Testimony

The Economic and Housing Markets Outlook

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Testimony to the U.S. Houses of Representatives, Committee on Financial Services

**The views expressed here are my own and do not represent the position of the American Action Forum. I thank Thomas Wade for his assistance.*

Chairwoman Waters, Ranking Member McHenry, and members of the Committee, thank you for the privilege of appearing today. In this short testimony, I want to make three key points:

- The dominant feature of the economic landscape is consumer price inflation. Housing has a central role in the emergence and control of that inflation.
- Owner-occupied and rental housing markets have displayed high and rising prices, despite a recent construction boom. This suggests that the primary underlying cause of stress is demand stimulus from federal subsidies, especially those from the housing government-sponsored enterprises (GSEs) Fannie Mae and Freddie Mac.
- Before looking to new initiatives, Congress would be better served by a more complete understanding of the current state of existing subsidies, both from existing Housing and Urban Development initiatives and COVID-19 grants, from which a significant amount of funding remains unspent.

Let me discuss each in turn.

Consumer Price Inflation and Housing

Inflation is at levels not seen in four decades. Despite some recent respites, year-over-year growth in the Consumer Price Index (CPI) was 7.7 percent in October. Stripping out the volatile food and energy categories yields "core" inflation at a 6.3 percent rate. More important to families is the reality that the essentials of food, energy, and shelter – which constitute roughly half of the CPI – are rising at a 9.5 percent rate over the past year.

For the purposes of this hearing, however, the striking fact is that shelter inflation – which by itself makes up one-third of the CPI – rose 6.9 percent between October 2021 and October 2022. Year-over-year shelter inflation was 1.5 percent in February 2021, has risen every month since, and shows no sign yet of reaching its peak.

Shelter inflation is the biggest inflation problem. Clearly, if one-third of the CPI is rising at a nearly 7 percent rate, it will not be possible for overall inflation to hit the target rate of 2 percent unless there is deflation in prices of all other categories of spending. As a matter of arithmetic, it will be necessary to cool shelter inflation.

This leads to three observations: (1) As noted above, the Federal Reserve (Fed) will have to take aim at housing inflation just as a matter of fighting inflation, (2) it will take aim at housing as a way of broadly slowing the

economy, and (3) the stated plan by the Fed cannot avoid affecting housing disproportionately.

Regarding the second point, notice that as residential construction declines, so does the demand for all sorts of goods and services associated with houses and apartments – durable goods such as furnaces, air conditioners, stoves, ovens, and the like; household items such as carpeting and rugs, curtains, furniture, and so forth; and services such as inspections, landscaping, and others. Housing has always been an important channel for the transmission of monetary policy and slowing the housing market reduces demand in a broad swath of the economy.

Finally, the Fed's plan cannot avoid affecting housing especially strongly. As the Fed raises the federal funds rate, all interest rates will rise. Credit cards and auto loans will go up, and so will mortgage interest rates. (Indeed, mortgage rates have already risen sharply.) But there is a second channel of impact. As part of its monetary stimulus, the Fed purchased $30 billion monthly in mortgage-backed securities (MBS), pumping $30 billion in capital into the mortgage market each month. As part of tightening financial conditions, this will no longer occur. That means to get the same total amount of funds into the mortgage market, rates will have to rise even further to attract the $30 billion in capital. But it doesn't end there. The Fed intends to draw down its holdings of MBS by $35 billion a month, essentially pulling $35 billion in capital out of the market. The upshot is that rates must rise even a bit more to completely offset the $65 billion (roughly 20 percent of mortgage funds at 2021 rates) net swing in mortgage funds.

To summarize: The Fed must slow housing demand to get housing inflation down and slow housing supply to get overall inflation down, and its plan will inevitably impact the housing sector harder than other parts of the economy. The unfortunate irony is that this is happening at a time when housing supply is at record lows.

The State of Housing Markets

House prices and rents rose rapidly in 2021. These price increases reflect some combination of the long-term, slow expansion in the supply of units and rapid expansion in the demand for units. Supply has been at the center of attention. The total inventory of homes available for sale fell 26 percent in January 2021 year-over-year. At its lowest point, the Federal Reserve Bank of St. Louis estimated that there remained only three and a half months of total housing inventory – in other words, there would be only three and a half months without construction until there would be no homes available in the United States. Nevertheless, in the main, U.S. price pressures seemingly reflect growth in demand. According to the Joint Center for Housing Studies: "Single-family starts hit 1.1 million in 2021, exceeding the million-unit mark for the first time in 13 years. Multifamily starts were also at a 30-year high of 470,000 units."

So, the main reason for high housing prices is demand. Unfortunately, there appears to be rising sentiment to create even more demand. As detailed in a recent *Politico* article: "The housing slump is the economy's biggest casualty so far from a series of Federal Reserve rate hikes designed to tame inflation….Groups representing builders, realtors and lenders are urging Congress and the White House to intervene to spur more home construction and boost affordability. It's an increasingly urgent plea, with mortgage demand down more than 40 percent from a year ago and rates topping 7 percent for the first time in two decades."

To make a dent in the supply of owner-occupied homes and apartments would require a *lot* of money – certainly north of $200 billion – and quickly. These advocates (correctly) point out that if one could snap one's fingers and create a substantial increase in the supply of houses and rental units, shelter inflation would come down. But such a program would be unwise.

As noted earlier, when the Fed raises rates, mortgage rates rise, the demand for mortgages and homes falls, and the construction of houses and apartments decreases. But importantly, the impacts do not stop there. When fewer units of all types are built, no furnaces are put in them, no refrigerators are installed, no carpeting is laid, no furniture is purchased, and generally demand is dented across the economy. That is one element of reducing inflation in the two-thirds of the CPI that is not shelter.

The housing advocates are essentially arguing to undo this or worse by boosting housing construction and stimulating demand across the economy. Even if shelter inflation went away magically, inflation elsewhere in the CPI must fall to 3 percent to hit the inflation target. The Fed will not be able to tolerate this large spillover demand stimulus. It will be forced to raise rates even higher to offset the housing program and reduce both shelter and non-shelter inflation.

The proposed strategy by housing advocates will accomplish nothing but slowing and making more painful the Fed's fight against inflation. Admittedly, none of this analysis is good news. But it is a reminder that once inflation is embedded in the economy, there are no good, easy choices. Either live with the inflation or accept the consequences of the steps needed to fight inflation.

Government Intervention in Housing Has Frequently Done More Harm Than Good

Housing finance was at the center of the 2008 financial crisis that visited substantial economic stress on Americans and spawned dramatic government intervention. Yet more than a decade later, the central actors in the crisis and response – Fannie Mae, Freddie Mac, and the Federal Housing Finance Administration (FHFA) – remain essentially unchanged.

Fannie Mae and Freddie Mac need to be wound down and closed as a matter of both policy and politics. From a policy perspective, the GSEs were central elements of the 2008 crisis. First, they were part of the securitization process that lowered mortgage credit quality standards. Second, as large financial institutions whose failures risked contagion, they were massive and multidimensional cases of the too-big-to-fail problem. Policymakers were unwilling to let them fail because financial institutions around the world bore significant counterparty risk to them through holdings of GSE debt, certain funding markets depended on the value of their debt, and ongoing mortgage market operation depended on their continued existence. They were by far the most expensive institutional failures to the taxpayer and are an ongoing cost.

Moreover, despite 14 years under the conservatorship of the FHFA, "each Enterprise remains undercapitalized." Nevertheless, the FHFA just moved to relax the capital requirements. Worse, the FHFA announced it would require Fannie and Freddie to put in place Equitable Housing Finance Plans that would deploy a number of "special purpose credit program" that would assist racial minorities and particularly African American borrowers with home buying costs such as title insurance, appraisals, and down payments. Typically, these costs are the responsibility of the homebuyer and in the case of down payments, some of the capital risk is taken by private mortgage insurance for borrowers who do not provide 20 percent down. This approach takes capital that is supposed to protect taxpayers to subsidize home purchases by borrowers who simply don't have the financial preparation to do so.

This strategy seems destined to repeat the errors of the past that yielded a wave of foreclosures that wiped out millions of homeowners, hurting many minority families that were beginning to accrue generational wealth. Congress should urge the FHFA to reconsider these housing subsidy plans. It risks setting up another generation of minority borrowers for failure.

These plans also suggest a return to GSE mission creep. Instead, the FHFA should finalize the rulemaking on Prior Approval of Enterprise Products, which was proposed in October 2020 and would ensure there is adequate oversight and transparency around new products and activities the GSEs bring to the market.

Efforts such as the Equitable Housing Finance Plans are simply demand subsidies by another name. They build upon the questionable track record of the housing trust fund, the HOME program, and Community Development Block Grants and will not serve to alleviate house price pressures. Instead, they will simply exacerbate the problem. Similarly, the Biden Administration's Housing Supply Action Plan contains as many demand subsidies as ideas to expand housing supply. These are steps in the wrong direction.

Multiple Avenues for Congressional Support Already Exist

The federal government already provides multiple avenues of support for the construction of affordable housing and assistance for low-income renters and homebuyers, including seniors. The most prominent of these is the Low-Income Housing Tax Credit (LIHTC). Unfortunately, a recent review by Desai, Dharmapala, and Singhal casts considerable doubt on the efficacy of this program. In addition, the federal government provides appropriated funding through more than 30 programs within the Department of Housing and Urban Development, tax credits and deductions for both corporations and individuals, housing programs for veterans through the Department of Veterans' Affairs, rural housing programs through the Department of Agriculture, and mortgage insurance programs through the Federal Housing Administration and government corporation Ginnie Mae.

The failures of this overly complex constellation of programs not performing as designed are clear. House price indices are at record highs, housing affordability indices are declining, and homeownership rates have barely changed since the 1970s. The housing market is under considerable stress, further impacted by the challenges of the recent pandemic. It is difficult, however, to point to stressed markets as a justification for further government intervention if the government itself is responsible for significant portions of that stress.

There is less evidence of market failure than there is of government failure.

Thank you and I look forward to your questions.