



Permits, Contracts, Closings:

REAL ESTATE IN THE EIGHTH DISTRICT

by Adam M. Zaretsky

National real estate markets have been booming for several years now. In fact, many analysts labeled 1994 a banner year because of the strength of residential construction and sales. All told, construction started on almost 1.2 million new single-family houses, and a record-breaking 4 million existing homes were sold that year. The following year, new construction and existing sales returned to average levels, before rebounding to above-average levels in 1996. In that year, construction began on about 1.15 million new single-family homes, and nearly 4.1 million existing homes were sold.

The Eighth District's seven states also enjoyed a record year of residential construction and sales in 1994.¹ About 138,000 new single-family houses were built, and slightly more than 708,000 existing homes were sold. As with the rest of the nation, though, 1995 was an average year for District real estate construction and sales, followed by another boom in 1996 when almost 144,000 new single-family homes were built, and about 736,000 existing homes were sold.

National and District nonresidential real estate markets have also been growing, but without the peaks and valleys seen in residential markets.² The amount of square footage built in the nation went from about 936 million in 1992 to more than 1.2 billion last year—a greater than 28 percent increase. In the District's seven states, square footage built went from about 142.5 million in 1992 to almost 207 million last year—a 45 percent increase. Since the beginning of this year, though, some of the fervor in both housing and nonresidential markets has waned, most likely signaling a return to more stable, sustainable growth rates.

Lively Local Markets, Low Mortgage Rates

Healthy local economies have been the driving force behind these gains. Even with globalization occurring in much of the economy, local influences continue to dominate movements in real estate markets because housing and other buildings are immovable goods. And, for the most part, local economies in the District have recently been quite healthy. Many areas have been experiencing very low levels of unemployment, relatively strong job growth and better-than-average personal income growth.³

Movements in interest rates, which considerably affect the num-

ber of households that can afford to buy a house, have also helped carry the trend. According to the National Association of Home Builders (NAHB), a 1 percentage point decline in mortgage rates means more than 4 million additional households can afford to buy a \$100,000 home. For example, the monthly mortgage payment for a \$100,000, 30-year loan at the current rate of almost 8 percent would be about \$734. To qualify for this loan, a household would typically need an annual income of at least \$31,500.⁴ The same loan at 7 percent, however, would cost \$665 monthly and require an annual household income of \$28,500—almost 10 percent less. Since 1994, interest rates on conventional 30-year mortgages have generally fluctuated somewhere between 7 percent and 8.5 percent, with the low of 7.03 percent occurring in January 1996. The high of 9.2 percent came in December 1994. Between 1994 and 1996, average mortgage rates fell 55 basis points.⁵ In April 1997, the year-to-date average mortgage rate hit 7.88 percent, up 7 basis points from the 1996 average rate, but still hovering near levels not seen essentially since the early 1970s.

Location, Location, Location

The District still contains some of the most affordable housing markets in the nation. According to the NAHB, housing affordability conditions improved nationwide in the fourth quarter of 1996, but are still better in smaller cities and towns than in larger coastal cities.

The NAHB computes its quarterly Housing Opportunity Index (HOI) by measuring the share of homes sold in a specific market that a household earning the median income in that market could afford to buy (see table note). The index uses a national, weighted average of mortgage rates from adjustable- and fixed-rate loans and accounts for differences in house prices by market area.

As the table shows, housing is cheaper and more affordable in the District's major metro areas than in the rest of the nation, with St. Louis and Memphis having the most affordable markets. It also shows that housing affordability has worsened over

the past year in St. Louis, Little Rock and Louisville, while it improved in the rest of the country. In each of these three cities, median house prices grew faster than median income between the fourth quarters of 1995 and 1996, making home ownership tougher for many households. At the same time, however, this growth has also meant that real estate prices appreciated faster in these metro areas than they did in the rest of the nation, thereby increasing household wealth.

Building Where We Live . . .

In the first quarter of this year, the number of building permits issued for single-family homes in District metropolitan areas was below last year's record-high levels. Evansville, Ind., and Fort Smith, Ark., are the only District metro areas where more construction permits were issued through March of this year than last. The recent declines, though, have generally not been as great as those that occurred in 1995 after 1994's high levels. In addition, the current drop reflects both a return to more stable, long-run growth for these areas, as well as the effects of early spring flooding and an unusually wet winter.

In the District's four major metropolitan areas (Little Rock, Louisville, Memphis and St. Louis), single-family home building permits issued in the first quarter of 1997 were down considerably from a year ago—ranging from 9 percent in Louisville to 26 percent in Little Rock. These declines were about the same as those that occurred in 1995. And as in 1995, the rate of decline in most of these cities is slowing.

. . . And Where We Work

The recent slowing in District residential construction is mirrored by a deceleration in nonresidential construction. More than 8.5 million square feet were built in the first quarter of 1996, compared with about 6.5 million square feet under construction this year. Louisville is the only metro area to see substantial year-over-year growth—some-what more than 1.75 million square feet was under construction, which is more than double last year's level. The square footage being built in other metro areas is down; in Memphis, for example, it has dropped more than 50 percent from a year

ago to about 1.5 million square feet.

Several explanations could account for this recent decline. One is that the moderate increases in recent interest rates have made financing more expensive and, therefore, projects less profitable. Another, more likely explanation, however, is that large projects, which can dramatically increase the square footage built, have been completed, and new ones are not replacing them. In fact, the number of projects undertaken so far this year is greater than the number last year, implying that 1997 projects are smaller on average than last year's.

Closing the Deal

Will the first-quarter slowing in District construction continue, or is it just an aberration? The jury is still out, but no one is predicting another record year. Yet, at this writing the District economy is still extremely

ENDNOTES

- ¹ The numbers that follow were compiled from statewide data, which include information on large and vibrant regions that are outside of the Eighth District. The map on the back cover shows the seven states and the region that makes up the District.
- ² Nonresidential real estate includes commercial, industrial, educational, hospital, dormitory, religious and public buildings.
- ³ See Zaretsky (1996) and Kliesen (1995) for descriptions of recent economic conditions in the Eighth District.
- ⁴ According to current Federal National Mortgage Association (Fannie Mae) underwriting guidelines, the monthly mortgage payment can be as much as 28 percent of monthly income. The annual income stated is based on this figure. Other information is also used when lenders underwrite mortgages, though.
- ⁵ A basis point is one-hundredth of a percentage point, like a penny is one-hundredth of a dollar.

How Affordable Is Housing?						
metro area	HOI*		MEDIAN PRICE		MEDIAN INCOME	
	1996 4th quarter	1995 4th quarter	1996 4th quarter	1995 4th quarter	1996 Annual	1995 Annual
MEM	70.2	64.6	\$84,000	\$92,000	\$39,500	\$37,400
STL	70.2	73.0	104,000	98,000	46,900	44,600
LR	66.7	67.6	95,000	92,000	39,000	38,300
LVL	65.8	69.3	95,000	88,000	39,700	37,800
U.S.	64.1	63.4	120,000	117,000	41,600	40,200

* Housing Opportunity Index: A measure of the share of homes sold in a market that a household with the median income could afford to buy. For example, a household in Memphis with an annual income of \$39,500 could have afforded to buy 70.2 percent of the homes that were sold in the 4th quarter of 1996.

SOURCE: National Association of Home Builders

healthy, and the national economy is outperforming most expectations. This bodes well for further increases in personal income and people's expectations of economic security, which are both important determinants in home ownership and construction investment. Although moderate increases in long-term interest and mortgage rates will probably dampen some of the exuberance, real estate markets will most likely remain lively and prove 1997 to be a year in which they held their own.

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