Current Economic Conditions

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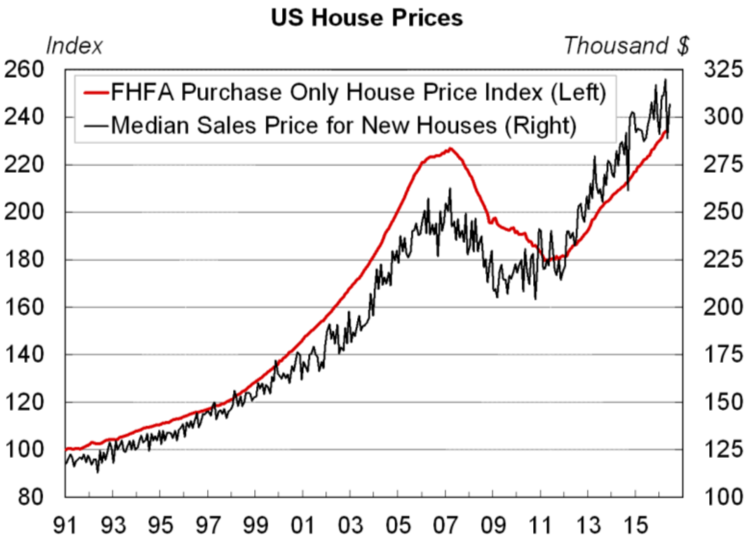
WHY HAS THE HOUSING RECOVERY BEEN SO WEAK?

U.S. housing starts rose in July to a 1.211 million seasonally adjusted annual rate. Except for June 2015 and February 2016, when starts reached a 1.213 million rate, July was the best month for housing starts since 2007. Nevertheless, housing starts remain well below the 1.584 million average for the 1970-2007 period and even further below the 2.207 million peak reached in February 2006. In the second quarter, real investment in residential construction, the component of real Gross Domestic Product that includes housing, was still 33% below its third-quarter 2005 peak. The recovery in housing remains weak even with the average rate on 30-year fixed-rate mortgages near its all-time low.

Many economists and politicians blame the weak recovery in housing on tight lending standards. Homebuyers (and builders) who got access to credit all too easily in the last decade can't get credit today and thus can't take advantage of low mortgage rates. Accordingly, the average FICO credit score of homebuyers has risen to an all-time high. The tightening of credit standards is partly the result of tighter regulations on the banking sector, but much of it is simply a case of "once bit, twice shy." A significant tightening of lending standards was definitely appropriate, but it might have been overdone.

Compounding the impact of tight credit standards is the weak recovery in the overall economy. Weak growth in wages and salaries makes it difficult for potential homebuyers to accumulate a down payment or qualify for a mortgage, and uncertainty about employment and memories of the collapse in house prices make them reluctant to buy a home even if they can obtain a mortgage.

Potential homebuyers might be especially reluctant (or unable) to buy a house at today's prices. Numerous measures show that house prices have rebounded to new record highs, pricing some potential buyers out of the market. High house prices, high rents, low wage growth, and employment uncertainty have kept household formation far below the level consistent with growth in the adult population. Recent statistics show more people in the 18-34 age group living with their parents than with romantic partners, the first time that has ever happened. Along with Willem Buiter, Chief Economist of Citigroup, who wrote a paper in 2008 called *Housing Wealth Isn't Wealth*, I believe that high and rising house prices are **not** a good thing, and that any boost to economic activity from higher house prices is temporary and will be undone later on. The boost to consumer spending from cash-out refinancings in the last decade was not sustainable and helped set up the economy for a great fall. High house prices might be good for old people who already own their biggest and most expensive houses, but those gains are fully offset by losses to young people who want to buy a first house. I frequently ask people who think high and rising house prices are a good thing, "Why do you hate your kids?"



Now, if you're thinking, "If demand is weak, but house prices are rising, supply must be even weaker than demand," congratulations; you know more economics than most politicians and many economists. With prices rising, factors that have restricted the supply of new homes (and have kept existing homes off the market) must be more important than factors that have limited demand. The collapse in housing construction from 2006 to 2009 drove builders out of business, damaged the building material supply chain, and caused many of the construction workers who built homes before the housing crash to leave the industry and, in the case of Mexican immigrants, even leave the country.

While teaching a class on managerial economics this summer at the University of Delaware, I was reminded that companies in concentrated industries (monopolies and oligopolies) produce and sell less than companies in less concentrated, more competitive, industries. Housing construction has historically been dominated by small local builders and was close to the textbook model of perfect competition. However, large national companies have significantly increased their share of homebuilding since the last housing recovery (and their share of lot ownership is even higher). With the industry more concentrated than in the past, builders are inclined to build fewer houses at high prices than they would if the market were as competitive as it was in the past. (The negative impact of increased industry concentration on the strength of the economic recovery might go well beyond housing construction. Increased concentration in banking might be partially responsible for tight lending standards. Mergers and acquisitions in other industries could be holding back investment in new capacity and production more generally.)

Local government regulations, including zoning restrictions and permitting fees, are perhaps the most important factor restricting the supply of new homes and keeping house prices too high for many potential homebuyers. Restrictions on residential density and building height, though popular with current homeowners who want to preserve the "character" of their communities and keep prices high, discourage new construction, especially in areas where people want to live, like New York City and the San Francisco Bay area. And because zoning restrictions raise lot prices, they force builders to build more expensive homes, rather than less expensive "starter" homes. (Economists have long argued that the primary result of zoning laws is higher real estate prices. Those who favor strict zoning laws must hate your kids too.)

Factors on both the demand and supply sides have slowed the recovery in housing from the 2006-2009 collapse, but ultimately, people need someplace to live. Unless you believe that children will live in their parents' homes forever, household formation and housing construction must eventually catch up with growth in adult population. As a result, the housing recovery, while weak, is also likely to be very long. Housing starts are likely to continue to rise for several more years, and the next downturn might not occur until the next decade. Unless we get collectively stupid again, starts will never get back to a 2 million annual rate, but are likely to rise above 1.5 million. Because of difficulties in obtaining mortgages and changes in locational preferences of the young (towards cities), multi-family units – apartments and condominiums – will continue to account for a bigger share of housing starts than in the past.

Industrial production in U.S. manufacturing rose strongly for a second straight month in July, and leading indicators point to a resumption of growth after 22 months of stagnation. But the recovery in manufacturing and in the economy as a whole is likely to remain weak without an acceleration in housing starts. Low interest rates are obviously doing little to boost starts. (In fact, it might take **higher** rates to get hesitant buyers off the fence.) Easing constraints on the supply side is likely to have more success.