Michelle W Bowman: The outlook for housing

Speech by Ms Michelle W Bowman, Member of the Board of Governors of the Federal Reserve System, at the 2020 Economic Forecast Breakfast, Home Builders Association of Greater Kansas City, Kansas City, Missouri, 16 January 2020.

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Few sectors are as central to the success of our economy and the lives of American families as housing. If we include the amount families spend on shelter each month as well as the construction of new houses and apartments, housing generates about 15 cents out of every dollar of economic activity. As homebuilders, you set the foundation that supports the work of architects, bankers, electricians, carpenters, plumbers, furniture makers, and many others. In our time together today, I'd like to discuss the outlook for housing at the national level and also look at the labor force and credit challenges facing your industry.[1]

Let me start with just a few words about the overall economic picture. I'm pleased to say that the U.S. economy is currently in a good place, and the baseline outlook of participants on the Federal Open Market Committee (FOMC) is for continued moderate growth in gross domestic product (GDP) over the next few years. Unemployment is the lowest it has been in 50 years, and FOMC participants expect it to remain low. Inflation has been muted and is expected to rise gradually to the FOMC's 2 percent objective.

One of the most remarkable features of the current economic expansion has been the vitality and resilience of the U.S. job market. More than 22 million jobs have been created since the low point for employment at the end of the last downturn, and the pace of job gains has been amazingly consistent. Until this expansion, even in good times, scarcely a year went by without at least one month when payrolls shrank. Yet during the past 10 years, we haven't had a single month with a decline in the overall number of jobs. I should note that I would not necessarily consider a single month of job losses as saying much about the direction of the economy. But the unbroken string of job gains that we have experienced during this recovery highlights how our economy has kept humming along during this past decade, weathering the occasional lull. Let me also add here that, as good as the national numbers for the job market look, things seem even better here in the Kansas City area, where job growth has been steady and the unemployment rate has consistently run around 1 percentage point below the national average—at last count, it was 2.8 percent.

Let me now turn to the main topic of my talk today. My colleagues and I at the Federal Reserve pay close attention to developments in the housing sector, in part because it has historically been such an important driver of economic growth. In the national economic data, the part of GDP that includes homebuilding activity is referred to as residential fixed investment. This measure summarizes a variety of housing-related activities, including spending on the construction of new single-family and multifamily structures, residential remodeling, real estate brokers' fees, and a few other smaller components.

If we look at the growth of residential fixed investment in periods since World War II that are defined as economic expansions, we see that this broad category has increased at an average rate of around 7 percent per year, faster than the roughly 4 percent pace of GDP growth in those same periods. And, as many of you know from experience, the opposite is true as well—that housing activity tends to experience relatively large declines in economic downturns. In particular, residential fixed investment declined an average of about 15 percent annually during periods defined as recessions, compared with an average annual rate of decline in GDP of just 2 percent in those same periods.

These numbers illustrate that residential fixed investment is particularly sensitive to where we are in the business cycle. The strong economy we are experiencing now has an obvious upside for the housing sector: A robust job market translates into higher incomes, greater confidence, and more people looking to buy a new home or considering whether to make a change from their current home.

Yet even though the financial crisis and the bursting of the real estate bubble occurred more than a decade ago, all of us here are no doubt aware of the lasting imprint that those developments left on the housing market. On an annual basis, both new and existing home sales did not increase again until 2012, and they remained at modest levels for several years thereafter. Given the large and persistent inventory overhang of unsold homes in the aftermath of the crisis, the construction of new homes was also sluggish for many years into the recovery.

Part of the weak recovery in the housing market during the first few years of this expansion can be traced to extremely tight mortgage credit conditions. Despite the fact that the Fed slashed interest rates and kept them low for many years, many households were underwater on their existing mortgages, with more owed on their housing than their homes were worth, while others were unable to obtain a loan to finance a new purchase. As a result, housing demand remained very weak for an extended period.

Another factor that played a role in the slow housing recovery was the low rate of household formation, which dropped significantly during the recession and remained low for most of the following decade. Much of this drop was due to a larger share of young people continuing to live with their parents, though this is not unusual when the economy is weak and jobs are hard to find.[2]

In the past few years, though, we have seen some encouraging signs that the broader strength in the economy has eased these housing market headwinds. Along with ongoing improvements in households' balance sheet conditions, mortgage credit conditions appear to be less of a constraint for creditworthy borrowers. I should add that housing activity is also being supported by interest rates that remain quite low by historical standards, with the fixed rate charged on a 30-year mortgage now below 4 percent, substantially lower than the rates observed just before the last recession. As you well know, activity in the housing sector is highly sensitive to interest rates and other factors that have a powerful effect on the overall cost of owning a home.

In addition, amid the strong job market of the past few years, we have seen a rise in the rate at which young adults are moving out of their family homes and forming households of their own. Even so, millions of young adults are still living with their parents who likely wouldn't have been before the crisis. While their reasons for doing so are probably varied, there is potential for many more individuals to shift back to forming new households.

Although the effects may evolve slowly, the higher rate of household formation will eventually result in higher demand for housing and encourage further increases in homebuilding. Home sales have been rising in recent years, the percentage of homes that are vacant has been falling, and inventories of both new and existing homes for sale have drifted back down to relatively low levels. In fact, at this point, the residential real estate market is quite tight in some areas of the country and by enough that I have heard that the volume of home sales is being restricted by the low inventory of homes on the market.

The most recent housing data have been encouraging: Both new and existing home sales moved up strongly in the second half of 2019, and traffic of prospective buyers in new homes for sale and expected sales within the next six months have approached all-time highs. Permits for new residential construction, which had been sluggish early last year, recently moved up to highs for this expansion. In all, the national indicators suggest a positive growth outlook for the housing sector over the next several quarters.

Before I conclude, I'd like to address two challenges currently facing the housing sector. The first relates to the difficulties that some employers face, including homebuilders, in finding and retaining qualified and skilled workers. To provide some context, the national data show that the unemployment rate in the private construction industry is now well below the rate we observed in the early 2000s, a time when the housing market was booming. In addition, the ratio of job vacancies to unemployment in the construction industry—a measure of labor market strength—shot up to historic highs at the end of 2018, and it has remained near those levels. These indicators confirm what I have been hearing from construction industry employers during my visits to different parts of the country—it's extremely difficult to find and hire workers, skilled or otherwise.

In response to these hiring-related challenges, we have seen a renewed and broad focus on workforce development initiatives by the public and private sector, a development we have followed closely at the Federal Reserve. I recently heard a very encouraging presentation from representatives of vocational training organizations about progress they are making in connecting young adults, students, and high school grads with skilled trades. I am hopeful that these efforts, along with a continued strong job market, will encourage more people to join—or, in some cases, rejoin—the construction trades.

The second challenge I want to highlight relates to the declining presence of community banks in the consumer real estate mortgage market. As regulatory burdens have risen, many community banks have significantly scaled back their lending or exited the mortgage market altogether. These developments concern me for several reasons. Home mortgage lending has traditionally been a significant business for smaller banks, and the decline in this business threatens a part of the banking industry that plays a crucial role in communities. Bankers who are present and active in their communities know and understand their customers and the local market better than lenders outside the area. Because of their local knowledge and customer relationships, they are often more willing to help troubled borrowers work their way through difficult times.

These two challenges notwithstanding, I remain optimistic about the outlook for housing. I expect construction to continue advancing to meet the underlying expansion in housing demand from population growth and the strong economy. In addition, low interest rates will continue to be a key factor supporting growth in housing activity. As reported in the latest Summary of Economic Projections, released in December, most FOMC participants see the current target range for the federal funds rate as likely to remain appropriate this year as long as incoming information remains broadly consistent with the economic outlook I described earlier.

In closing, let me say that I would also appreciate hearing what is on your minds. As a policymaker, I particularly value opportunities to travel outside of Washington to hear your perspectives on the national and local economies. These conversations improve our work at the Fed by helping us make better-informed decisions.

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[1] 1. These remarks represent my own views, which do not necessarily represent those of the Federal Reserve Board or the Federal Open Market Committee.

[2] 2. See, for example, Aditya Aladangady, Laura Feiveson, and Andrew Paciorek (2019), " Living at Home Ain't Such a Drag (on Spending): Young Adults' Spending in and out of Their Parents' Home ," FEDS Notes (Washington: Board of Governors of the Federal Reserve System, February 5).