



Creating Value in Distressed Neighborhoods

The last time I spoke at this annual luncheon in February of 2008, before the depths of the global financial crisis, northeast Ohio was already experiencing very high foreclosure rates. Unfortunately since that time, foreclosures have become a national crisis. We all know too well that foreclosures and abandoned properties have been imposing significant hardships on millions of people and an untold number of communities over the past few years. In fact, housing market issues pose a significant headwind to our economic recovery. Specifically, losses in housing wealth have held back consumer spending, sapped household confidence, and reduced the ability of small-business owners to obtain credit. Further, housing issues continue to affect bank earnings and credit quality. So, I can assure you that I see the consequences of our housing market challenges both as a resident of northeast Ohio and in my role as a Federal Reserve policymaker.

Today I will share with you some thoughts about the significant housing challenges that we face in northeast Ohio and in other aging, industrial cities across our nation. First, I will talk about the fact that in our community, the roots of vacancy and abandonment were in place even before the financial crisis hit. Then, I will focus on the importance of making our neighborhoods and communities more appealing places to live and work, which will require broad coalitions committed to addressing the full range of community needs.

As always, the views I express are mine alone and do not necessarily reflect those of my colleagues in the Federal Reserve System.

Let me turn, first, to the roots of the problem. The timing and causes of foreclosure, vacancy, and abandonment vary depending on the region of the country. In the lead-up to the housing crisis, large numbers of people moved to the southern and western states, driving up demand for residential property in these regions. When you add in creative loan products, the loosening of credit standards, and the erosion of down payment requirements, you can understand how home prices skyrocketed in many of these regions. After the financial crisis and deep recession took hold, a wave of delinquencies and foreclosures hit these states, and property values fell sharply. This is the "conventional" story of the housing crisis reported widely across the nation.

However, in older, industrial cities such as Cleveland, the story doesn't quite match this tale of boom and bust. As you know, property values in our region didn't rise as dramatically prior to the financial crisis and recession, and foreclosures here started increasing earlier than in other regions. We have to look for other explanations. Here is one. Cleveland and similar older, industrial cities also

Additional Information

Sandra Pianalto

*President and CEO,
Federal Reserve Bank of Cleveland*

**Neighborhood Housing Services of
Greater Cleveland**

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experienced their credit booms in the form of mortgage refinancing - not just in loans for new purchases. However, the end result was the same - more highly leveraged homeowners, and more foreclosed, vacant, and abandoned properties.

Research conducted by the staff at the Federal Reserve Bank of Cleveland has shown that the interrelationships between foreclosure, vacancy, and abandonment are complex, particularly in cities with weaker housing markets. Our research, using data on properties in Cuyahoga County, indicates that in stronger submarkets, our performance is similar to the rest of the nation. In these stronger submarkets, foreclosure and vacancy play an important role in substantially lowering the property values of surrounding homes through supply and spillover effects. Relatively few properties are abandoned in strong submarkets.

In the weaker submarkets of the county, however, our research indicates that vacancy and abandonment have a stronger impact on property values than foreclosures. In weaker submarkets, although foreclosures lead to some abandonment, not all abandoned property goes through the foreclosure process. In these areas, property abandonment appears to arise from the mismatch between the supply and demand for homes, which is driven by long-term population loss.

Of course, it is hardly a secret that Cleveland and other industrial cities have lost population over the past couple of decades. For example, based on census data, Cuyahoga County's population has declined continuously since 1990, and in those 20 years, the county lost nearly 10 percent of its population. However, in that same 20-year period, construction of housing units within the county rose by about 3 percent.

In addition, we know that housing stock is durable-meaning that it lasts for decades and in many cases, for more than a century. Understanding the effects of this durable housing stock is critical to understanding urban growth and decline. Researchers have found that urban decline is not a mirror image of urban growth. Population growth tends to be followed by new construction and rising home prices, but population loss is typically not followed by reductions in the housing stock. Instead, we usually see the prices of homes decline, and the houses are then purchased by residents with lower wealth and lower income than previous owners. During these transitions, the relative attractiveness of neighborhoods can be affected by various factors such as the level of homeownership, the educational attainment of residents, and crime rates. Eventually, rehabbers can see an opportunity to fix up the properties once again and then a renewal phase can take hold. This type of cycle can go on for as long as one hundred years as neighborhoods transition through phases of decline and renewal. Moreover, this research also indicates that once a city's economic vibrancy starts to fade, it will continue to cause population declines over many decades to come.

The research also shows that population growth is much lower in cities that have a large share of their housing stock valued below the cost of new construction. This is not necessarily a causal connection, but it demonstrates the role that the housing market plays in urban growth. Simply put, when it costs more to build than to buy, you don't see much growth and vitality.

The upshot, then, is that population loss and durability of the housing stock are important forces in urban cycles of decline and renewal. Here in northeast Ohio, these forces were in place well before the recession and the financial crisis rapidly increased foreclosures and accelerated the levels of vacancy and abandonment. So how can we overcome the forces that cause vacancy and abandonment?

One policy option that is receiving a lot of attention is to aggressively reduce the supply of housing, particularly low-value housing. In Cuyahoga County, we are fortunate to have a land bank that is already hard at work on making this process a reality. Our research leads us to believe that land banks can play a vital role in the mix of policy options to address abandoned properties, specifically low-value properties. You are probably aware that the Federal Reserve Bank of Cleveland has actively supported this concept as it was being planned and implemented locally. We continue to maintain a strong working relationship with land bank officials. While reducing the supply of housing stock certainly should have a positive effect on neighboring property values, I think it is an incomplete solution. We also need to focus on the demand side of the market.

My staff looked at what caused the significant increase in property values prior to the crisis in the "hotter" housing markets. This is relevant as we consider the policy of reducing the supply of housing stock. We know that housing prices include both the cost of the structure and the value of the land on which the structure sits. Our research found that since the 1950s, the price of residential property across the nation rose faster than the cost of building the structures themselves. In regions with more rapidly growing property values, much of the increase in value came from the value of the land, not from the value of the structure. This research concluded that the supply and demand for land for residential housing drove the change in housing values. Based on this relationship, demolishing low-value housing stock may not have a lasting or significant impact in increasing property values, unless there is a strong, ongoing interest in the land itself.

This brings me to my second point—that property values will rise only when our neighborhoods and communities become more appealing places to live and work. For older, industrial cities to be able to retain existing residents, as well as attract new people, our communities need to offer amenities such as good schools, access to transportation, safety and green spaces. Communities that can attract residents with the skills to earn good incomes should see an increased demand for housing, and in turn, neighborhood revitalization. To accomplish this, however, we must look beyond housing capital and look at human capital.

First and foremost, we have to improve the level of educational attainment in our city and region. Research has repeatedly shown, and we intuitively know, that with higher levels of education, people are able to earn higher incomes. Today's employers need people with good skills, and employers tell us that they are having a hard time finding enough people who are prepared to fill positions. Moreover, many cities in our region have levels of educational attainment that are quite low. Only 13 percent of the residents of the City of Cleveland have a 4-year college degree, compared to 25 percent for Ohio and 28 percent for the nation.

To address the challenges I've touched upon today, this region will need broad coalitions across our community with the expertise and commitment to find and implement solutions. The coalitions should include government, private enterprise, financial institutions, foundations, and community development groups and practitioners, where applicable. One example of a meaningful partnership for economic development is the Cleveland Foundation's Greater University Circle Initiative. This partnership brings together institutions like Case Western Reserve University, University Hospitals, the Cleveland Clinic, and various cultural institutions. As you are probably aware, this initiative focuses on a broad range of development issues including housing, enhanced education, the arts,

a workforce strategy, and neighborhood safety. It strives to connect neighborhoods, schools, anchor institutions and private enterprise to revitalize a range of neighborhoods. We have just begun to see the spillover effects of this initiative through the announcement of a new partnership to construct rental housing in East Cleveland, a city that borders University Circle and has been struggling for years. That partnership also includes University Circle, Inc., Cuyahoga County, and the city of East Cleveland.

Another example of a successful coalition is the partnership between Cleveland State University and private developers to create rental housing near campus, coupled with retail space in the same building. In partnership with the Cleveland Metropolitan School District, CSU opened the Campus International School, which is expected to grow one grade at a time into a full K-12 program. The university has also partnered with the regional medical college (NEOMED) to offer students a degree option to become a doctor with a specialization in urban medicine. I think it is reasonable to expect these partnerships to produce positive spillovers that would attract more than just the students to an increasingly productive urban setting.

Let me offer one suggestion for a potential coalition. Cuyahoga County has a strong network of pre-K programs, and these programs have been shown to be successful in elevating children's educational attainment. But the county faces fiscal and budget pressures that may limit its ability to expand its pre-K program, and other providers are facing similar challenges. With the right partnerships, local CDCs, with their strong knowledge of the residents' needs, could help to fill this gap. Efforts such as this would not only support local students' educational attainment, but also enhance the neighborhood's attractiveness as a place to live.

Let me conclude by observing that our challenges with vacant and abandoned housing are immediate, but they are the result of forces that have been at work long before the recent financial crisis and recession. While the effects of the crisis and recession certainly deepened their impact and significantly increased the challenges we face, we cannot hope to overcome these forces by implementing a single program or through the efforts of any one governmental or private organization.

Cleveland, Cuyahoga County, and northeast Ohio have historically been well served by a strong CDC network, and these organizations, your organizations, have made a positive and tangible difference in fulfilling the housing needs of neighborhood residents. I believe that community development organizations will be integral to successful strategies to revitalize neighborhoods. We will need you, working creatively and collaboratively with others to reverse the trends that have been building for decades.