



REGIONAL SPOTLIGHT

What's Holding Back Homebuilding?

BY PAUL R. FLORA

Homebuilding is typically a casualty of economic downturns, but it is also true that most economic recoveries are built upon a resumption of pounding hammers and buzzing blades. Not so with the recovery from the Great Recession. After new home construction slowed dramatically in the recession, the sector not only failed to lead the overall recovery as usual but significantly lagged it. Even now that overall economic growth and employment have largely resumed growing solidly, homebuilding and construction employment levels remain far below normal in Pennsylvania, New Jersey, and Delaware as well as in the nation.

Why? What was different this time? The housing boom and bust significantly altered key dynamics in the housing sector that have yet to resolve. Mortgage delinquencies and foreclosures soared to their highest rates since at least the Great Depression, and though they've fallen somewhat, they remain atypically high. The housing bust and the severe recession it spawned also reduced the financial wherewithal of many individuals and families, changing attitudes and behaviors enough to lower household formation rates and create a greater propensity to rent rather than own.

Drawing on economic data, research by the Federal Reserve and others, news accounts, and conversations with numerous homebuilders, this article reviews how the housing boom and bust influenced the weak recovery in new home construction and total construction employment, focusing mainly on the three Third District states served by the Philadelphia Fed.¹

CONSTRUCTION HIRING IS LAGGING

Construction employment is underperforming compared with past recoveries.² Had the construction sector behaved in this recession-expansion cycle as it had in the prior two, its net employment would have increased by 26,000 workers instead of declining by 61,000 workers — a potential difference of 87,000 jobs.³ Although construction is not alone in this regard — trade; information; finance, insurance, and real estate; and state and local government have all been slower to resume hiring than in the past — construction's underperformance is more stark (Figure 1).⁴ Moreover, much of the underperformance in services, trade, and the rest of the economy may be related to the same factors causing weak residential construction, especially the low household formation rate.

Posing hypotheticals is risky. A significant portion of the net job loss in construction is desirable from an efficient markets perspective. That is, we wouldn't expect employment levels to return to what was, arguably, an elevated level during the housing bubble. Also remember that this business cycle has not ended. Greater job growth may lie ahead, and sectors that have lagged in our three states may yet catch up with past cycles.⁵

Hypotheticals aside, the three-state region has suffered a net loss of 88,000 jobs (0.1 percent annualized) since the peak in Decem-

Paul R. Flora is a research and policy support manager and senior economic analyst in the Research Department of the Federal Reserve Bank of Philadelphia. The views expressed in this article are not necessarily those of the Federal Reserve.

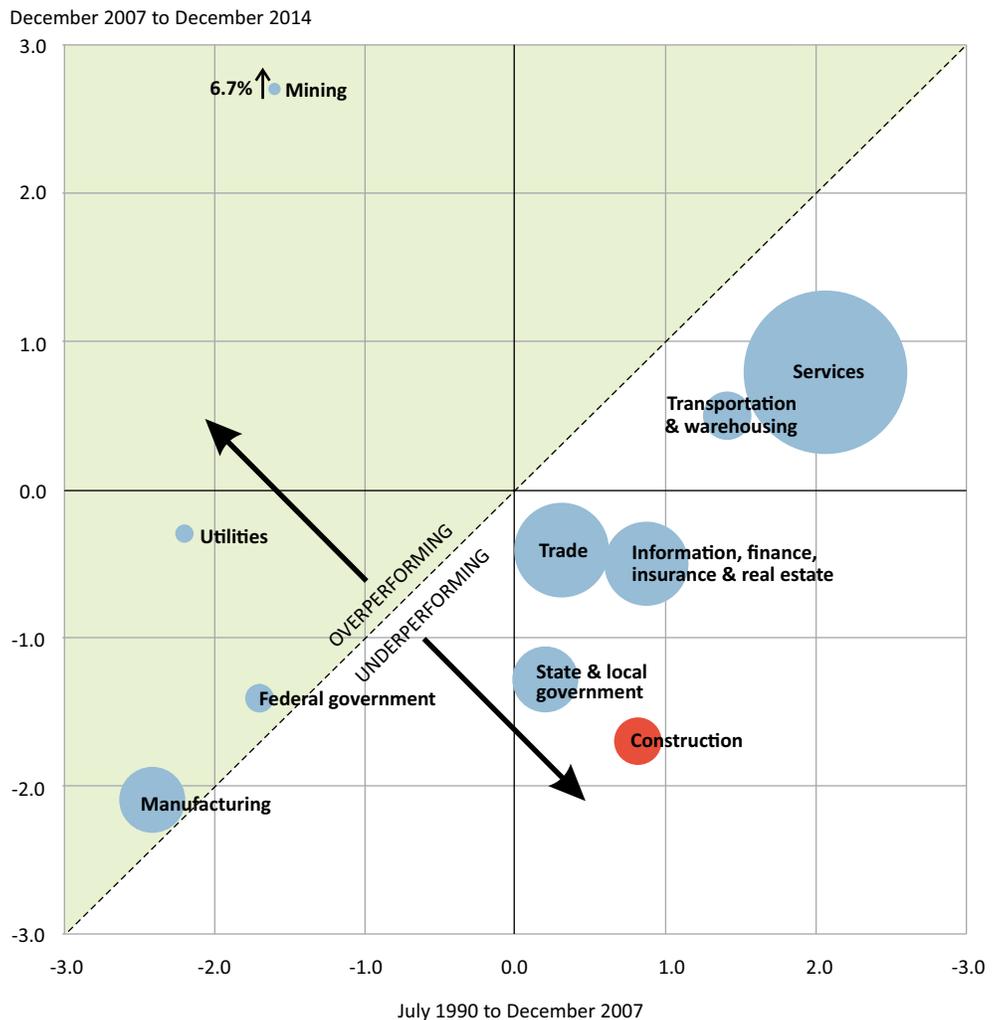
ber 2007. The largest losses have come from construction (61,000 jobs, or -1.7 percent) and manufacturing (155,000, or -2.1 percent); the largest gain has come from services (316,000, or 0.8 percent). These trends are similar to the nation's employment, which has grown a mere 0.2 percent annualized over the same period. U.S. construction job losses stand at 2.1 percent, or 1.2 million jobs.

SEVERE, PERSISTENT CONSEQUENCES

The two initial consequences of an emerging housing bubble, if not its definition, are oversupply as homes are increasingly purchased for short-term investment rather than to live in and house prices that exceed their longer-run value.⁶ In the frothiest markets, such as in Florida, investors made quick profits by reselling even dilapidated homes in impoverished neighborhoods to buyers with little or no evidence of adequate creditworthiness.⁷ News coverage at the time documented a case of 10 houses sold to one low-income buyer with no-down-payment loans that required little or no documentation to verify income or assets.⁸ With the exception of vacation homes in shore areas and in the Poconos, growth was generally slower in our Third District, and there was less opportunity for rising prices and frothy market conditions.

Even in the absence of any other negative consequences, this oversupply would require substantial time to work off, as owners were left holding houses with no buyers in sight when the bubble burst. Such a situation had occurred in Texas and other energy states in the mid-1990s.⁹ But this time there were greater consequences that spread across the country.

FIGURE 1
Construction Hiring Is Underperforming vs. Prior Cycles
 Annualized payroll job growth rates in the three-state region.



Source: Bureau of Labor Statistics, via Haver Analytics.
 Notes: Monthly data based on 2014 annual benchmark. Seasonally adjusted.

The ensuing financial crisis revealed overvalued homes, underwater mortgages, unemployed borrowers, and undercapitalized financial institutions. Housing prices fell, foreclosures rose, and the economic crash that followed set off a second round of bad debt as people lost their jobs, then their homes. It was these secondary effects from house price declines and high unemployment in the bubble's aftermath that had the greater economic impact in our Third District states.

No recession since the Great Depression — not the double-dip recessions of the early 1980s or the 1990–91 recession that was triggered in part by the S&L crisis — generated anything close to the staggering rate of delin-

quencies and foreclosures that occurred during the Great Recession. The rate of seriously delinquent loans increased nearly fivefold in the nation from its 2006 average (Figure 2). Delaware’s rate increased nearly as much as the nation’s. Pennsylvania’s rate increased less than threefold. However, New Jersey’s rate continued to increase until it was nearly nine times greater than in 2006. Rates rose much higher still in Arizona, California, Florida, and Nevada (the “sand states”).

In most states, including Delaware and Pennsylvania, the rate has fallen since 2009. However, these problem loans remain at historically high levels. Moving delinquent loans into and through the foreclosure process has been especially challenging in New Jersey, which now has the highest percentage of seriously delinquent loans among all 50 states.

DEMAND SHIFTING BY TYPE, LOCATION

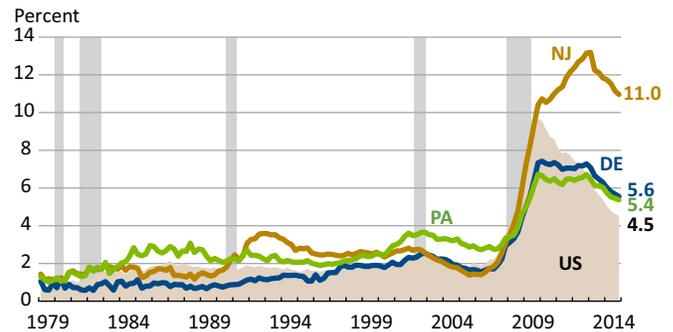
A confluence of trends has emerged that homebuilders are watching closely. Demand for apartments has grown throughout the recession and recovery as a consequence of damaged credit scores, lower incomes, and other difficulties of securing a mortgage. The Great Recession has also increased people’s wariness of homeownership. Moreover, demand for apartments and condominiums in urban centers has increased at the expense of new single-family suburban housing. Generational shifts may also be contributing. Millennials (defined in this case as those born from 1981 to 1997) recently came to outnumber baby boomers (1946 to 1964), whose rising death rate is reducing demand for housing.¹⁰ In addition, popular theories suggest that retiring boomers are showing a taste for urban living, while millennials are also attracted by the lifestyle.¹¹

In our three states, the shift has reduced rental vacancy rates and increased homeowner vacancy rates. Moreover, vacant homes that are delinquent or in foreclosure but are not available for sale or rent are excluded from this measure.¹² They represent part of the shadow inventory that may yet emerge as housing markets stabilize.

In addition, the greater share of multifamily housing further dampens construction employment. Constructing single-family homes is more labor intensive than constructing apartment buildings and condos, which deploys more heavy equipment and delivers fewer square feet per unit.¹³

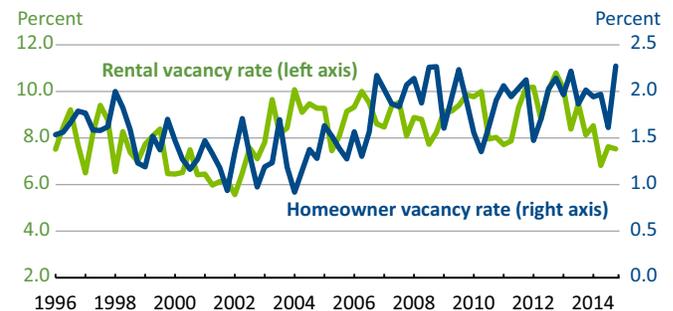
In recent years, Third District builders have commented most about the low household formation rates that had prevailed from 2006 through 2013. The overall trend had already been moving lower for the prior three decades;

FIGURE 2
Distressed Mortgages Remain Far Above Normal
Percent of mortgages in foreclosure or more than 90 days past due.



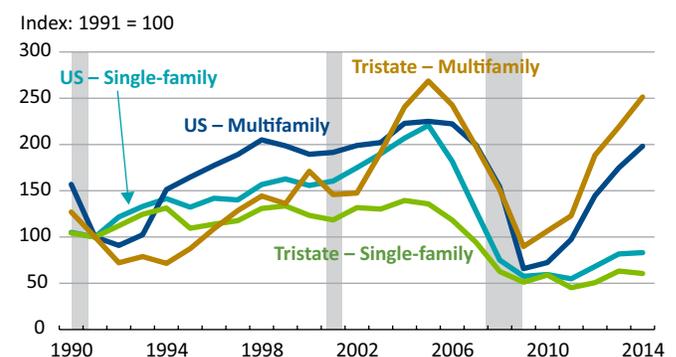
Source: Mortgage Bankers Association, via Haver Analytics.
Notes: Quarterly data. Not seasonally adjusted.

FIGURE 3
Rental Market Tightening, Owner Housing Still Soft
Regional vacancy rates for Pennsylvania, New Jersey, and Delaware.



Sources: Census Bureau Current Population Survey/Homeowner Vacancy Survey, via Haver Analytics.
Notes: Quarterly data. Not seasonally adjusted. Rates are calculated by weighting each state’s vacancy rate by that state’s proportion of the total units in the region.

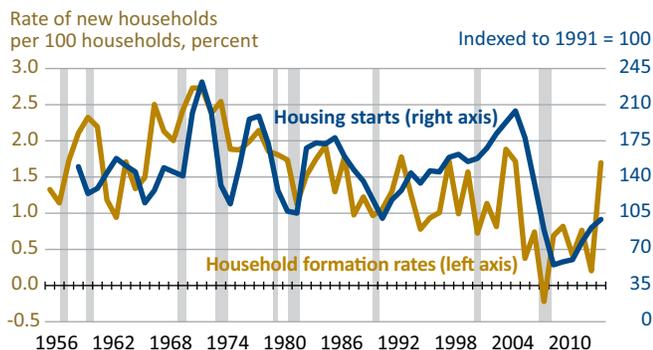
FIGURE 4
Single-Family Construction Remains Weak Here and in U.S.
Housing permits by type of home for the three-state region and the nation.



Source: Census Bureau.
Note: Monthly data aggregated to annual averages and indexed to 1991.

FIGURE 5

After Long Slump, Household Formation Surged in 2014
 U.S. household formation rates and housing starts.



Sources: Census Bureau Housing Vacancy Survey and New Residential Construction series, via Haver Analytics.

however, the rate collapsed during the Great Recession.¹⁴ Credit conditions, slow employment growth, rising student debt, and changing attitudes toward homeownership are among the factors contributing to low household formation rates.¹⁵

Each new household generally drives new spending on furnishings and services such as cable hookups. So, the dampening effect of low household formation rates on new home construction has also contributed to subpar demand for goods and services, which weighs on employment in those sectors.

WHAT MIGHT LIE AHEAD?

Data released in January offered some hope to builders and the broader economy. The 2014 household formation rate rebounded to 1.7 — more than three times higher than the average over the prior eight years.¹⁶ The 2014 upturn represents just one year, and household formation can be volatile from year to year. Yet, most of the largest declines have occurred near recession years. So it seems unlikely that household formation will retreat to its recent lows. Since new residential construction, represented in Figure 5 as housing starts, tends to follow the household formation rate, another decent year of household formation should drive a pickup in housing construction. An important question for employment is the extent to which those starts will be for single- or multifamily homes.

The Great Recession has significantly disrupted both the demand for and the supply of housing in the region and the nation. Progress remains slow, and other demographic and market trends are still developing. Generally, builders continue to react to the ongoing uncertainty by hesitating to overextend their businesses by adding workers and equipment. The evidence may soon be clearer as to whether household formation has continued to grow and whether builders benefited from the spring 2015 homebuying season. ■

NOTES

¹ In this report, construction employment for the three states includes logging and mining workers in Delaware, which reports these sectors together, but the number of mining and logging jobs is too small to have a substantive impact on these results. The mining category includes logging.

² In the chart, sectors clustered near the dashed 45-degree line have generated about the same annualized rate of job growth from December 2007 (the prior expansion's peak) through December 2014 as from July 1990 through December 2007. Sectors above the line have "overperformed" in the latest business cycle; sectors below have "underperformed." The construction sector is farthest away from the 45-degree line on the underperforming side.

³ Business cycles for which consistent employment data were available were examined back to 1990. These business cycles are also generally more alike in that manufacturing was no longer contributing such large cyclical swings after the double-dip recession in the early 1980s.

⁴ Also stark is the overperformance of mining, which is literally off the chart with an annualized job growth rate of 6.7 percent this cycle, mostly attributable to Pennsylvania's Marcellus shale boom. However, the sector represents only 0.4 percent of total employment. Manufacturing and federal government employment in the three states have also overperformed in the sense that their payrolls have contracted slightly less this cycle.

⁵ In fact, construction employment growth in our Third District states over the five-and-a-half years since the Great Recession ended has not been significantly weaker than in the first five-and-a-half years after the 1990-91 recession. That recession had been driven in part by the savings and loan crisis, which temporarily reduced financing to housing developers and prospective homebuyers, and it took eight-and-a-half years to recover in our three states.

⁶ Wenli Li's *Business Review* article examines how speculators fed the boom.

⁷ See the *Tampa Bay Times* article.

⁸ See the *St. Petersburg Times* article.

⁹ See the presentation by John Duca and others at a 2014 Dallas Fed conference.

¹⁰ Richard Fry of Pew documents the shift.

¹¹ For example, see Leigh Gallagher's book.

¹² Melissa Kresin's Census Bureau report details these other categories of vacancies.

¹³ From conversations with builders.

¹⁴ See Andrew Paciorek's discussion paper.

¹⁵ Meta Brown and Sydnee Caldwell discuss the various factors in their New York Fed blog posting.

¹⁶ The high 2014 rate of net new households per 100 households was driven by especially strong gains in September and October. The 2014 rate is more typical of rates prior to and including 1981 (which averaged 1.9) than with rates since 1981 (which averaged 1.1).

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