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To Build or Not to Build: 
Prospects for New Residential Construction in the Year 2000

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What is now the longest economic expansion in U.S. history has been a boon to home builders locally and nationally. Figure 1 shows the trend since 1980 in single-family home construction in the Grand Rapids MSA; builders are now producing about five times as many houses annually as in the depths of the especially severe recession of the early 1980s, and about 50% more than during the recession of the early 1990s. Not surprisingly, home builders, real estate brokers, lenders, and others involved in real estate are wondering whether we can expect yet another good year.

Their concern is understandable: the market for new homes is extremely sensitive to general economic trends. There have been nine cycles of general economic expansion and contraction in the last fifty or so years. Construction of new homes during expansions averages nationally about 2.5 times that during contractions. The swings up and down have tended to be even bigger locally due to the relatively high proportion of employment in durable goods manufacturing. Clearly, the producers of housing and of the services associated with producing and marketing new homes like to have a reasonable amount of warning of when and how conditions in the housing market are likely to change.

In this article I do two things: (1) I look at a variety of indicators to get a feel for how likely the housing market will turn within the next year or two; and (2) I look at how home builders might respond to a softening of the market should it occur.

Economic Indicators
As already mentioned, the market for new homes is highly procyclical. Indeed, the trend in permits for new construction of housing, which is tracked by the Bureau of the Census, is considered a leading indicator of changes in the economy. The trend in building permits tends to turn downward several months before the start of a recessionary period. The idea is that homebuilders need to be extremely sensitive to changes in their market, and they generally succeed in sniffing out a downturn.

There are a variety of other leading indicators, such as new orders for industrial plant and equipment, new unemployment claims, and surveys of consumer confidence. The Bureau of Economic Analysis (BEA) compiles an index of 10 of these leading indicators. The index historically has reliably turned downward prior to each of the recessionary periods since the second world war. As of January 2000, the index of leading indicators not only is rising but is also at an all-time high. A component of the index especially important to the housing industry, an index of consumer confidence, is also at an all-time high. The survey of local business leaders described in detail in Hari Singh's article also indicates confidence in the prospects for the local economy.

Demographic trends also tend to support the market for new homes. The population of the Grand Rapids area is expected to continue to grow, though at perhaps a slightly slower rate than it has over the past ten years. Baby boomers, people born roughly between 1945 and 1955, have had big effects on housing markets. In the late 1970s this group fueled a period of major construction of starter homes. Now reaching their peak earnings years, many of these households will likely want to move up to newer and better houses. At the same time, the baby boomers' children, sometimes referred as members of the baby boomerlet, are at the age of household formation and some will be interested in new starter homes. Given an otherwise strong or stable economy, these peaks in the population distribution are likely to spur demand for new houses for several years to come.

That said, there are some clouds on the horizon. Energy prices have recently crept up as the OPEC oil cartel has regained control of its members' production levels. Though many economists consider the economy to be more resistant to oil price shocks than it was in the 1970s, higher energy prices will put a bite into household disposable income. The second source of concern is higher interest rates induced by the Federal Reserve specifically to cool the construction industry. A cooler construction market tends to cool other markets and reduce the risk of generally rising prices caused by wage increases in tight labor markets.

In sum, the prospects for continued economic expansion appear to be good. Most likely continued economic growth and favorable demographic trends will lead to another year like the previous few. It's possible, however, that higher energy prices and higher interest rates will significantly affect the market for new houses. It's also possible, of course, that some event difficult to foresee will push us quickly into a deeper contraction; the historical record of business cycles reminds us that things can change unexpectedly.

Responses to a Softening Market
In this section I look at the ways the housing industry might respond to a softening of the market for new houses if energy prices and mortgage interest rates continue to climb. The concern here is not that the economy will go into recession, but that potential housing consumers will be affected by these sources of higher costs. Note that these cost increases may not occur. Given their possibility, however, it seems useful to ask what housing and service suppliers can do to minimize the impact on their business?

A primary line of defense is innovative financing. The 30-year fixed rate mortgage has long been the mainstay of housing finance. The long repayment period provides the advantage of relatively low monthly payments. Another advantage from the
The standpoint of the borrower is that the 30-year fixed rate loan places all of the risk—interest rate, prepayment, and default risk—onto the lender. This is reasonable in that institutional investors are well able to spread that risk. But these investors still require an interest rate premium to accept the risks; borrowers who are willing to accept part of the risk are rewarded with lower rates and lower payments. More borrowers who expect to see earnings increase over time, or who plan to move within a time period short relative to the 30-year term, are willing to take adjustable rate mortgages (ARMs) or other types of mortgage that shift some of the risk from the investor. Banks have reduced the cost of refinancing mortgages, which also increases the attraction of ARMs.

Another tack lenders have taken is to use advances in information-processing technology to better evaluate loan applications. Some borrowers who might not pass conventional rules of thumb to qualify for a mortgage might still be reasonably good risks. On the basis of more and better information, more banks are lending to households who might not have qualified a few years ago.

While creative financing increases consumer ability to pay for a new house, housing suppliers can also take steps to reduce the purchase price of the house. Part of this may come in the form of smaller margins. But the supplier can also scale back the house in ways that might reduce construction costs considerably while maintaining the attractiveness of the house. This might include marginal scale-backs in house size, in the quality of fixtures and trim work, or leaving part of the house unfinished for the time being. The trick here is to find those characteristics of the house that consumers value the least relative to the cost of construction. Building in a little price flexibility seems desirable in a softening market.

Finally, builders might reduce their risk through increasing up-front marketing to increase the proportion of the houses they build to order. Builders can either increase their own marketing efforts, or look to brokers to help market plans for a new house. Brokerage commissions play a role in the level of marketing the builder chooses, and in sales prices and volumes. Evolution in the relationships between builders and brokers, and in the ways that brokers can market houses built to order can also influence the market for new construction.

![Figure 1: Single Family Permits, GR MSA, 1980-1999](image)