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ECONOMIC Synopses

The Housing Supply Puzzle: Part 1, Divergent Markets

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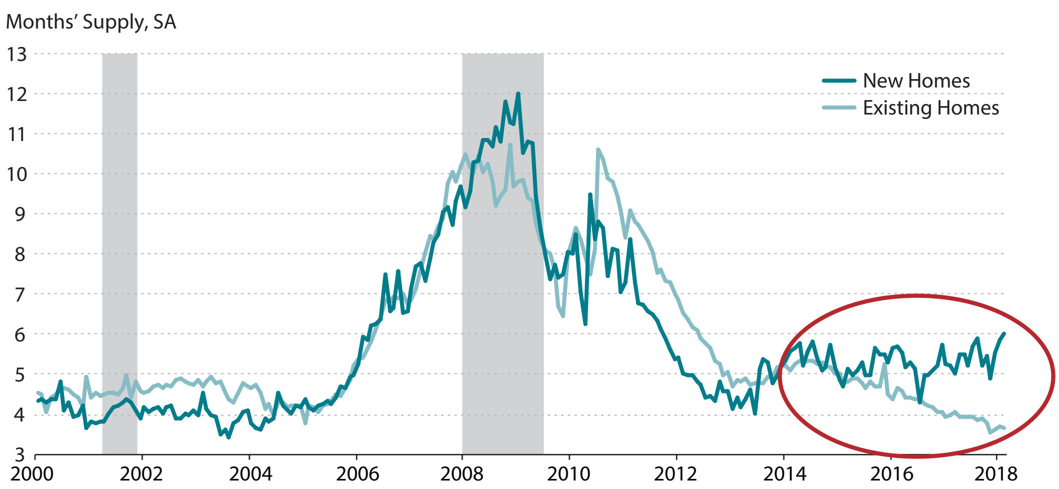
Over the past several months, the pace of U.S. home sales has shown few signs of growth, and as of February 2018, overall home sales were only slightly higher compared with year-ago levels. Analysts have pointed to a tight housing supply as the key constraint holding back the housing market. However, statistics on housing inventories indicate shortages only for *existing* homes, while the supply of *new* homes remains at a relatively healthy level. Existing and new home supplies typically move in sync, which poses an important question: What has changed to prompt this decoupling?

> Homebuyers looking for lower- and middle-tier housing have been increasingly priced out of the new-home market.

One statistic used to gauge the health of housing inventories is the ratio of homes for sale to homes sold in a given month. This ratio, known as "months' supply," represents how long the current inventory of homes would last given the current sales rate and if no additional inventory is added to the market. Historically, the months' supplies of new and existing homes have moved in tandem since new and existing homes tend to be close substitutes. However, Figure 1 shows that in 2015 the relative supplies of new and existing homes began moving in different directions: The supply of new homes remained relatively unchanged while the supply of existing homes fell to a historically low 3.6 months' worth of inventory. This divergence implies that new and existing homes have possibly become weaker substitutes for one another.

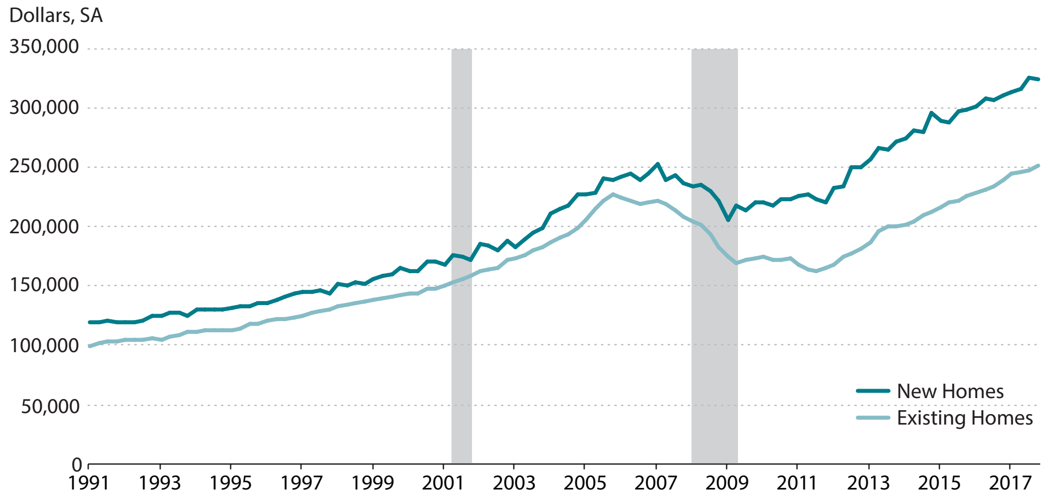
To the extent that price reflects quality, recent home price data (Figure 2) reveal that the difference in quality between new homes and existing homes has widened over the past few years. In 2006, the median sales price of new single-family homes was just 10 percent above the median sales price of existing single-family homes. Since 2010, that gap has averaged over 30 percent. Statistics on housing characteristics and amenities similarly illustrate that new homes have been rising in quality. From 2010 to 2016, the

Figure 1
Housing Supply, Single-Family Homes



NOTE: "Months' Supply" is the ratio of homes for sale to homes sold in a given month. It represents how long the current inventory of homes would last given the current sales rate and if no additional inventory is added to the market. SA, seasonally adjusted.
SOURCE: U.S. Census Bureau, National Association of Realtors, and Haver Analytics.

Figure 2
Median Sales Prices of Single-Family Homes



NOTE: SA, seasonally adjusted.
SOURCE: U.S. Census Bureau, National Association of Realtors, and Haver Analytics.

average square footage of new homes increased by 10 percent, a significant increase over the trend seen from 1990 up to the 2007-09 recession. Over the same post-recession period, the fraction of new homes with at least four bedrooms increased from 35 percent to 46 percent, and the fraction of new homes with at least three bathrooms rose from 25 percent to 37 percent.

Why have new homes gotten nicer? One reason might be that as the recession hit, homebuilders focused more heavily on the high-end housing market where buyers were less affected by the economic downturn. Since then, rising construction costs, labor shortages, and a lack of desirable lots have pushed builders to continue operating in the upper end of the market where profit margins are higher. As a result, homebuyers looking for lower- and middle-tier housing have been increasingly priced out of the new-home market and forced to operate predominantly in the existing-home market.[1] This influx of buyers into the existing-home market has, in part, resulted in slimmer inventories and widened the gap in housing supplies.

What else might be contributing to this divergence in housing supplies? Several possibilities include the following: First, demand for affordable housing may have independently become more robust over the past few years because of improved household balance sheets and aging millennials beginning to consider homeownership. Second, current owners of lower- and middle-tier housing may be unwilling or unable to trade up to new, high-priced homes, creating gridlock in the market. Third, investors purchased homes in large numbers following the recession. Because rental demand has strengthened since 2007, those investors may be disinclined to sell right now. Fourth, the stronger rental market may have also prompted homebuilders to shift construction from single-family homes to multifamily units.

We address some of these factors in Part 2 ("Rental Demand") and Part 3 ("Price Gaps") of this series. Analysis of other potential drivers of the divergence is left to further research. Regardless, the current housing situation is unlikely to be resolved until homebuilders begin catering to buyers of lower-tier homes. Given that developers continue to face the same supply constraints that pressured them to focus on premium homes, the current shortage of affordable housing is likely to persist. ■

Note

[1] In Figure 1, the first divergence of the two housing-supply series, from late-2010 to 2013, also appears to be related to this segmentation of the market. Some of the divergence may be attributed to the expiration in 2010 of a temporary tax credit for first-time homebuyers, which might have disproportionately affected the market for affordable housing and thus the market for existing homes.

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