

## Housing in the Nation and in New England

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Thank you for inviting me to address you today. The Federal Reserve Bank of Boston has strongly supported the New England Economic Project since its creation. We frequently use NEEP's forecasts and analyses in our work, as do many others throughout the region and the nation.

Nationally and regionally, housing is an important and timely topic. On the national level, housing's contributions to economic growth during the most recent business cycle have been a subject of more than usual interest. In the region, housing has buoyed growth as well. But analysts and commenters have focused on persistent structural issues and their implications for long-run economic performance. This afternoon, I'd like to delve into both sets of issues and the interplay between them.

Over the past three years, housing has been a key mainstay of the national economy, moderating its contraction and sustaining its recovery. Housing exerted these effects directly, through residential investment, and indirectly, through effects on wealth and consumption. It goes without saying that robust demand for housing increases residential construction. Less obviously, strong sales and rising values strengthen the economy by stimulating consumption and home improvements. When a home is purchased, the buyer often remodels it, buying new furniture, big-ticket appliances, and other assorted housing-related materials and equipment. When a home obviously increases in value, the owner, encouraged by his or her new-found wealth, often increases spending on a wide variety of items. Many believe this wealth-effect from continuing housing appreciation has had an even more important and broad-based impact on spending over the last 8-10 years than the ups and downs of the stock market.

Normally--that is in post-World War II history--residential investment tends to be volatile and to lead the business cycle. It contracts sharply near the peak of the cycle, helping to drag the economy into recession. In contrast, shortly after the bottom, housing leaps out of the starting blocks ahead of other sectors, helping to vault the economy into recovery.

Over the past three years, however, housing's behavior has deviated markedly from this historical pattern. ([see Figure 1](#)) From the third quarter of 2000, just before the most recent peak, to the third quarter of 2001, the end of the recession, real residential investment grew by nearly two percent. Had it followed its average postwar pattern for this segment of the business cycle, it would have fallen by 15 percent. Rather than drag the economy down, it moderated the recession.

As in the past, residential construction bolstered the recovery. It expanded at an annual rate of over 7 percent for the six quarters since the fourth quarter of 2001. However, while it was a source of strength, housing construction has contributed less to the recovery than it has in the past. Had it tracked its historical postwar trend, it would have expanded at a rate of about 13 percent. Thus, the most recent residential construction cycle has been smooth by historical standards. In part, as a result, the entire economic cycle has been muted, with GDP falling less during the recession and rising less in the recovery.

This smoothness largely reflects the recent atypical pattern of interest rates. Rates generally rise as the economy approaches a peak, and then fall after the economy weakens. Housing, obviously an interest-sensitive sector, responds accordingly. ([see Figure 2](#)) However, this time the recession followed the downturn in rates. Mortgage rates started to fall in the middle of 2000, likely reflecting broader long-term interest rate trends. They continued to do so as the Fed

began to ease right through the middle of 2003. Thus, there has been no sharp fluctuation in rates to induce a corresponding swing in residential construction.

(see [Figure 3](#)) Similarly, home sales have not exhibited the volatility of previous business cycles. They have increased at an annual rate of over 4 percent since the end of 1999 and have fallen in only four of the past 14 quarters. Like residential investment, in previous cycles they were leading indicators, falling sharply near the peak and rebounding shortly after things began to recover. Not this time.

(see [Figure 4](#)) Home values have also risen steadily, exhibiting much less volatility than in previous cycles. On a year-over-year basis, the real value of houses financed by a conventional mortgage increased more than 3 percent every quarter since late 1997, and grew in excess of 5 percent throughout the recession. This truly was a break with the past, when houses sold during a recession fetched lower rather than higher prices. This helps to account for the fact that consumption was relatively unaffected by the plummet in stock market values in 2001 and 2002. During that period \$ 3.4 trillion in household stock wealth evaporated; in contrast, housing values added \$ 2.3 trillion and, arguably, added this to the wealth of a broader swath of Americans, many of whom had been little affected by the stock market.

How much have rising housing values stimulated the economy? Recent analyses of mortgage refinancing activity provide some insights. Over the past few years, refinancing has been one of the most important vehicles through which households have liquified housing wealth. (see [Figure 5](#)) The volume of mortgage refinancing activity rose sharply in 2000 and 2001 and exploded from the third quarter of 2002 through the middle of this year. This contrasts with the 90-91 period when rates fell but housing values appreciated less and refinancing did not surge. Likely the historically low rates of the 2000-2002 period accounts for some of this difference.

Survey research recently conducted by economists at the Federal Reserve Board attempted to quantify the impact on consumption of the home equity cashed out through refinancing in 2001 and early 2002. According to their study, homeowners used refinancing to extract about \$130 billion dollars of housing wealth during this period. Survey respondents said they devoted about one-half of this to consumption; about one-quarter to the repayment of other debts; and the rest to investments and tax payments. Based on these responses, Board economists estimated that consumption financed with cashed-out equity boosted personal consumption expenditures by between one-quarter and one-half of a percentage point of personal consumption, or between \$18 and \$36 billion, on an annual basis. The study ended before the huge spike in refinancing that began in mid-2002. Thus, it seems reasonable to suspect that the impact of refinancing since then has been greater.

The rise in mortgage rates over the summer acted to shrink the volume of refinancing activity dramatically. Some analysts fear that this contraction may foretell a decrease in housing activity generally; a decline in the growth rate of housing prices, and a slow-down in consumption. However, mortgage rates have reversed their upward trend in the past few weeks. Other recent monthly data suggest that housing remains robust. A few weeks ago, the Department of Commerce revised its estimate of July housing starts to an annual rate of 1.82 million units, the highest level in 17 years. Starts remained very high by historical standards in August, and housing permits rose. Existing home sales surged in August, reaching an all-time high. If a marked slow-down in housing is in the works right now, we haven't seen it yet.

Will we see it in 2004? Will the powerful engine of residential investment growth, and its related impact on consumption, continue into next year? Clearly that will depend on the fundamentals--mortgage interest rates, home affordability, and individual incomes and need for housing. I won't comment on future mortgage interest rates, except to say that despite some bounciness in the early summer, rates remain at levels that are low relative to those over the past 30 or 40 years. As a result, despite price increases, housing affordability remains high. Similarly, the basics of new household formation remain favorable as well. The area of most concern at least for the present involves personal income and that means jobs. So far this recovery has been the most jobless on record. With strong growth in the forecast for the second half of this year, it's reasonable to suspect that job growth will begin in earnest. If employment grows as expected it will bring with it the confidence consumers need to continue making housing investments. So, I believe it is reasonable to suspect the level of housing investment will remain high, though as other aspects of the economy expand its impact on growth may well decline.

While housing's strength has been a boon for the macro-economy, it has presented New England with a good news, bad news situation. On the one hand, it has directly and indirectly stimulated final demand, just as it has in the nation as a whole. On the other hand, it has exacerbated a chronic problem that has plagued the region for years—very high housing costs. New England households devote a larger percentage of their income to shelter than their counterparts nationwide. Costly housing is seen as an increasingly serious liability for the region as it competes for jobs and industry. Some say housing costs have driven workers away and deterred in-migration, limiting labor force growth. Furthermore, homebuilding on the fringes of high cost urban areas has extended development into previously open space. Many decry increasing "sprawl" as a blight that erodes the essential character of New England, uses resources and infrastructure inefficiently, and results in extended commercial development. For others this same "sprawl" is the only affordable way to enjoy the American dream of single family home ownership.

Starting with the good news, housing has exhibited the same strength here in New England as in the rest of the country. During most of the 1990s sales of existing homes in the region grew in line with the nation. Similarly, growth in the value of residential construction contracts kept pace with the nation. In July, the regional index of such contracts hit an all-time high. But the demand for both new and existing homes clearly seems to be outstripping the supply. Home prices have appreciated more rapidly in the region than in the nation in every quarter since early 1998. And this increase was off an already high base. During the '80s, regional housing prices grew much faster than the nation as a whole. This growth moderated, and the typical home price even declined for some types of housing in the early '90s. Over the past five years, however, the average price of a house in New England grew at a pace roughly twice that of the nation as a whole.

Thus, even including the early 1990s declines, home prices in New England are now roughly 4-1/2 times their 1980-82 levels, while U.S. home prices are less than three times as high as they were in the earlier period.

Clearly, rising house prices have benefited New Englanders who already own a home. The rising value of this important asset and the related rise in home equity undoubtedly buoyed spending, and offered many a family the opportunity to move up to that dream house. And many have benefited from a supply of "starter" homes vacated in this process of moving up. But supply constraints, and rising prices, may also have made housing too expensive for some workers migrating in to new jobs, and for many hoping to move up to home ownership for the first time.

Rising prices of homes have also increased costs relative to home owner income. In 2000, the nationwide median sales price of an existing home was about 3 times median family income. The comparable ratio was higher in every New England state, except Rhode Island and Connecticut. Massachusetts' housing burden was higher than those in the rest of the region, 73 percent above the national ratio. With house prices continuing to rise faster here than nationally, and income weakened by the recession, housing burdens have clearly increased in the region relative to the nation in the past three years.

And things aren't much better for renters. Rental housing is expensive in most states within our region. According to HUD estimates, the median rent for a two-bedroom apartment in Massachusetts is currently about 18 percent of median family income, third highest in the nation. Only Rhode Island, ranked 35th, lies below the national median.

When the term "affordable" housing is used, one often thinks of low or moderate income housing. In New England, generally, and Massachusetts, in particular, even many middle to high income professionals face a real challenge in finding houses that they can afford. These workers have other job options in lower-cost locations, and many perceive the cost of housing as a threat to the health of the high-value added businesses of New England.

Many employers in Massachusetts have warned that the Commonwealth's soaring housing burdens have caused workers to leave or not to come, slowing growth in the state's work force. Newspaper stories about prominent doctors and professors who have left the state, or who have been deterred from accepting a job in it, because of its onerous housing costs are common. And employers have tried several innovative ways to address this problem. Some firms have tried to attract and to retain employees by offering them financial housing assistance. The Greater Boston Chamber of Commerce, in conjunction with Fannie Mae, is urging their members to offer such programs. Health care providers on Cape Cod are joining forces to provide housing subsidies for nurses in training, given the persistent shortage in that profession. Such circumstantial evidence strongly suggests that expensive housing is a serious competitive liability for

the Commonwealth.

These problems go beyond Massachusetts. In recent years, the Granite State has experienced some of the same problems. Three years ago, the state's Department of Employment Security issued a report stating that "Finding people to work has become a consuming endeavor for many New Hampshire employers....While New Hampshire employers are seeking labor, their employees are seeking housing." In Kingston, New Hampshire, Northland Forest Products, a hardwood processing and distribution firm, was at one point planning to construct new housing for its workers. The company's CEO, Jameson French, said, "I'm a practical business person, and I'm trying to figure out a way to keep long-term employees who can live locally...Around here, they can't find anything to rent, let alone buy." I'm told this company ended up buying housing for its workers, but the message remains the same.

The relatively high cost of shelter in New England can be attributed to several factors. First, demand tends to be fairly strong. Many people want to live here and are willing to pay a lot to do so. While our climate may be harsh, we possess many attractive characteristics: New England charm; scenic mountains, lakes, and coastline; world class hospitals and universities; outstanding cultural amenities; and a thriving--and we hope winning--major league baseball team.

Second, construction costs are generally higher in New England. In particular, construction labor is relatively expensive. Furthermore, compared to the nation's most rapidly growing regions, New England has colder, snowier winters. Consequently, our building season is shorter and our homes have more insulation and other special features that add to costs.

Third, land supply constraints exist as well. A relatively large percentage of New England's land was developed long ago. New England states are small and face geographic challenges such as mountain ranges, rivers and lakes, and large areas of wetlands that are less than ideal residential building sites. Transportation to and from major places of work can be constrained by roads that run north and south, not east and west, especially in the northern states, further restricting desirable building space.

And New England has a certain character and charm. Existing communities understandably want it to stay that way. More and more affordable housing might destroy the character of communities and create what are arguably burdensome demands on public services. In particular, expansion of the housing supply could bring an influx of families with school-age children, create traffic congestion and parking problems, and strain utilities. Some communities argue that additional tax revenues collected on new residential property would be insufficient to cover additional fiscal costs. So, the construction of new housing, especially affordable units in multi-family structures, has been resisted.

There is evidence that such fears are justified. Consider a home in Massachusetts with an average value subject to the statewide average property tax rate. In fiscal year 2000, the tax yield on that home would have been less than half the average cost of educating just one child. The fiscal gap for a relatively inexpensive home occupied by a family with more than one child would have been even greater. State school aid blunts, but does not eliminate, the net fiscal burden imposed on a community by the development of moderately priced housing inhabited by families with school-age children. Thus, when communities resist development of inexpensive housing, they are defending their own interests. Local autonomy is valued in the region and housing is a key area where this is felt.

In New England, localities have ample authority over zoning rules and other land use regulations. Many require stringent minimums on lot sizes, lot widths, setback area, front yard area, building height, and ratio of parking spaces to residents. Reportedly, they also deter local development by imposing significant, costly paperwork requirements. As a result, between 1950 and 1990, development within the Commonwealth spread beyond previous developed areas and grew six times faster than the population. Thus, population density has actually declined over the years as people have spread out, and household size has become smaller. In 1950 each developed acre housed 11 people; in 2000 each acre housed only 5 people. So-called "sprawl" is an issue not only in Massachusetts but in every New England state.

With limits on supply, concerns about sprawl, inherent cost challenges and booming housing demand, housing prices have had no place to go but up in New England. A comparison of housing trends provides some evidence on the relationship between housing construction and home prices—with the causation running in both directions, of course. (see [Figure 6](#)) Consider differences between housing trends in New England and the South Atlantic region. In New England, the number of housing permits issued per 100,000 residents has been low and fairly steady for over a decade.

In some respects, this persistently slow pace of permitting is an understandably cautious response to speculation and overbuilding in the last half of the 1980s. However, partially as a result of this caution, housing prices have accelerated since the mid-1990s. Contrast this with the experience of the South Atlantic region. There, permitting per 100,000 residents has been much higher than in New England since at least 1980, and has increased fairly steadily since the early 1990s. Partially as a result, the rate of increase in housing prices has been much slower.

What can be done to increase the supply of housing in New England? Policymakers and housing specialists have made recommendations. Generally, they focus on increasing the population density within communities by increasing the amount of housing available without adding to "sprawl." Such recommendations include limiting the autonomy of municipalities in controlling zoning and permitting; eliminating duplication among local and state agencies with authority over housing development, and restoring public financial support for low- and moderate-income housing. While some of these proposals deserve serious consideration, there are few, if any, "no brainers" among them. Local autonomy and control are deeply engrained values in New England. Many households, especially those up the income scale, prefer single-family houses rather than dense development. As with most public issues, the choices that policymakers must confront in addressing housing problems are difficult and complicated.

In some ways, the tradeoffs surrounding housing issues at both the national and regional level reflect the numerous roles that housing plays in our lives. For the more than two-thirds of the nation's households who own their home, it is a source of pride and wealth, the very definition of what it is to be successful in the United States. For the majority of homeowners, and certainly for those in the lower half of the income scale, their home is the most valuable asset they possess. Our homes also define the community in which we live, a choice that shapes our broader living environment and influences our access to amenities and work opportunities. At the same time, the availability of affordable housing is an important component to a region's ability to attract and retain the base of thriving businesses it needs to continue to grow. Without housing that is within the reach of workers, the region's businesses--high-tech, low-tech, bio-tech, medical, financial, educational-- will have trouble remaining competitive. And this, too, shapes people's lives, forcing out-migration on some who would prefer to stay, or preventing in-migration. Public policy choices are all about balancing the needs of often conflicting aspects of our society--clearly housing is an area where this balancing act is a major challenge.

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