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# Building Permit

This recession has a number of peculiar characteristics. First its severity, then the slowness of recovery. While the recovery is broad based with improvement in employment, personal income, corporate profit, factory activity and most other gauges of economic activity, one area is noticeably absent—housing. During prior recessions residential construction spending was a leader in the recovery. In the past the first two years of recovery saw an average rise in this spending of 30%. This time the first two years actually have seen a fall in residential investment. During the boom years of 2003 to 2006 there were over a million new homes built annually. In the more ordinary years of the 1990s the average was around 700 thousand. Now the number is not quite one-half million and even that is an improvement over the last several years. The story is the same if we include all new housing units, meaning apartments and condos as well as single family residences. The total of new units is now about 1 million, in boom times it was around 2 million.

Residential construction brings a number of economic benefits. First are those expenses directly related to construction like labor, materials, and architects. These costs translate into income for construction workers, truck drivers, architects and building supply merchants. Then there are expenses related to home acquisition. Regardless of whether the home is new or already

existing there are financing costs, broker commissions, furnishings, appliances and moving. Purchasers of existing homes often contract for additional construction work. These additional costs are called a multiplier effect. Purchase of one thing, in this case a house, requires other expenses. Estimates are that home purchase has a multiplier of 1.3 to 1.6. In other words a dollar spent for home purchase implies an additional 30 to 60 cents of related expense. A $500,000 house creates an extra $150-300,000 of economic activity.

Then there is the wealth effect. When the value of our home goes up we feel more expansive and are willing to spend more on other things. One of the leading real estate economists estimates that 3 to 5% of a rise in home value translates into additional consumer spending. If the price of a $500,000

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home goes up 10%, as it did in 2013, we can expect $1500 to $2500 more personal consumption. If the value goes up 15%, as it did in both 2004 and 2005, that should mean as much as $3,750 of new consumption.

There are two significant barriers keeping the housing industry from returning to normal. The first is household formation. Household formation occurs with the settling in of immigrant families or, more often, when young people leave home and begin to live independently. Statistics bear out the now stock theme of kids leaving home to go to college then returning, unemployed, because they have no other place to go. Although unemployment is at 5.8% of the labor force in general it is over 10% for those aged 18-29; and that makes no allowance for the quality of jobs young people hold. One half of employed new college graduates have jobs that don't require their education. 31% of 18-34 year olds live with their parents. In 2012 45% of 18-30 year olds lived with some older family member, not necessarily the parents. In 1980 the corresponding number was 35%. Added to the problem of unemployment and underemployment is that of student debt, which has tripled in the last decade.

These factors have led to a serious fall in the creation of new households. In the five years preceding 2006 households were formed at an average rate of 1.35 million per year, in 2006 it reached a peak of over 2 million. Since that time the rate has fallen to around 500 thousand. The share of purchasers who are first time home buyers is at its lowest level in three decades.

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The other significant problem is finance. Banks are afraid to lend to a whole population of people who in the past would have easily gotten home mortgages. Back in the boom years preceding the recession loan qualification standards were lowered to the point that they became really quite laughable. 'No-doc' loans, as the name implies, required no documentable proof that the borrower could repay. The applicant's mere assertion was enough. Without tax returns, credit checks or employment verification borrowers were getting into loans without even a down payment. Mortgages were often designed not just to absorb the borrower's maximum ability to pay but also to have payments which would automatically rise in the future. When these mortgages went predictably bad the credit crisis and ensuing recession resulted.

Banks played the role of intermediary in this process. They would certify the loan application, make the mortgage, then pass it along to one of the two big housing finance agencies, Fannie Mae and Freddie Mac, for re-imbursement. Since qualification standards were so loose they were easily abused and in the aftermath of the crash it was easy to make accusations of fraud. As a consequence banks have paid fines in the tens of billions of dollars for certifying misrepresented applications. The process is called 'put back' and the bank is essentially on the hook for the entire value of a loan obtained on the basis of faulty evidence.

Predictably banks have become reluctant to make mortgages. During the boom years over $700 billion worth of home loans were made annually. Last year the rate fell to under $250 billion. The current average credit score for a new mortgage borrower is 755, on a scale of 850. Ten years ago it was 715.

The key lies in clarifying lending standards. Banks must know what they need to do in order to avoid having a loan put back to them. Fortunately the Obama administration has begun to move

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in that direction with the appointment of a new director of the Federal Housing Finance Agency. His charge is specifically to shift the focus away from avoiding bad loans and toward promoting new ones. Late last year the Agency and banks came to an agreement. Essentially it says that if a lending institution just goes back to what used to be sound lending practice then there will be no problem. This means reviewing a tax return, getting a credit check, verifying employment and getting a legitimate appraisal. Low down payments will still be permitted, as long as there is mortgage insurance.

For the economy to return to full strength it is vital that the housing industry recover. The Housing Finance Agency's new initiative is an important first step. There is also a glimmer of hope in another area. Household formation appears to be growing. It usually takes a while after the fact to know for certain that a household has been formed but it does look like we have finally gone beyond the annual rate of a half million new formations. The latest indication is that this number is now closer to 800 thousand.

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