



# HOUSING MARKETS

Defying expectations, housing markets delivered another record performance in 2004. New and existing home sales, single-family starts, residential fixed investment, remodeling expenditures, home equity, and total mortgage debt all hit new highs. Even in the weak spots, the trends were positive—rents turned the corner in a growing number of markets, and manufactured housing stabilized after a dismal four-year slide.

With house price appreciation at its strongest since 1979, the amount of equity that homeowners cashed out in 2004 nearly rivaled the record level set in 2003 despite a sharp retreat in refinancing. For the fourth consecutive year, the wealth effects from rising home prices generated about a third of the growth in consumer spending. Add to that the contribution of residential construction and fees earned on home sales, and it is clear that housing continues to be an important mainstay of the current economic recovery.

## ANOTHER BANNER YEAR

Housing markets have been remarkably resilient for some 13 years. With only a couple of modest dips, national housing production and sales have continued to climb despite a global credit crunch, a terrorist attack, a recession, and the slowest labor market turnaround in postwar history.

Traditionally one of the sectors that drives the economy into recession, housing instead helped to temper the 2001 downturn and is now playing a major role in the recovery. Unquestionably, the drop in mortgage interest rates to 46-year lows is a key factor in housing's strength. But so, too, is the greater integration of the US housing finance system into global capital markets, as well as the technological advances that have brought down financing costs and encouraged greater product innovation. On the supply side, tighter land use restrictions and longer lags in the permitting process have also helped to prevent overbuilding in some markets.

With such strong underpinnings, the housing boom remained remarkably broad-based in 2004 (Fig. 5). Existing home sales were up in every state except Michigan, Montana and Utah. While permits fell year-over-year in six states, the drop exceeded 1,000 units in just two. Of these states, only Indiana was in a second year of decline.

Single-family starts hit a record 1.6 million units in 2004, while multifamily starts remained within the same 330,000–350,000 unit range of the past eight years (Table A-1). With demand rising and prices soaring, condominium starts increased last year to 121,000—up from only 71,000 the year before. Starts of mul-

**Figure 5** Most Housing Market Indicators Again Set Records

	2003	2004	Change (%)
Homeownership Rate (%)	68.3	69.0	+1.0
New Single-Family Home Sales (Mil.)	1.1	1.2	+10.8
Existing Single-Family Home Sales (Mil.)	6.1	6.8	+11.2
Median New Single-Family Home Price	\$210,896	\$221,000	+4.8
Median Existing Single-Family Home Price	\$170,895	\$184,100	+7.7
Home Equity (Tril.)	\$8.7	\$9.6	+10.2
Mortgage Debt (Tril.)	\$6.5	\$7.2	+9.9
Mortgage Refinancing (Tril.)	\$2.8	\$1.4	-51.3
Residential Fixed Investment (Bil.)	\$587.5	\$662.3	+12.7
Home Improvements and Repairs (Bil.)	\$181.6	\$198.6	+9.3

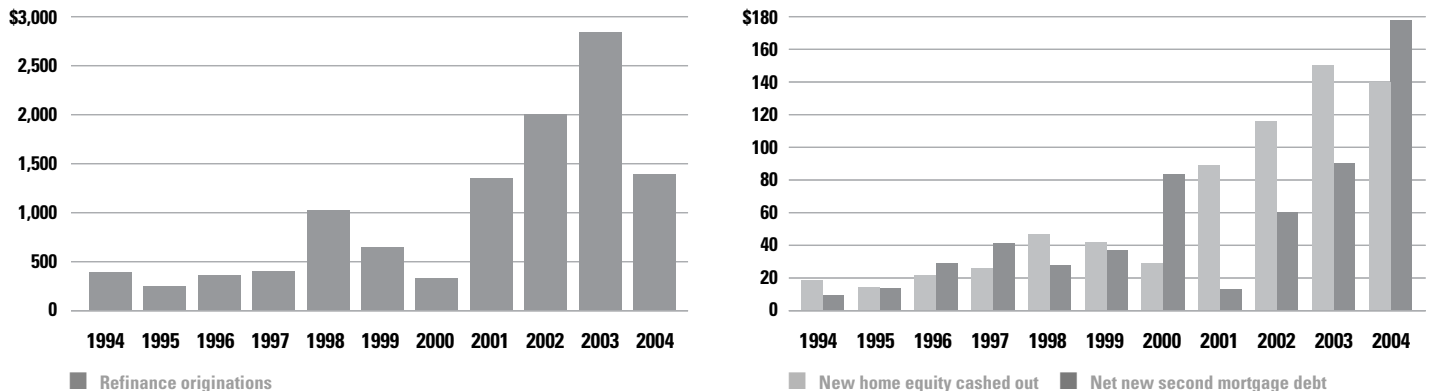
Notes: All dollar figures are in 2004 dollars, adjusted by the CPI-UX for All Items. Percent change was calculated using unrounded numbers.

Sources: Census Bureau; Tables A-1, A-4, A-8; Freddie Mac; Federal Reserve; Bureau of Economic Analysis.

Figure 6

## While Refinance Volumes Plummeted in 2004, Cash-out Refinances Held Firm and Second Mortgage Borrowing Surged

Billions of 2004 Dollars



Notes: Net new second mortgage borrowing is the change in second mortgage debt outstanding at the end of the year. New home equity cashed out is net of amounts used to pay off second mortgages.  
Sources: Table A-4 and Federal Reserve, Flow of Funds Accounts, Table L.218. Values indexed by the CPI-UX for All Items.

tifamily rentals, in contrast, dipped to a 10-year low as builders pulled back on production in the face of sliding rents and rising vacancies in many markets. The fall-off in multifamily construction might have been even worse if not for the record prices investors were willing to pay for rental properties.

### THE RISING TIDE OF HOUSING WEALTH

With double-digit real house price appreciation in 53 out of 163 of the country's largest metros and four of nine census divisions, aggregate home equity climbed 10 percent to \$9.6 trillion in 2004. Although refinance originations fell by nearly half in real terms to \$1.4 trillion, homeowners that did refinance cashed out \$139 billion in equity (Fig. 6). In addition to pumping huge sums of cash back into the economy, rolling debt over to lower interest-rate loans also saved homeowners \$1.7 billion in annual mortgage payments.

The cashed-out amount remained so high because borrowers extracted a record 13 percent of their refinanced debt—exceeding even the 11.5 percent share posted when the refinancing boom began in 2000, according to Freddie Mac. This time around, households were quicker to refinance (median of 2 years vs. 4.3 years) and so experienced much less appreciation (median of 9 percent vs. 24 percent).

In addition, less of the proceeds from last year's refinances went to pay off second mortgages. From a record high of \$77 billion in 2003, the amount of second mortgage debt rolled into refinanced first mortgages fell to \$42 billion in 2004. At the same time, though, many owners chose to take out home equity loans or lines of credit, boosting the total amount of second mortgages outstanding by \$178.2 billion.

### ESCALATING HOUSE PRICES

Speculation that housing price bubbles are forming has dominated the residential real estate news since at least 2000. Fueling this concern is the fact that over the past five years, house price appreciation has outpaced per capita income gains by more than 4 times in 31 metros, 3–4 times in 19 metros, and 2–3 times in 32 metros.

From this short-term perspective, house prices and incomes do appear way out of line in many locations. But from a longer-term perspective, the picture changes considerably. Over the past 20 years, house price inflation in 90 metros—which together account for about 44 percent of households in all 153 studied areas—has not exceeded income growth by more than 30 percent. Still, even over this longer time frame, house prices have increased at least twice as fast as incomes in 25 metros and 30 to 99 percent faster in 38 others.

Natural and regulatory constraints on development have likely contributed to house price gains in areas that have seen the most outsized increases in the past five years. Development constraints drive up land and construction costs as well as prevent new housing from keeping pace with rising demand. With inventories of homes for sale especially lean in these areas, buyers competing for the limited number of homes are bidding up prices.

According to a recent Joint Center for Housing Studies report, metro areas with stringent development regulations generate less employment growth than expected given their industrial bases. While wages in these locations rise somewhat more than in less regulated environments, house prices increase much more sharply (Fig. 7). To help keep prices from spiraling higher, jurisdic-

tions in these metros could relax regulations in order to free up more land for residential development, increase residential densities, reduce stiff impact fees on new construction, and speed up the entitlement and permitting processes.

With prices in many areas increasing so rapidly, more investors are entering the market in hopes of making quick capital gains. Perhaps the most solid evidence that such speculative buying is on the rise comes from Freddie Mac data on loans it originated in 1998 and 2003. According to this source, the share of homes flipped within a single year edged up from 5 percent in 1998 to 6 percent in 2003, while the share flipped between one and two years rose from 11 percent to 14 percent.

These levels of speculative buying are probably too low to be the principal cause of escalating prices. Even in some rapidly appreciating housing markets like Boston, Los Angeles, New York, San Diego, San Francisco, and San Jose, the share of loans made to investors other than owner-occupants remains below the national average. According to Home Mortgage Disclosure Act data, the market share for such loans—which also include investments in rentals and vacation homes—was only 8-10 percent in these metros in 2003, compared with 11 percent nationwide.

Even though the cost of owning now exceeds the cost of renting a comparable home by 30 percent nationally (and by much more in certain areas), homeownership continues to set new records. While renting is clearly a bargain in many places, households make housing choices based less on today's rents and prices than on their expected direction. The continued growth in homeownership indicates that most people still believe that rents and house prices will increase enough over time to justify buying. This expectation, and not classic speculative behavior, largely accounts for the increase in the house price/income growth mismatch.

### SPRAWLING METROS, LONGER COMMUTES

Most new residential development is concentrated at the metropolitan fringe. In fact, the number of the largest metros where more than half of households live 10 or more miles from the central business district (CBD) has tripled since 1970. The number of metros with more than a fifth of their households living 20 or more miles from the urban center has also increased dramatically (Fig. 8). Among the metros added to this group in the 1990s are Austin, Kansas City, New Orleans, Norfolk and Sacramento.

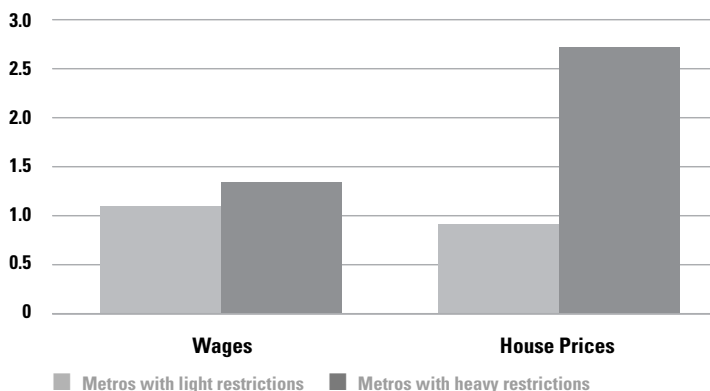
Several metropolitan regions extend even farther. For example, a third of Boston households and nearly one-quarter of San Francisco households live at least 30 miles from the CBD. About 1 in 5 Boston households live 40 miles or more out, as do about 1 in 10 households in the Las Vegas, New York, Portland, San Francisco, and Washington, DC metropolitan regions.

The outward push of development, coupled with Americans' strong preference to drive to work, has led to much longer commute times. Between 1990 and 2000, the number of workers in the 49 largest metros commuting an hour or more increased by an astounding 2 million. In the rest of the nation, the number of workers facing at least an hour-long commute increased by an additional 1.1 million over the decade.

In share terms, workers with hour-long commutes expanded from 6.4 percent to 11.8 percent in Atlanta, from 5.9 percent to 11.8 percent in San Francisco, and from 4.3 percent to 9.1 percent in Seattle. In other fast-growing areas such as Charlotte, Miami, and Raleigh, the share of workers with commutes of 45 minutes or more also jumped by at least five percentage points. While some of these long commutes are between homes at

**Figure 7** Land Use Restrictions Drive Up Metro Area Wages and House Prices

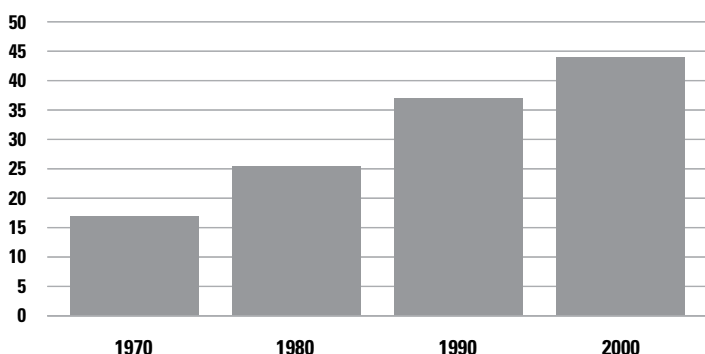
Estimated Percent Change Following a 1% Increase in Labor Demand



Notes: Metros with light restrictions rank in the bottom third of regulatory restrictions. Metros with heavy restrictions rank in the top third.  
Source: R. Saks, "Job Creation and Housing Construction: Constraints on Employment Growth in Metropolitan Areas," JCHS Working Paper W04-10, December 2004.

**Figure 8** Metro Area Households Are Living Greater Distances from Central Cities

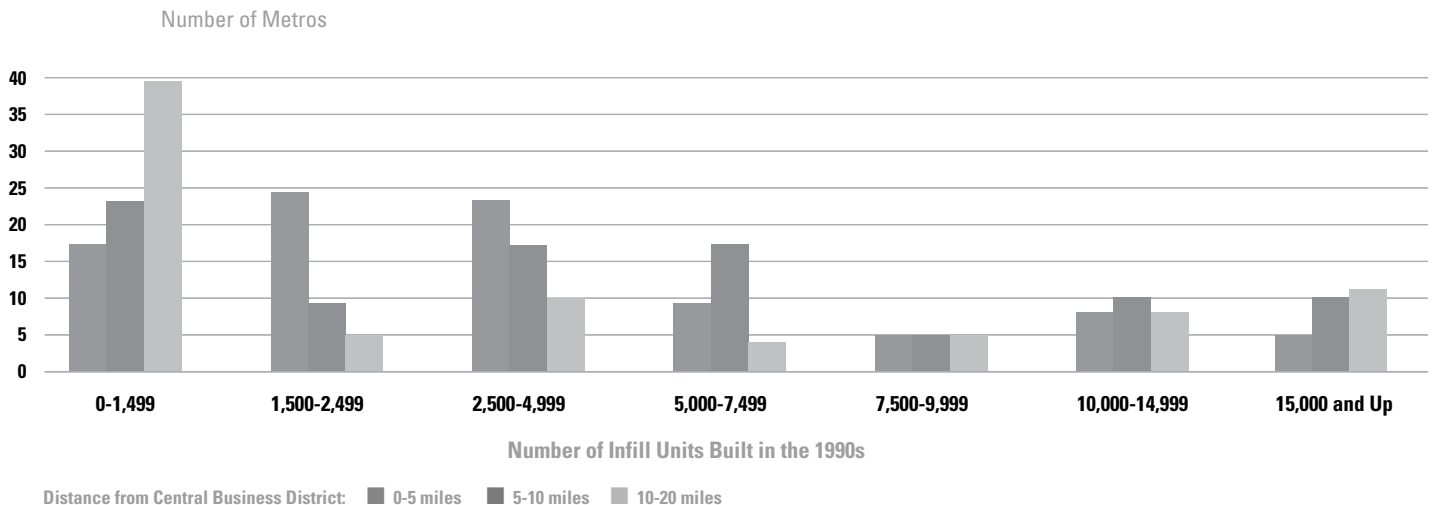
Number of Metros Where at Least 1 in 5 Households Live 20+ Miles from the CBD



Note: For metro region definitions, see Table W-10 at [www.jchs.harvard.edu](http://www.jchs.harvard.edu).  
Source: JCHS tabulations of Decennial Census tract-level data.

Figure 9

Despite Sprawl, Infill Construction Has Been Robust in Many Areas



Notes: Infill construction defined as construction in tracts with densities of at least 2,500 persons per square mile as of 1980. Only 82 of the 91 metro regions have tracts that are 10-20 miles from the CBD with at least the required density. For details on metro definitions, see Table W-11 at [www.jchs.harvard.edu](http://www.jchs.harvard.edu). Source: JCHS tabulations of the 2000 Decennial Census tract-level data.

the metropolitan fringe and jobs in the central city, many others are between homes and jobs located in distant or congested suburban areas.

Meanwhile, the number of workers commuting by car increased from 81 million in 1980 to 113 million in 2000. Despite growing congestion, the share that carpool fell from 20 percent to 12 percent during this period. And while the number taking public transit remained near 6 million, the share declined from 6.2 percent to 4.9 percent. More than half of those who do use public transportation are clustered in just three metro areas—Chicago, New York, and Washington, DC.

Some smart growth advocates propose special incentives to create “transit-oriented development” near public transportation as a way to relieve traffic congestion. Some lenders have also introduced “location-efficient” mortgages to allow people to buy more expensive houses in places with easy access to public transit because these buyers save so much on transportation costs. So far, though, most Americans cling to their far-flung suburban lifestyles and the cars that make them possible.

**CHANGING CITY FORTUNES AND URBAN INFILL**

Although the suburbs still attract most households, some cities are making comebacks. Fully 36 of the nation’s 84 largest cities that lost population in the 1970s saw a turnaround in the 1980s and 1990s. These include not only the exemplars of urban renaissance, such as New York, Portland, Providence and San Francisco, but also cities like Fort Worth, Indianapolis, and Tampa. Another nine cities also began to regain population in the 1990s, including Atlanta, Chicago, Denver, and Minneapolis.

But even as many cities added residents, the pace of infill development slowed. In the high-flying 1980s, unusually favorable tax treatment resulted in a wave of multifamily rental construction in built-up urban areas. By the 1990s, though, tax-driven building had subsided.

As a result, only 9 of the 91 largest metropolitan regions saw an increase in the number of units built within the dense parts of the five-mile inner ring around their CBDs, and only 7 saw gains in the five-mile infill share of metro-wide new construction. Atlanta, Buffalo, Charleston, Houston, Knoxville, and Seattle were the only places with both numerical and share gains.

Even so, inner ring infill construction in the 91 largest metro regions during the 1990s totaled nearly 500,000 units. Indeed, production in the dense parts of the inner ring topped 15,000 units in 5 metros and 10,000 units in 13 (Fig. 9). Given the concentration of older housing near city centers, though, significant amounts of infill development simply replace units rather than add to the stock.

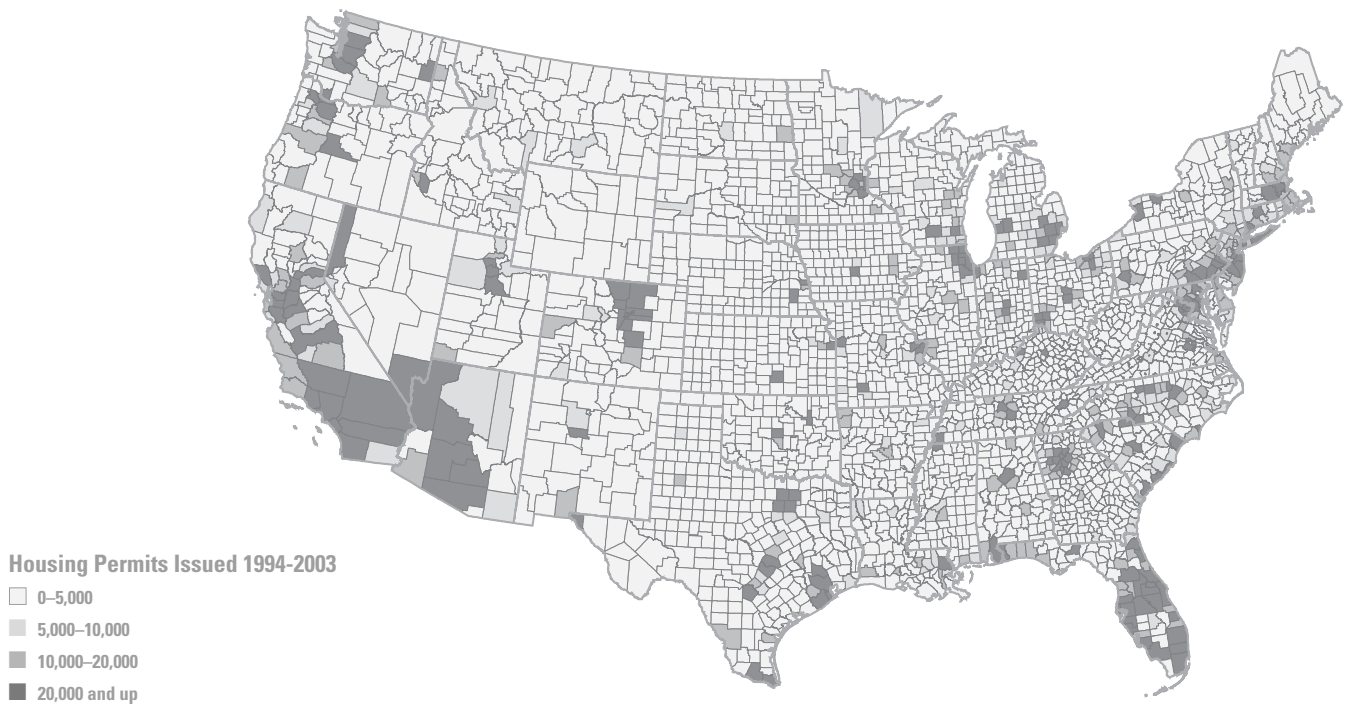
Residential construction was also strong between 5 and 20 miles from the CBD in many of the larger metros. Over the 1990s, infill development at these distances added about 137,000 new housing units in Los Angeles, about 119,000 in New York, about 47,000 in Chicago, and about 40,000 in Washington, DC.

**TOP CONSTRUCTION MARKETS**

With the heady pace of residential construction and the record-setting housing expansion, nearly 18 million homes were added to the nation’s housing stock over the last ten years. This growth

Figure 10

The Strongest Construction Activity Is Concentrated in Relatively Few Locations



Sources: Census Bureau, Construction Statistics, Building Permits by County.

ARIZONA'S MARICOPA COUNTY TOPS THE LIST OF THE FASTEST-GROWING COUNTIES WITH 417,000 PERMITS ISSUED SINCE 1994.

is, however, unevenly distributed across the country (Fig. 10). Not surprisingly, the states where the share of residential permits most exceeds the share of households are in the South and West. The West has been gaining share of households since the Gold Rush of 1849, ultimately surpassing the Northeast's share in the 1990s. The South finally rose again in the 1990s, returning to its pre-Civil War share of households.

The South and West now have well-developed and well-educated labor markets, and are beginning to benefit from agglomeration economies. Along with newer infrastructure, these areas also provide a favorable climate for business in terms of taxes, regulations, and labor costs. All these attractions should keep population and employment growth in these regions going strong.

Nonetheless, construction has also been intense in some of the larger consolidated metro areas of the Northeast and Midwest.

Indeed, several of the top 20 construction markets over the last 10 years are in these regions. New York takes second place with 480,000 permits, Chicago seventh place with 420,000, and Detroit twelfth place with 250,000.

THE OUTLOOK

A favorable interest-rate environment and an expanding economy bode well for housing markets in 2005. Some slowing in house price appreciation in the most overheated markets is likely, although less so if interest rates stay low and job growth is steady. A sharp increase in interest rates or declines in real income would, however, put stronger pressure on house prices. Meanwhile, new construction is running broadly in line with demand, and rental vacancy rates are starting to improve.

Looking further ahead, household growth and replacement demand will support the construction of as many as 20 million new homes over the next ten years. Lower land costs will continue to push the lion's share of residential development to outlying locations, adding more workers to the ranks of long-distance commuters. As traffic congestion increases, the value of land near business centers will rise—perhaps reinvigorating growth in central cities and the inner suburbs even as development at the metro fringe intensifies. ■