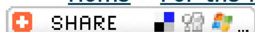

Housing in the National Economy: A Look Back, a Look Forward

I had the honor of addressing this same conference four years ago, when the nation was just emerging from the financial crisis. At that time, I discussed the Federal Reserve's actions to pull the economy back from the brink. I know that many of you have been on the front lines of rebuilding Ohio's damaged communities. With your help, a lot of progress has been made since the crisis.

Today I will begin my remarks with how the Federal Reserve continues to support the economy through monetary policy. Then I will turn to the focus of this conference—the housing market. I will discuss the importance of the housing sector in the broader economy and highlight some notable national trends. And I will wind up with some thoughts on the factors that continue to hold back the recovery. As always, the views I express today are my own and not necessarily those of my colleagues in the Federal Reserve System.

The Federal Open Market Committee (FOMC)—the Federal Reserve's monetary policymaking body--has a dual mandate given to us by Congress to promote maximum employment and price stability. The financial crisis and recession required us to supply a very accommodative monetary policy to get the economy back on a path to achieving those mandates. Our main and traditional tool to stimulate the economy in the face of a cyclical downturn is an interest rate for overnight loans between banks: the federal funds rate. As the recession that accompanied the financial crisis deepened, the Federal Open Market Committee drove short-term rates as low as they could go, right down to nearly zero.

But the recovery struggled to gain momentum, and it became clear that the economy would benefit from further monetary policy stimulus. So we turned to some unconventional tools to push down longer-term rates.

One of them is large-scale asset purchases, often referred to as quantitative easing, or QE. The FOMC is now on a third round of

Additional Information

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buying Treasury securities and mortgage-backed securities. When we began the current program last September, the FOMC said it would continue asset purchases until there was a substantial improvement in the outlook for the labor market, as long as this was accomplished without a threat to price stability. Whether and when the pace of asset purchases would begin to slow has been the focus of much attention over the past few months.

In my view, we have accumulated meaningful progress in labor markets since the program began; on net, employers have created about 180,000 jobs per month. At the same time, inflation has been running below the Committee's longer-run objective of 2 percent. And for this audience, I would add that the program has also helped conditions in the housing market by keeping mortgage rates historically low.

However, the latest employment report was a case where the glass could be described as either half empty or half full. The half-full perspective is that the unemployment rate fell to 7.2 percent, which represents steady improvement from the approximately 8 percent unemployment rate that prevailed at the start of the asset purchase program last September. The half-empty perspective is that only 148,000 jobs were added, which is fewer than we would expect to see in a labor market firing on all cylinders. The impact of the federal fiscal retrenchment over the past year has also slowed momentum in economic growth, which may impact employment growth in the coming months.

At last week's meeting, the FOMC described the improvement in economic activity and labor market conditions since it began its asset purchase program as consistent with growing underlying strength in the broader economy. However, the FOMC decided to await more evidence that the recovery's progress will be sustained before scaling back the pace of asset purchases. My hope is that the economic recovery will accelerate so that the Committee gains the reassurance it needs to begin winding down the program. As I have said in the past, we have limited experience with asset purchases so it pays to be cautious, especially in this uncertain economic environment.[1] While to date the risks have mostly remained theoretical, I remain convinced that we need to be cautious in our expansion of asset purchases. The FOMC is constantly weighing the known benefits of asset purchases with their potential costs.

But when these initial steps to scale back our asset purchases occur, they should not be interpreted as an outright tightening of monetary policy. I want to reinforce the Committee's message that even when the rate of purchases is slowed and eventually stopped altogether, an accommodative monetary policy will still be needed to support the economy. Indeed, the FOMC expects that the federal funds target rate will remain near zero for at least the next two years.[2] Most FOMC participants don't anticipate the first rate increase until sometime in 2015. Even by 2016, when unemployment is projected to be much improved and inflation approaches our 2 percent objective,

most FOMC participants expect the federal funds rate to be at or below 2 percent—still far below historical norms, still very supportive of the economy.

A major reason why the economic recovery has been so slow and has required so much policy support has been the performance of the housing market. Ordinarily, deep recessions are followed by strong economic snap-backs. But an economist at my Bank and his co-author found two exceptions to that rule: the Great Depression and the recent recession.[3]In this last episode, the evidence points to the collapse of the housing market as the key explanation for the slow recovery. Most of the time, home construction and spending on household goods can be counted on to provide a big push to the recovery. Historically, residential investment has contributed about half a percentage point to GDP growth in each quarter during the two-year period immediately following a recession. During the first two years of this recent recovery, however, the contribution from residential investment to GDP growth was basically zero. Because the recent recession was caused in part by a housing crisis, the housing market was too damaged to provide its customary lift to GDP growth.

Let me briefly discuss the housing bubble’s origins and its aftermath. The run-up of housing prices in the early 2000s was partly attributable to the outsized amount of mortgages taken out by credit-constrained borrowers—primarily people with low credit scores who probably would not have qualified for mortgages in the 1980s and 1990s. The easing of credit constraints for many borrowers resulted in a larger than usual amount of consumption—not only for homes, but for items to fill homes, including furniture and electronics.

The housing boom fueled spending by enabling homeowners to withdraw cash from the housing equity on their balance sheets, or to borrow against it as collateral. It is difficult to know how much spending during the boom years was driven by access to homeowners' equity. Some recent research indicates that homeowners borrowed roughly $1.25 trillion against their homes from 2002 to 2006.[4] However, the most interesting aspect of this research is the finding that the borrowing was not evenly spread among households. Homeowners with the lowest credit scores borrowed very aggressively against increases in their home equity, while those with the highest credit scores, as is typical, borrowed hardly anything. Altogether, household debt rose from about 75 percent of household income in 1990 to 135 percent in 2007.[5]

Then came the bust. The housing crisis wiped out more than $7 trillion of household net worth. This is particularly important because housing is the single most important asset on most families' balance sheets. Households hold the equity in their homes as a form of saving and can use it as collateral to secure loans.

With the crash, home values fell but debt obligations did not. This created a situation in which millions of homeowners owed more on their homes than their houses were actually worth, making them so-called underwater homeowners. Even those who did not sink underwater got pretty soaked. In the two decades before the recession, equity accounted for 60 percent of the value of all residential real estate in this country. After the recession, equity plunged to 40 percent. In essence, mortgage holders went from owning more than half their homes outright, to owning less than half. Faced with this sizable loss of wealth, households hunkered down. They cut back on spending and started saving.

Besides affecting consumers, the housing downturn also affected small businesses. In another research finding by my Bank's

economists, we learned that the decline in housing prices posed a significant constraint to small business borrowing. That is because small business owners often use their own homes as collateral to finance their businesses. Small businesses lost nearly $2.5 trillion in the value of real estate assets during the recession.[6] Those losses in turn made it more difficult for small business owners to qualify for loans.

Since the financial crisis, the Federal Reserve's highly accommodative monetary policy has helped to put downward pressure on mortgage rates, enabling millions of homeowners to refinance on better terms, freeing up cash flow for additional spending and saving. The combination of higher housing prices and the paying down of mortgage debt has enabled homeowners to rebuild their housing wealth. In the aggregate, homeowners now hold a 50 percent equity stake in their homes, up sharply from the aforementioned 40 percent share a couple years ago. And household debt as a share of household income has dropped 26 percentage points from its pre-recession highs to 109 percent today.

Improving household balance sheets has helped contribute to the recovery in housing. Over the past year, in fact, housing has been a relative star performer in the economy. Prices, starts, and sales are up.

But despite this progress, the housing sector still has a way to go to regain the vitality it enjoyed prior to the recession. Existing home sales have, for the most part, not climbed back to their pre-recession levels, nor has new residential building. Even mortgage originations are not what they used to be, despite the still historically low rates available to borrowers. In many markets, prices have not yet returned to their 2000 levels. Finally, mortgage applications fell in May and June when mortgage rates moved up, and they have been up and down since then.

So that is where we have been--a housing bust followed by a recession and sluggish economic recovery that was made all the more sluggish because of the weakened housing market. Looking ahead, tight conditions in mortgage credit markets will continue to hold the housing sector and broader economy from getting back to full strength more quickly.

Let me elaborate on that point. In a recent Federal Reserve survey of senior loan officers, bankers reported that credit standards for all categories of home mortgage loans have remained tighter than the standards that have prevailed on average since 2005.[7] Financing companies no longer assume that houses will provide adequate collateral for borrowers with fragile credit histories. In addition, financial market regulators are standing vigilant to ensure there is no recurrence of the housing bubble that almost brought the financial system and global economy to its knees.

Moreover, access to mortgage credit has become far more restrictive. To get a mortgage today, it helps to have a very high credit score. Lenders are more likely to extend mortgage credit to consumers they perceive as very low risk. As a result, the pool of potential mortgage borrowers has shrunk. Households with low credit scores that were able to get credit before the crisis now are the least able to refinance their homes, or to obtain new mortgage loans. These are also the households who seem to be especially cautious in their spending these days. For these households, the days of extracting "free cash" from their homes are over. It is now mostly households with ample savings that spend and save as they normally would.

Another development that could lead to tighter credit conditions in

the future involves the secondary mortgage market. The outlook for the government-sponsored enterprises Fannie Mae and Freddie Mac is uncertain. The GSEs, as they are known, had to be rescued after the financial crisis and Congress is weighing reforms that might greatly reduce the government's large position in housing finance. The housing market today is being heavily supported by Fannie and Freddie. Without the government guarantees on mortgage-backed securities, the amount of credit available for mortgage originations would be substantially smaller today.

To sum up my remarks, it was the housing bust that got us into this situation. And the lasting consequences of the bust continue to hold back the housing market and broader economy. The big picture is that many households are still adjusting to the large shock to their net worth that occurred during the financial crisis and are dealing with uncertainty over their future earnings prospects. For these reasons, consumer spending will likely continue at a moderate pace. But over time, I expect these effects to fade and credit conditions to improve.

The Federal Reserve is focused on fostering economic conditions that will promote job growth and keep prices stable.

Employment in our economy continues to expand, and the unemployment rate is declining. That will eventually lead to a more vibrant economy in which more people move to and from jobs and household incomes rise. As job and income prospects gradually improve, younger families who have been doubling up with relatives may increasingly leave the nest. Moreover, as I noted, a lot of people have been paying down their debt during the past five years, giving them renewed capacity to take on mortgage debt. My view is that these developments will continue to slowly but surely heal both the housing market and the overall economy. But patience is needed all around as we march forward, step by step, little by little.

What I hope is that this perspective provides some context for what you have been experiencing on the ground. I think it is crucial that we have best facts at hand when making decisions about the way forward—whether that is setting monetary policy at the Federal Reserve, or working on behalf of vibrant housing markets right here in Ohio.

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1. Reflections on What Works in Supporting the Economy, October 8, 2013
2. September 17-18 FOMC Meeting, Summary of Economic Projections
3. Deep Recessions, Fast Recoveries, and Financial Crises: Evidence from the American Record
4. Mian, Atif, and Amir Sufi. 2011. "House Prices, Home Equity Based Borrowing, and the U.S. Household Leverage Crisis." *American Economic Review* 101: 2132-56.
5. Ratio calculated using outstanding household debt from the Federal Reserve Board's Flow of Funds over disposable personal income from the Bureau of Economic Analysis.
6. Calculation based on Federal Reserve flow of funds data.
7. The July 2013 Senior Loan Officer Opinion Survey on Bank Lending Practices