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FRB SF Weekly Letter

Record Housing Boom in the 1980s?

The National Association of Homebuilders recently reaffirmed its forecast of 1.56 million housing starts in 1983 and a 1.76 million level in 1984. In making the latter prediction, the Association noted that analysts and builders are starting to worry about interest rate levels and the sustainability of the recovery. The homebuilders earlier had predicted a record level of housing construction in the 1980s, based upon the children born in the 1950s and 1960s reaching the ages in which they will form households and add to the demand for housing, but they now believe this prediction is too optimistic. While recent news about the housing market has been encouraging to the housing industry, a more careful look at the underlying demographics suggests that reduced expectations are in order.

Recent and future activity

In 1982, the sales of new homes (at about 412,000 units) were at their lowest level since the 1960s and housing starts (1.1 million units) were at their lowest level since 1946. The situation, however, has changed thus far in 1983. Through May, housing starts were running about 50 percent above the depressed 1982 level, and home sales followed not much farther behind. The renewed housing activity was aided by a substantial increase in the availability of construction and mortgage financing and a significant decline in the cost of that financing.

Whether the recent activity portends a record housing boom in the 1980s is a different question. To a considerable extent, such predictions have been based upon Census Bureau projections of household formations (Series B), which are themselves based upon extrapolations of the trends in marital and household status that occurred between 1964 and 1978.

The projections indicate about 15.9 million new households will be formed in the decade of the 1980s compared with 17.2 million in the 1970s. The latter provided the support for 18 million housing starts in the 1970s. The critical question for the 1980s is whether the demographics will continue to be as favorable to housing. An inspection of projected changes in the population and household formation of people in the homebuying age groups in the 1980s suggests that the number of housing starts in this decade will not surpass the record number of the 1970s.

Dubious demographics

The homebuying age groups generally are considered to be the population in the 20-24, 25-34, and 35-44 age brackets. The 25-34 group is thought to be the principal one, representing the bulk of first-time homebuyers. The 35-44 year old group contains many established homeowners whose demand for new housing represents a desire to upgrade existing shelter. In both cases, the actual demand for housing (including rentals) is determined by the number of households formed in each group, rather than the number of individuals in the groups, as several individuals may share one housing unit.

One way in which we can judge whether assumptions about household formation are reasonable is to compare the projected increase in households to the projected increase in population in the homebuying (and renting) age groups. A high ratio of increase in households to increase in population implies a high rate of household formation.

We know that the record number of housing starts in the 1970s was due primarily to the rapid rate of household formation in that decade. The number of households formed (17 million) between 1970 and 1980 equalled 63 percent of the 27 million population increase in the 20-and-over age

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groups. Current Census projections for the decade of the 1980s assume an even higher rate of household formation. They predict an increase of 23.7 million people 20-and-over in age (3.3 million less than in the 1970s), but household formations of about 16 million or about 66 percent of that population increase.

The projections assume an especially high rate of household formation for principal homebuyers. Chart 1 (Census "middle series" projections) shows that the population of the 20-24 age group is expected to decline by 3 million and that the population of the 25-34 age group is expected to increase by 6 million. Together, the two groups will experience a net increase of 3 million, but the number of new households formed by these two age groups is projected at 4.6 million (Chart 2). New households are thus projected to equal 153 percent of the population increase in those two age groups; the corresponding percentage in the 1970s was only 51 percent.

For the group 35-44 years old, the Census predicts a population increase of 12.2 million and household formations of 6.4 million or 52 percent of the population increase. The corresponding figures for the 1970s were a 2.5 million population increase and an almost matching household increase of 2.4 million.

Income and price constraints

There are several reasons for believing that the rate of household formation will be lower than the current Census estimate for the 1980s. (In fact, the Census will be revising its projections in the months ahead to take account of developments since 1978.) In the 1970s, the rapid increase in household formations (in comparison to net population changes) reflected a number of social and economic factors that may not be present or may not operate to the same degree in this decade.

One such factor is the vastly increased disparity between the costs of owning a home (house prices, financing costs, and maintenance costs) and household incomes. Since 1980, and in spite of the recession, average new home prices have increased by an additional 15 percent to $87,900 in 1983's first quarter. The increases about match the gain in average household income, but the costs of maintenance (due partly to soaring heating costs) have increased about 20 percent.

Moreover, the gains in *average* household income apparently have not been shared by potential householders in the crucial under-34 age group, which nonetheless has been projected to account for about 30 percent of all new household formations during the 1980s. Even assuming that one can find an "average" new home for $87,900 somewhere in the U.S., monthly mortgage payments at today's average lending rate of about 13 percent approximate 38 percent of average household income. This percentage is almost double that in the early 1980s when mortgage rates averaged 8 percent and new single family home prices, $30,500 (1972). The prospective huge federal demands on the credit markets due to federal deficits also raise doubts as to whether mortgage rates will fall significantly in the near future.

Of course, housing prices are not determined independently. If the "affordability constraint" becomes too binding, housing prices will fall (or increase less slowly) to reflect the reduced effective demand. Along the way, however, they will discourage high rates of household formation.

A second factor holding down household formation in the 1980s also involves the net cost of homebuying. It is widely believed that a significant part of the increased demand for housing in the 1970s was of a "speculative" nature. That is, households reacted to the environment of rapid inflation and preferential tax treatments for homeownership by buying homes for their expected capital gains. With lower inflation contributing to more stable house prices in

FRB SF Weekly Letter

the 1980s (although they still seem likely to increase faster than household incomes), prospective homebuyers presumably will have less incentive to buy houses for speculation and will be more likely to view them once again as a source of shelter.

A third factor is sociological. The number of households formed by other than married couples rose by 12 million (70 percent) in the 1970s and accounted for 76 percent of all household formations. A sharp rise in the number of single and divorced or separated women increased the demographic demand for housing, but it is unlikely that this phenomenon will be repeated in the 1980s. A similar phenomenon was the continued rise during the 1970s in the number of married women in the labor force; they augmented effective housing demand—adding upward pressure to home prices—by providing a second income to accommodate rapidly rising home prices. But, since female labor force participation rates are now very high by past standards, it is unlikely that this force will operate in the 1980s to the same extent it did in the 1970s.

Other factors

There are, of course, other elements in the housing equation that will help determine the rate of new construction. These include the rate of removal of existing structures from the housing stock and conversions. "Creative financing" techniques such as equity participations may serve to increase effective housing demand, while public policy in the area of housing subsidy programs may work in the opposite direction, since such programs as the multi-billion dollar Section 8 rental subsidy program will be phased out.

At the same time, a relatively high level of starts may be associated with demographic shifts to growth areas such as the South and West where vacancy rates are already low, but a mitigating circumstance is simply that no one, native born or in-migrant, has ever brought land with him. Home prices (and rentals) in growth areas such as California should therefore reflect this relative constraint and remain higher than the national average, thus discouraging some of that demand.

Conclusion

Forecasts of a record housing boom in the 1980s may be overly optimistic. They are based upon extrapolations of trends in household formation from the mid-1960s to the late 1970s that may not be as strong in the 1980s. Some of the heavy demands of the 1970s was a response to socioeconomic forces that are unlikely to be repeated, or at least are unlikely to operate to the same extent. Moreover, continued heavy demand for housing will to some extent tend to be self-limiting, as constraints on affordability and availability discourage household formation.

Verle B. Johnston

Chart 1
CHANGE IN POPULATION

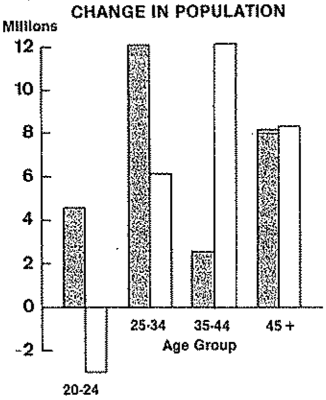
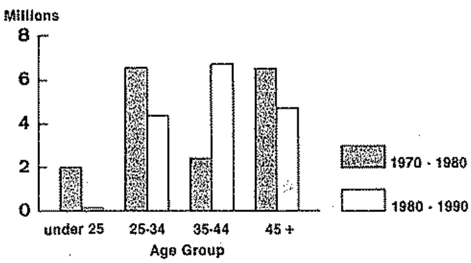


Chart 2
CHANGE IN HOUSEHOLD FORMATIONS



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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT
(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 6/8/83	Change from 6/1/83	Change from year ago Dollar	Percent
Loans (gross, adjusted) and investments*	163,116	76	2,587	1.6
Loans (gross, adjusted) — total#	141,453	− 31	1,798	1.3
Commercial and industrial	44,303	23	285	0.6
Real estate	56,161	− 46	− 1,128	− 2.0
Loans to individuals	23,679	21	354	1.5
Securities loans	2,919	278	734	33.6
U.S. Treasury securities*	8,215	133	1,716	26.4
Other securities*	13,448	− 27	− 927	− 6.4
Demand deposits — total#	41,107	−3,777	2,151	5.5
Demand deposits — adjusted	29,420	1,546	1,341	4.8
Savings deposits — total†	67,573	357	36,439	117.0
Time deposits — total#	64,387	247	− 31,034	− 32.5
Individuals, part. & corp.	58,100	185	− 27,416	− 32.1
(Large negotiable CD's)	18,222	− 42	− 17,280	− 48.7

Weekly Averages of Daily Figures	Week ended 6/8/83	Week ended 6/1/83	Comparable year-ago period
Member Bank Reserve Position			
Excess Reserves (+)/Deficiency (−)	147	104	95
Borrowings	72	110	199
Net free reserves (+)/Net borrowed(−)	75	− 6	− 104

* Excludes trading account securities.
\# Includes items not shown separately.
† Includes Money Market Deposit Accounts, Super-NOW accounts, and NOW accounts.

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