Unique Challenges in the Housing Market

The Fed’s monetary tightening over the past year has had an immediate effect on the housing market. The average interest rate on a 30-year fixed-rate mortgage more than doubled from about 3 percent at the end of 2021 to around 7 percent by the fall of 2022. Higher mortgage rates — so long as inflation is not expected to stay high — raise the real cost of borrowing to buy a new home, so it is no surprise that new home sales declined throughout 2022. But if the Fed didn’t act to bring inflation down, we could expect lenders to charge high rates simply to break even in real terms. The average 30-year fixed-rate mortgage at the start of 1980, before the Fed began tackling the Great Inflation, was nearly 13 percent.

The Fed pays close attention to the housing market. Housing often bears the brunt of monetary policy adjustments as an interest-sensitive sector. And since housing, and the construction industry more generally, are important parts of real investment in the economy, making sharp changes in this sector matters for both employment and production. It also makes up a large part of what we buy, so rapid moves in price of housing services — even if not a common occurrence — will matter for the inflation we all experience, which means it matters for the Fed. Housing is connected to our employment mandate for another reason too. Crises in the housing market are often associated with the worst kinds of recessions. Higher average house prices require many new homebuyers to take on more debt, and higher debt levels can lead to greater overall economic pain during a downturn. Finally, a lack of affordable housing can inhibit the ability of workers to freely move about and take advantage of new opportunities, which may stunt productivity growth.

Mortgage rates are just one component of housing affordability. As an economist, I’m struck by how different the housing market is from many other markets. In particular, the affordable housing shortage seems extremely durable, while there are few, if any, other goods or services consistently hard to find at reasonable prices. For example, economists have documented that the mortgage interest deduction incentivized the purchase (and construction) of more expensive homes, and not more homes of varying sizes. Local governments may benefit in the long run by funding more mixed housing developments to improve community diversity. More diverse neighborhoods may spur the creation of a wider array of surrounding businesses and amenities than homogenous subdivisions.

Residents in a neighborhood will be wary of changes that might hurt the value of their homes. Incumbents can — and do — vote for zoning and permitting rules that reduce the ability to build smaller, more affordable homes. Such political decision-making allows them to avoid paying according to the intensity of their preferences to not live among modest housing. They just need to vote on zoning — and that is free! So, it isn’t surprising we see different outcomes than in the case of other goods and services.

We also can’t ignore the lingering effects of historical discrimination in the mortgage market. At a conference hosted by the Richmond Fed late last year, my colleague Horacio Sapriza presented findings that minorities in neighborhoods that were deprived of access to credit through redlining practices that were made illegal decades ago continue to pay higher interest rates today.

What can be done to improve housing affordability? One thing is clear: Any long-term solution must involve expanding the supply of affordable homes. Subsidies without an increase in supply are only likely to increase prices over time. At a minimum, we can rethink policies that subsidize larger, more expensive homes. For example, economists have documented that the mortgage interest deduction incentivized the purchase (and construction) of more expensive homes, and not more homes of varying sizes. Local governments may benefit in the long run by funding more mixed housing developments to improve community diversity. More diverse neighborhoods may spur the creation of a wider array of surrounding businesses and amenities than homogenous subdivisions.

Researchers at the Richmond Fed and elsewhere are continuing to learn about housing challenges and potential solutions. As I’m writing these words, I’m getting ready to participate in a Richmond Fed District Dialogues event on this topic where I’ll hear from experts and members of our community. Sessions like this one are a great opportunity for our research team and members of the public to learn more together about the economic issues facing the communities we serve. I hope you’ll check out this event on our website. EF

Kartik Athreya is executive vice president and director of research at the Federal Reserve Bank of Richmond.