Home Building in the Early 1980s

by B. Frank King

Though we are well into 1980's second quarter, we still await the "Recession of 1979." Many analysts have seen the unexpectedly strong residential construction activity of 1979 as a partial explanation for the unexpected strength in the overall economy. After all, sharp declines in residential building have foreshadowed each recent recession and have accounted for substantial chunks of lost real output during those recessions.

Lately, however, signs of weakness in housing have dominated. Housing starts have dropped sharply since last October. Their fourth-quarter level of 1.6 million (at an annual rate) was 15 percent below the third-quarter rate and 30 percent below the fourth-quarter 1978 rate. By February, starts were down another 12 percent from December to a 1.3 million annual rate. Recent further increases in mortgage rates have dramatically slowed mortgage borrowing, and home sales are down sharply. Will declines in this pivotal sector continue, or will it snap back in 1980 for a good year? An examination of home building seems in order.

To begin, we can narrow our scope. A major part of multifamily residential building for the past couple of years has been either government-subsidized, low income apartments, or multi-unit condominiums. Only a small increase in the government-subsidized units is presently budgeted. The multi-unit condos are subject to much the same set of influences as single-family home building because both types of housing are owner occupied. Other multifamily building may fluctuate, but it makes up a relatively small portion of residential construction. So the search for forces that lead to changes in residential construction can be concentrated on single-family home building.

An analogy may aid in examining home building in detail. In looking at housing demand, it helps to make a distinction much like that generally made between climate and weather. Climate generally refers to more or less stable long-run influences; weather changes rapidly around the long-term trend. The climate of Georgia, for example, is usually described as subtropical, but when a winter storm comes down from the northern plains, Georgia weather can be downright arctic.

The climate for new home demand and output is principally provided by four elements: household formations; age distribution of additional households; loss of housing units through destruction, conversion, or dilapidation; and income growth. These together determine the number of separate households that need separate housing units, the proportion of these households that normally want single-family units, the part of the housing stock that must be replaced in each period, and the amount of income households have for acquiring these units. To be complete, one would add the single-family vacancy rate to the list of factors in the climate, but this rate is and is likely to continue to be so low and stable that

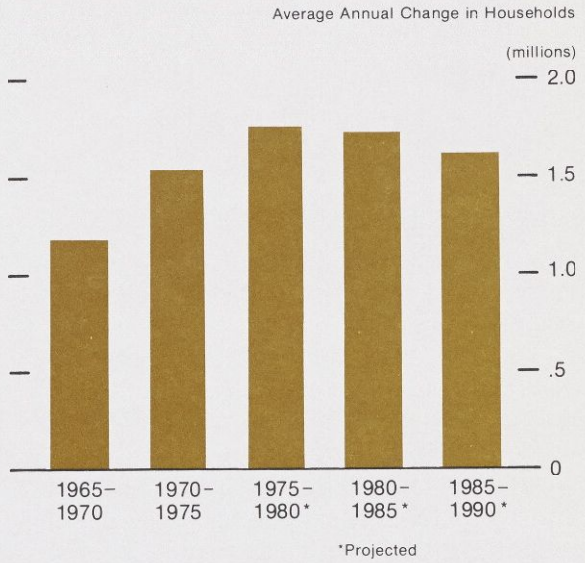
Home building activity was unexpectedly strong in 1979, but starts have fallen sharply since last October. Household formations, the age distribution of new households, loss of units, and income growth, the major factors which determine long-term demand for new homes, promise healthy home building for the next several years. But short-term factors, such as mortgage rates and sharply reduced income growth, are strong enough to temporarily halt the long-term trend.

it has minimal significance. Those elements are not entirely independent of one another or of weather fluctuations, but they are very much under the influence of long-run demographic, social, and economic trends.

A second group of factors make up housing's weather. They vary fairly widely over short periods. Similar to short-term variations in weather, large variations in these factors may overcome the long-run climate and cause floods and droughts in residential construction. In assessing short-term housing variations, one generally looks first at credit flows or mortgage rates. The latter is more relevant today because improvements in financial markets allow anyone who is willing and able to pay the market rate to get housing credit without exceptional trouble. Short-term variations in real income, housing costs themselves, and expected capital gains from housing assets are also important short-term influences on housing output.

As we enter the 1980s, what does the housing climate look like? Among the long-term factors, household formations should push housing demand strongly for several years. Additional households are likely to have greatest impact on single-family units. Lower destruction rates and slower income growth should counteract some of the strength provided by household formation.

Long-term factors are favorable. New households have been forming at a high rate for several years. The annual rate was around 1.2 million in the late 1960s but jumped to over 1.7 million in the late 1970s. It is expected to stay there in the early 1980s.[1] A large jump in the number of single-person households and the movement of baby boom members into their 20s account for this household formation bulge. The bulge is not likely to run its course for a while because both basic factors behind it are continuing.



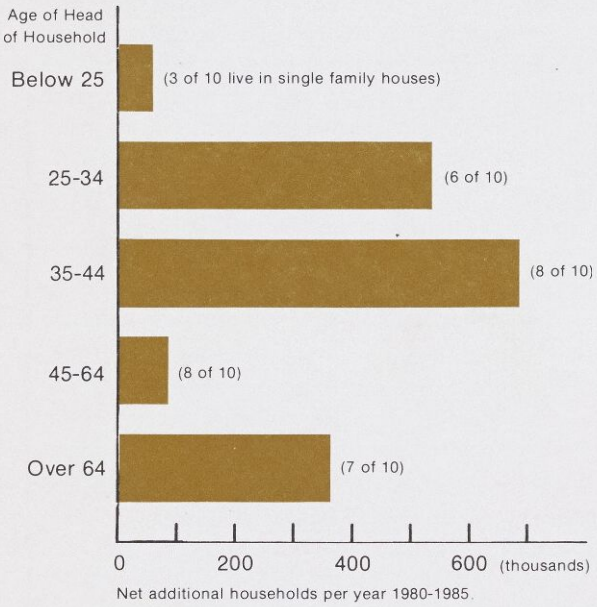
Household formations are booming

As members of the baby boom move into their late 20s and 30s, they enter

[1]Household formation projections used in this analysis are from projections series B found in the U. S. Bureau of the Census, "Projections of the Number of Households and Families, 1979 to 1995," **Current Population Reports,** Series P-25, No. 805, Washington, D. C., May 1979.

the age group that normally goes to market for a single-family house. Patterns observed in both 1960 and 1970 censuses indicate that about 3 out of 10 households in the under 25 age group live in single-family houses. But 6 of 10 in the 25-34 age group and 8 of 10 in the 35-44 group live in these units.[2] In these days, it is not necessarily (indeed, not often) a new house that younger families buy, but their purchases of existing houses often start the upgrading process that results in older families' purchases of new housing.

The movement of the baby boom generation into its late 20s and 30s partially



Additional households will boost single family demand

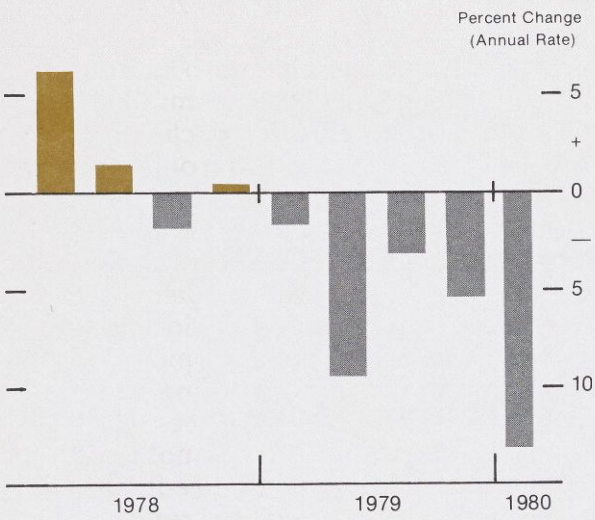
accounts for the jump in the share of single-unit houses from around 55 percent of newly built residential units in the early 1970s to around 70 percent during the past 3 years. This distribution will most likely hold stable as more than 70 percent of net change in households over the next 5 years occurs in the 25-44 age group.

The basic demographic push to housing demand in the early 1980s seems likely to get some resistance from a declining rate of loss of housing units and from slow income growth. The rate at which housing units were taken out of the housing stock slowed in the 1970s. This rate seems likely to slow further as remodeling and rehabilitation become more widespread. Travel cost increases put a premium on close-in locations where housing already exists. Many units in these places will be refurbished rather than demolished and replaced. Thus, a further reduction in the loss rate and the need for replacement units seem likely. Further, typical projections indicate slow growth in labor force, in capital investment, and in productivity in the early 1980s. This adds up to slow real income growth. Both of these forces would somewhat retard but not overcome the influence of high household formations. The climate still seems likely to be conducive to housing demand similar to that of 1977 and 1978, when housing starts were in the neighborhood of 2 million units.

But the current weather is terrible. Short-term influences appear, on balance, to provide strong resistance to housing output. Credit costs have climbed despite the vastly improved channels for mortgage availability. Mortgage rates finally climbed above the inflation rate in October, after being lower through most of 1979. They have continued to climb this year. These phenomena can be expected to cut down the number of housing units demanded.

Income growth has dropped below its long-term trends, making it less likely that people will feel that they can afford to buy houses. Real disposable income was down in each quarter of 1979 and dropped sharply again in the early part of this year. Slower income growth, combined with higher mortgage rates, makes

[2]An analysis of these tendencies is found in Thomas C. Marcin, "The Effects of Declining Population Growth on the Demand for Housing," U. S. Forest Service, General Technical Report NC-11, Washington, D. C., 1974.



Real disposable income has generally declined

it less likely that potential home buyers can qualify for loans, even if they are willing to take the plunge.

At the same time, however, the rates of increase in prices of both new and existing homes went negative in the fourth quarter of 1979 before rebounding somewhat in January. Ordinarily, one would think that slower rates of increase in the prices of homes would support demand for new housing units. But in today's economy, part of the motivation for purchasing housing is expected capital gains. Lower rates of price increase may also reduce expectations of capital gains and work against new single-family and condominium demand. All this leaves the influence of recent slowing in the inflation of housing prices in a fog, but the opposing forces involved may come close to cancelling each other. Recent slowing in housing inflation probably will have little impact on the number of new homes or apartments built for a while.

Government programs are not currently a depressant. On the other hand, they are not much of a stimulus in the single-family sector. The status of plans for housing support this year is in limbo. Recent increases in mortgage rates have brought many calls for massive support. At the same time, the move of the Congress and the Administration toward a balanced budget limits enthusiasm for more housing support spending on that front. There are even recent indications that some home building trade groups are ready to support restrictive fiscal policy at the expense of housing support.

Where does that leave housing production? A strong underlying demographic push is likely to be only somewhat mitigated by slower-than-usual long-term income growth and reduced losses from the housing stock. However, short-term forces are now overwhelming this strong push. When the short-term weather improves, when mortgage rates fall, and income growth rebounds, the slowdown we are now experiencing is likely to be followed by a rebound to 1977 and 1978 levels of starts in real residential construction spending. Early this year, the consensus forecast saw 1.4-1.5 million starts in 1980, with a slow first half and a rapid rebound in the second. These forecasts generally assumed that interest rates would reach their peak early in the year and that income growth would increase late in the year.

We already know that the early interest rate peak has not taken place. Most forecasters now see less strength late in the year than they previously did. Housing production, in all probability, will slow more than previously expected; the slowdown will continue longer, and the rebound may be less sharp than expected, particularly if efforts to balance the Federal budget fail and advances in defense spending induce larger deficits and continued upward pressure on interest rates. It looks more and more as if starts in 1980 will be below the earlier consensus range, and the rebound that is waiting in the wings will stay there until very late in the year if it comes at all during 1980. ER