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 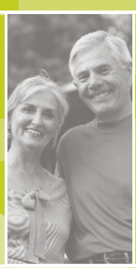 

THE STATE OF THE NATION'S HOUSING 2005

Joint Center for Housing Studies of Harvard University

Graduate School of Design
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National Low Income Housing Coalition
National Multi Housing Council

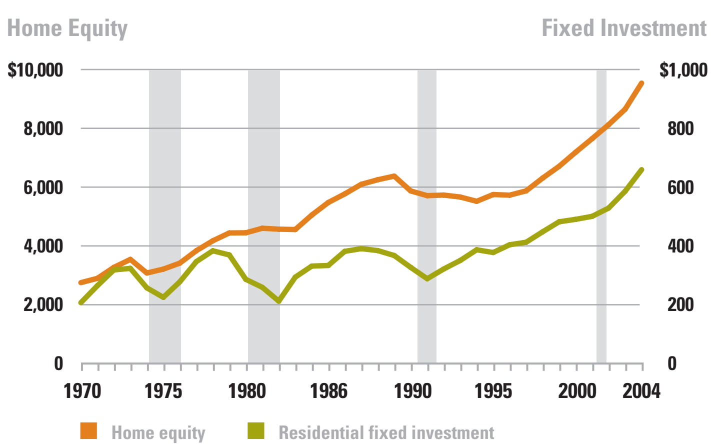
The State of the Nation's Housing: 2005 **is dedicated to the memory of Cushing Dolbeare, a former Fellow at the Joint Center for Housing Studies and a distinguished and tireless advocate for affordable housing.**

EXECUTIVE SUMMARY

House prices, residential investment, and home sales all set records again in 2004. But higher short-term interest rates and the strongest one-year price appreciation since 1979 made it more difficult for first-time buyers to break into the market. With low-wage jobs increasing and wages for those jobs stagnating, affordability problems will persist even as strong fundamentals lift the trajectory of residential investment.

Figure 1 Housing Investment Has Been On Its Longest and Strongest Run

Billions of 2004 Dollars



Note: Shaded areas indicate national recessions.
Sources: Federal Reserve Board, Flow of Funds Accounts, Table B.100; Bureau of Economic Analysis, National Income and Product Accounts, Table 5.3.5. Values adjusted for inflation using the CPI-UX for All Items.

In 2004, many households rushed to take advantage of still-attractive interest rates and buy in advance of potentially higher prices. As a result, homeownership posted an all-time high of 69 percent last year, with households of all ages, races, and ethnicities joining in the home-buying boom.

The rising tide of housing wealth gave consumer spending another boost. In combination with historically low mortgage interest rates, house price gains last year sparked near-record cash-out refinances and record home equity borrowing. Although refinancing volume dropped by half in real terms to $1.4 trillion, the amount of equity borrowers cashed out held fairly steady at $139 billion while net growth in second mortgage debt almost doubled to $178 billion. As cash-rich households stepped up their spending, housing wealth effects again accounted for a third of the growth in personal consumption last year.

RESILIENCE IN THE MARKETS

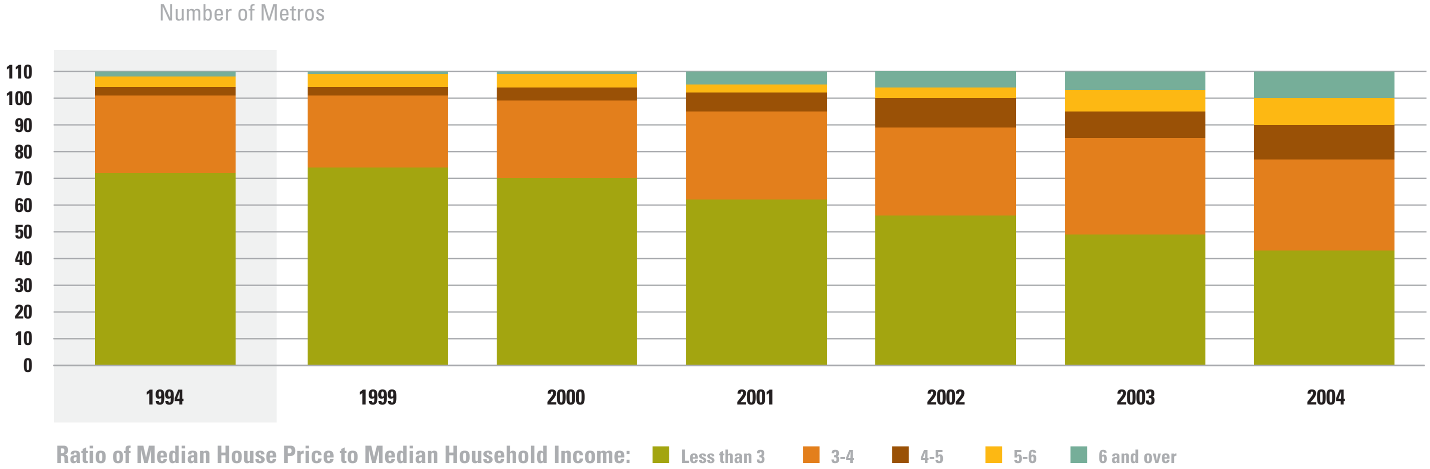
Aside from modest pullbacks in starts and sales, the current housing boom has lasted for 13 consecutive years (Fig. 1). By comparison, the next-longest expansion since 1970 with no significant drop in starts lasted just five years. In addition to record-setting endurance, this is also the first time in postwar history when the housing sector did not lead the economy into recession.

The unprecedented length and strength of the boom has, however, fanned fears that the rate of construction far exceeds long-run demand. Although averaging more than 1.9 million units annually since 2000, housing starts and manufactured home placements appear to be roughly in line with household demand. As evidence, the inventory of new homes for sale relative to the pace of home sales is near its lowest level ever. Given this small backlog, new home sales would have to retreat by more than a third—and stay there for a year or more—to create anywhere near a buyer's market.

Moreover, the US mortgage finance system is now well integrated into global capital markets and offers an ever-growing array of products. This gives borrowers more flexibility to shift to loans tied to lower adjustable rates in the event of an interest-rate rise. Although adjustable loans do increase the risk of payment shock

Figure 2

Since 1999, House Prices Have Catapulted Ahead of Incomes in Many Metros



Sources: National Association of Realtors median house prices indexed by the Freddie Mac Conventional Mortgage Home Price Index, and Economy.com Median Household Income.

at the end of the fixed-rate period, borrowers are increasingly choosing hybrid loans that allow them to lock in favorable rates for several years.

PERSISTENT HOUSE PRICE CONCERNS

With homes appreciating so rapidly over the last few years, there is concern that house price bubbles have formed in many markets. Clearly, ratios of house prices to median household incomes are up sharply and now stand at a 25-year high in more than half of evaluated metro areas.

Indeed, the number of metros where the median house price-to-income ratio is at least four has more than tripled from 10 to 33 in the past five years (Fig. 2). These high-priced markets—which include most of Southern California, New York City and surrounding areas, and the larger metros of Southern Florida—are home to about one-quarter of the nation's households. In these locations, buyers trying to enter into the housing market must struggle to keep up with escalating costs despite low prevailing interest rates. Outside of these 33 metros, however, house prices and household incomes are more in line. Fully 77 of 110 of the nation's largest metros have price-to-income ratios of less than four. As a result of lower interest rates, housing is still relatively affordable in these metropolitan areas.

Whether the hottest housing markets are now headed for a sharp correction is another question. The current economic recovery may give house prices in these locations the room to cool down rather than crash if higher interest rates slow the sizzling pace of house price appreciation. Moreover, in several metropolitan areas where house prices have appreciated the fastest, natural or regulatory-driven supply constraints may have resulted in permanently higher prices.

Still, the recent uptick in investor loans does give pause. Between 1998 and 2003, the share of home purchase loans made to other than owner-occupants climbed from 7 percent to 11 percent. While this likely signals that speculation has begun to creep into the single-family housing market, it also reflects strong growth in vacation home demand. The sudden and rapid growth in the use of interest-only loans also suggests that more buyers are hitting the wall on affordability.

For now, though, house prices should keep rising as long as job and income growth continue to offset the recent jump in short-term interest rates. House prices would come under greater pressure, however, if the economy stumbles and jobs are lost.

FAVORABLE LONG-RUN FUNDAMENTALS

Thanks to immigration, household growth is likely to accelerate over the next 10 years. With family reunification laws and the extraordinary appeal of the open US economy, the number of new arrivals could easily top the 1990s record of about 10 million. As a result, immigrants are expected to account for about one-third of net household growth in the decade ahead.

At the same time, the children of immigrants who arrived in the 1980s and 1990s are about to become a force of their own in housing markets. These second-generation Americans now account for 21 percent of children between the ages of 1 and 10, and 15 percent of those between the ages of 11 and 20. If history is any guide, members of this generation are likely to out-earn their parents and thus become an even greater source of housing demand in the next two decades.

Immigrants—particularly Hispanics and Asians—have also lifted the growth of minority households. As a result, between 1991 and 2003, the minority share of first-time home buyers increased from 22 percent to 35 percent, of new home buyers from 13 percent to 24 percent, and of home remodelers from 12 percent to 19 percent.

Although their homeownership rates still lag white rates by about 25 percentage points, minorities are clearly making economic progress. Between 1980 and 2000, over 6.2 million minority households joined the ranks of middle-income earners—a number nearly equal to that of whites. In fact, households of all ages, both white and minority have benefited from the strong income and wealth gains of the past 15 years, which in turn are strengthening housing demand across the board (Fig. 3). As each successive generation spends more on housing and remodeling than the one preceding it, residential fixed investment will set new records in the decade ahead.

DECENTRALIZATION PRESSURES

Demand for new homes is on track to total as many as 20 million units between now and 2015. The vast majority of these homes will be built in lower-density areas where cheaper land is in greater supply. Indeed, with each passing decade, metro areas are sprawling more and more into what were once non-metro communities.

People and jobs have been moving away from central business districts (CBDs) for more than a century. The number of the country's largest metros with more than half of their households living at least 10 miles from the CBD has more than tripled from 13 in 1970 to 46 in 2000. The number of metros with more than a fifth of households living at least 20 miles out has likewise jumped from 17 to 44. And in six metros, more than a fifth of households live at least 30 miles out.

As sprawl continues, commute times of an hour or more are increasingly common. In fact, the number of workers with such long travel times increased by 3.1 million in the 1990s. Lengthening commutes and worsening congestion are keeping demand for newer units in and near city centers robust, adding to the premium households must pay to live closer to employment centers. Without looser restrictions on higher-density construction closer to city centers, though, the lion's share of new development will occur in cheaper, outlying areas.

HOUSING AFFORDABILITY CHALLENGES

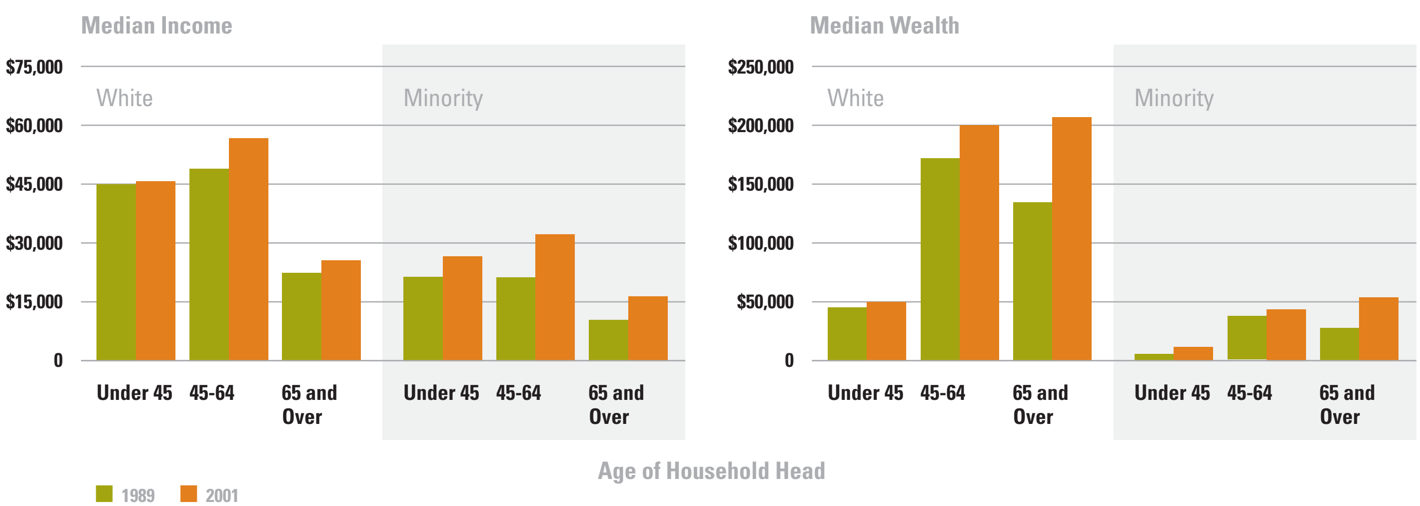
Despite only modest increases in rents in recent years, growing shares of and low- and moderate-wage workers, as well as seniors with fixed incomes, can no longer afford to rent even a modest two-bedroom apartment anywhere in the country (Fig. 4). Today, nearly one in three American households spends more than 30 percent of income on housing, and more than one in eight spend upwards of 50 percent.

Even these sobering statistics understate the true magnitude of the affordability problem because they do not capture the tradeoffs people make to hold down their housing costs. For example, these figures miss the 2.5 million households that live in crowded or structurally inadequate housing units. They also exclude the growing number of households that move to distant locations where they can afford to pay for housing, but must spend more for transportation to work.

Among households in the lowest expenditure quartile, those living in affordable housing spend an average of $100 more on transportation per month than those who are severely housing cost-burdened. With total average monthly outlays of only

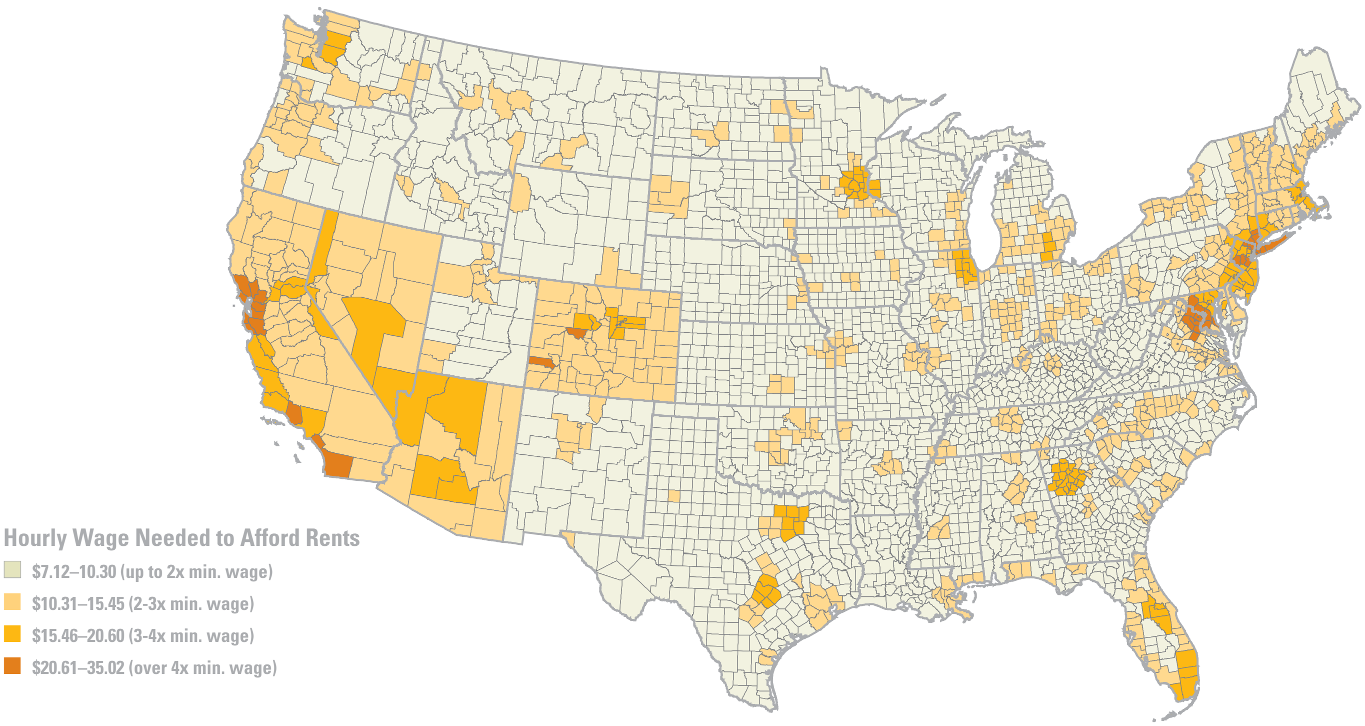
Figure 3 Income and Wealth Gains Are Broad-Based

2001 Dollars



Source: JCHS tabulations of the 1989 and 2001 Surveys of Consumer Finances.

Figure 4 Even Modest Rental Housing Is Beyond the Means of Many Low- and Moderate-Wage Workers



Notes: Federal minimum wage in 2004 was $5.15 per hour. Hourly wage needed to afford the Fair Market Rent on a modest 2-bedroom unit assumes paying 30% of income on housing and working 40 hours a week for 52 weeks a year.
Sources: HUD's Fair Market Rents for 2004, based on methodology developed by the National Low Income Housing Coalition.

$1,000, these extra travel costs amount to 10 percent of the entire household budget.

Meanwhile, the nation's affordable rental stock is rapidly shrinking. Additions are occurring only at the upper end of the rent spectrum while heavy losses continue at the lower end. As a result, increasing numbers of lower-income renters are spending more than half of their incomes on housing at the sacrifice of other basic needs.

Expanded access to credit has permitted more low-income households to buy homes in recent years. But many have made the leap with little in savings to cover mortgage payments in the event of a financial setback. Furthermore, many of these recent home buyers have blemished credit records that add to their financing costs.

HOUSING POLICY AT A CROSSROADS

Today, 28 million households in the bottom half of the income distribution spend more than 30 percent of their income on housing. Clearly, the combined response of federal, state, and local governments must expand significantly to make material progress toward easing the country's housing affordability problems. Two bipartisan platforms—one chartered by Congress and the other drawn up by two former Secretaries of the Department of Housing and Urban Development—suggest that consensus on many issues is emerging. But the federal government remains under fiscal pressure to cut rather than expand housing assistance programs. In response, state and local governments have stepped up their funding for housing, although most have done little to relax the regulations that make affordable housing so difficult to build.

Still, political pressure to address housing affordability concerns may be building as more voters begin to feel the effects. From 2000 to 2003, the number of middle-income households with severe housing cost burdens shot up by nearly one million. And in some high-cost markets, local chambers of commerce are already making affordable workforce housing a high-priority issue as more businesses struggle to attract and retain employees.

Meanwhile, worsening congestion, longer commutes, and higher infrastructure costs will no doubt add fuel to the smart growth debate. With sprawl encroaching farther into undeveloped areas, the public calls to allow higher-density residential construction near city centers will become louder even as the opposition to new development remains firmly entrenched.