAs during the period 1987-1999. Models are estimated by 2SLS in an error component framework. σ_{it}^2 and σ_i^2 represent the variance of time and MSA components of the error, and σ_t^2 is the variance of the white noise component.

Table 4

Estimates of Vacancy Equation
(t-ratios in parentheses)

| | <i>Model I</i> | <i>Model II</i> | <i>Model III</i> | <i>Model IV</i> | <i>Model V</i> |
|-----------------|------------------|------------------|------------------|------------------|-------------------|
| p_{it} | -2.415 (5.43) | -1.938 (4.09) | -1.630 (4.08) | -2.179 (4.74) | -1.456 (4.89) |
| s_{it} | 1.348 (2.04) | 1.311 (2.00) | 2.324 (2.70) | 1.933 (1.99) | 1.577 (2.76) |
| p_{it-1} | 2.282 (6.01) | 2.033 (5.72) | 2.011 (5.90) | 2.146 (5.62) | 2.286 (7.34) |
| v_{it-1} | -0.260 (8.01) | -0.249 (7.75) | -0.243 (7.44) | -0.256 (7.86) | -0.223 (7.13) |
| y_{it} | | -0.348 (0.46) | | | |
| em_{it} | | | -1.551 (1.86) | | |
| un_{it} | | | -0.028 (0.49) | | |
| h_{it} | | | | -0.970 (0.84) | |
| $Var(p_{it})$ | | | | | 10.926 (2.27) |
| $Var(p_{it-1})$ | | | | | -13.519 (2.73) |
| $E(p_{it})$ | | | | | -2.491 (4.33) |
| $E(p_{it-1})$ | | | | | 2.460 (4.30) |
| σ_u^2 | 0.537 | 0.536 | 0.544 | 0.540 | 0.530 |
| σ_i^2 | 0.452 | 0.384 | 0.353 | 0.433 | 0.190 |
| σ_t^2 | 0.155 | 0.153 | 0.150 | 0.153 | 0.131 |

Note: Estimates are based upon annual observations on 74 MSAs during the period 1987-1999. Models are estimated by 2SLS in an error component framework. σ_i^2 and σ_t^2 represent the variance of time and MSA components of the error, and σ_{it}^2 is the variance of the white noise component.

Appendix A.

Approximation of Equation (3), the Equilibrium Condition for Housing Demand

Following Campbell, Lo and MacKinlay (1996),

$$\begin{aligned}
 \text{(A.1)} \quad \log\left(1 + \frac{X}{Y}\right) &= \log\left(1 + \exp\left(\log\left(\frac{X}{Y}\right)\right)\right) \\
 &= \log(1 + \exp(\log(X) - \log(Y))) \\
 &= \log(1 + \exp(x - y)) \cong \alpha + \beta(x - y)
 \end{aligned}$$

Consider equation (1) in the text. Taking logs on both sides, and using equation (A.1) yields,

$$\begin{aligned}
 \text{(A.2)} \quad \log(H_t) + \log(D_t) &= \log(S_t - V_t) \\
 &= \log(S_t) + \log\left(1 - \frac{V_t}{S_t}\right) \\
 &= \log(S_t) + \gamma_1 + \gamma_2(\log(V_t) - \log(S_t)) \\
 &= \gamma_1 + (1 - \gamma_2)\log(S_t) + \gamma_2 \log(V_t).
 \end{aligned}$$

Taking first order differences in the above expression yields

$$\text{(A.3)} \quad \Delta \log(H_t) + \Delta \log(D_t) = (1 - \gamma_2)\Delta \log(S_t) + \gamma_2 \Delta \log(V_t).$$

Assuming linearity in (2) and solving for p^* yields expression (3) in the text.

Appendix B. Computation of Conditional Expectations and Variances.

Assume that r_t , quarterly housing returns, follow AR(k)-GARCH (1,1), i.e.,

$$(B.1) \quad r_t = \beta_0 + \sum_{k=1}^K \beta_k r_{t-k} + \varepsilon_t,$$

where $\varepsilon_t = \sqrt{h_t} u_t$ and $u_t \sim \text{iid } N(0, 1)$ and $h_t = \gamma_0 + \gamma_1 \varepsilon_{t-1}^2 + \gamma_2 h_{t-1}$.

The conditional expectation and volatility of annual housing returns are

$$(B.2) \quad E\left(\sum_{j=1}^4 r_{t+j} \mid I_t\right) \text{ and}$$

$$(B.3) \quad E\left[\left(\sum_{j=1}^4 r_{t+j} - E\left(\sum_{j=1}^4 r_{t+j} \mid I_t\right)\right)^2 \mid I_t\right].$$

In calculating (B.1), we need an expression for (m+1)-period ahead forecast given m-period ahead forecast. Starting with $E[r_{t+m} \mid I_t]$, we have

$$\begin{aligned} (B.4) \quad r_{t+m} &= E[r_{t+m} \mid I_t] + \sum_{n=1}^m \delta_n \varepsilon_{t+n} = C + \sum_{j=1}^K b_j r_{t-j+1} + \sum_{n=1}^m \delta_n \varepsilon_{t+n} \\ &= C + b_1 r_t + \sum_{j=2}^K b_j r_{t-j+1} + \sum_{n=1}^m \delta_n \varepsilon_{t+n} \\ &= C + b_1 \left(\beta_0 + \sum_{k=1}^K \beta_k r_{t-k} + \varepsilon_t \right) + \sum_{j=2}^K b_j r_{t-j+1} + \sum_{n=1}^m \delta_n \varepsilon_{t+n} \\ &= C + b_1 \beta_0 + \sum_{k=1}^K b_1 \beta_k r_{t-k} + \sum_{j=2}^K b_j r_{t-j+1} + b_1 \varepsilon_t + \sum_{n=1}^m \delta_n \varepsilon_{t+n} \\ &= C + b_1 \beta_0 + \sum_{k=1}^{K-1} b_1 \beta_k r_{t-k} + \sum_{j=2}^K b_j r_{t-j+1} + b_1 \beta_K r_{t-K} + b_1 \varepsilon_t + \sum_{n=1}^m \delta_n \varepsilon_{t+n} \\ &= C + b_1 \beta_0 + \sum_{k=1}^{K-1} (b_1 \beta_k + b_{k+1}) r_{t-k} + b_1 \beta_K r_{t-K} + b_1 \varepsilon_t + \sum_{n=1}^m \delta_n \varepsilon_{t+n}. \end{aligned}$$

Then,

$$(B.5) \quad r_{t+m} = E[r_{t+m} \mid I_{t-1}] + \sum_{n=1}^{m+1} \delta'_n \varepsilon_{t+n} = C' + \sum_{j=1}^K b'_j r_{t-j} + \sum_{n=1}^{m+1} \delta'_n \varepsilon_{t+n-1},$$

where

$$\begin{aligned} C' &= C + b_1 \beta_0, \\ b'_k &= b_1 \beta_k + b_{k+1} \text{ for } k < K, \quad b'_K = b_1 \beta_K, \end{aligned}$$

$$\delta'_1 = b_1 \text{ and } \delta'_n = \delta_{n-1} \text{ for } n > 1.$$

Starting m=1 and iterating over m=2,3 and 4, it is easy to compute (B.2) using (B.5).

For the conditional variance in housing returns, $E \left[\left(\sum_{i=1}^K r_{t+i} - E \left(\sum_{i=1}^K r_{t+i} \middle| I_t \right) \right)^2 \middle| I_t \right]$,

note that

$$\begin{aligned} \text{(B.6)} \quad E_t \left[\left(\sum_{m=1}^K \sum_{j=1}^m \delta_{m,j} \varepsilon_{t+j} \right)^2 \right] &= E_t \left[\left(\sum_{m=1}^K \sum_{j=1}^m \delta_{m,j} \varepsilon_{t+j} \right) \left(\sum_{n=1}^K \sum_{i=1}^n \delta_{n,i} \varepsilon_{t+i} \right) \right] \\ &= E_t \left[\left(\sum_{m=1}^K \sum_{j=1}^m \delta_{m,j} \varepsilon_{t+j} \right) \left(\sum_{n=1}^K \sum_{i=1}^n \delta_{n,i} \varepsilon_{t+i} \right) \right] \\ &= E_t \left[\left(\sum_{m=1}^K \sum_{j=1}^m \delta_{m,j} \varepsilon_{t+j} \right) \left(\sum_{n=j}^K \delta_{n,j} \varepsilon_{t+j} \right) \right] \\ &= E_t \left[\left(\sum_{m=1}^K \sum_{j=1}^m \delta_{m,j} \varepsilon_{t+j} \right) \left(\sum_{n=j}^K \delta_{n,j} \varepsilon_{t+j} \right) \right] \\ &= E_t \left[\left(\sum_{m=1}^K \sum_{j=1}^m \delta_{m,j} \left(\sum_{n=j}^K \delta_{n,j} \right) (\varepsilon_{t+j})^2 \right) \right] \end{aligned}$$

since $E_t(\varepsilon_{t+r} \varepsilon_{t+s}) = E_t[\varepsilon_{t+s} E_{t+s}(\varepsilon_{t+r})] = 0$.

Then, starting with 1-period ahead forecast of volatility, the K-period ahead forecast can be calculated as follows.

$$\begin{aligned} \text{(B.7)} \quad E_t(\varepsilon_{t+k}^2) &= E_t(h_{t+k}) = \gamma_0 + \gamma_1 E_t(\varepsilon_{t+k-1}^2) + \gamma_2 E_t(h_{t+k-1}) \\ &= \gamma_0 + \gamma_1 E_t(h_{t+k-1}) + \gamma_2 E_t(h_{t+k-1}) \\ &= \gamma_0 + (\gamma_1 + \gamma_2)(\gamma_0 + (\gamma_1 + \gamma_2) E_t(h_{t+k-2})) \\ &= \gamma_0 + \gamma_0(\gamma_1 + \gamma_2) + (\gamma_1 + \gamma_2)^2 (\gamma_0 + (\gamma_1 + \gamma_2) E_t(h_{t+k-3})) \\ &= \gamma_0 + \gamma_0(\gamma_1 + \gamma_2) + \gamma_0(\gamma_1 + \gamma_2)^2 + (\gamma_1 + \gamma_2)^3 E_t(h_{t+k-3}) \\ &= \sum_{h=0}^{k-1} \gamma_0 (\gamma_1 + \gamma_2)^h + (\gamma_1 + \gamma_2)^k h_t \end{aligned}$$