Post #15. Debt servitude - the real estate problem. Date 2024-1-15

A recent video clip of a speech by US presidential candidate Robert F. Kennedy Jr. (RFK) where he discusses his economic solutions to addressing the "housing problem" caught my interest and made me think. I like RFK's candidature as he is a refreshing break (on the liberal side) from the uniparty system, and in my view, he brings some common sense and humanity into the US political arena. For this reason, my thoughts led to writing this post, as sometimes with the best intentions, policies can lead to the inverse outcome.

1. The context. The hamster wheel of debt.

In 2016 I wrote a book on macroeconomics entitled "Economic Cycles, Debt and Demographics"[1] where I explain what I see as the "invisible" forces that drive economies. For this post, the chapters on debt are particularly relevant, as in the aftermath of the 2008 real estate crisis (the Great Recession) and 2010 European sovereign debt crisis, central banks "solved" the debt problem by: producing more debt. Since then, I've been following closely central bank actions as the solution seemed to me like curing a drinking hangover by drinking some more the next day.

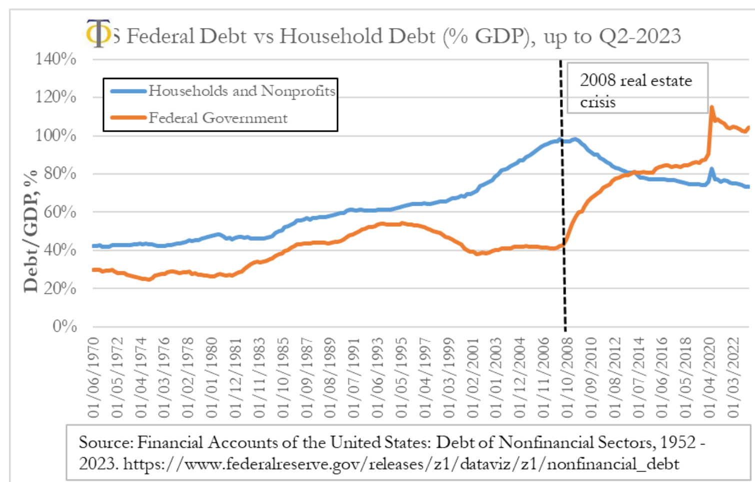

Figure 1 - US Federal Government versus Household Debt/GDP from 1970 onwards.

When writing the second edition of my book, I noticed that there were some positive trends in reducing debt levels, in particular in the private sectors, from 2016 to 2020. Government debt, however continued rising, which can be expected as the leveraging of the public sector gives an opportunity for the private sector to improve its balance sheet, which did seem to be occurring. The next step, would be the slow deleveraging of the public sector to ensue, but then we had the Covid-19 pandemic in 2020 that was accompanied by a surge in public debt (See Figure 1) and expansion of the Fed balance sheet leading to a period of high inflation that started mid-2021.

The record low interest rates and expansive monetary policy led to a record rise in house prices during 2020 and 2021. Inflation raising its head from mid-2021 led to higher rental prices and also higher mortgage rates that were reflected in lower home-ownership rates, particularly in younger individuals who struggle to get a foot on the property ladder.

Household incomes did not keep pace with the rises in house prices since 2020, as shown in Figure 2, which compares median family income and median house prices in the US since 1963. The plot shows that in 2020, median new house sales prices were about $335,000 with median family incomes at $84,350. In 2022 median new house sales prices rose to about $455,000, a 35.8% rise, while median family incomes were $92,750, corresponding to only about a 10% rise. House prices dropped slightly in 2023 but remain at historically high levels.

[1] http://www.cyclesdebtanddemographics.com/

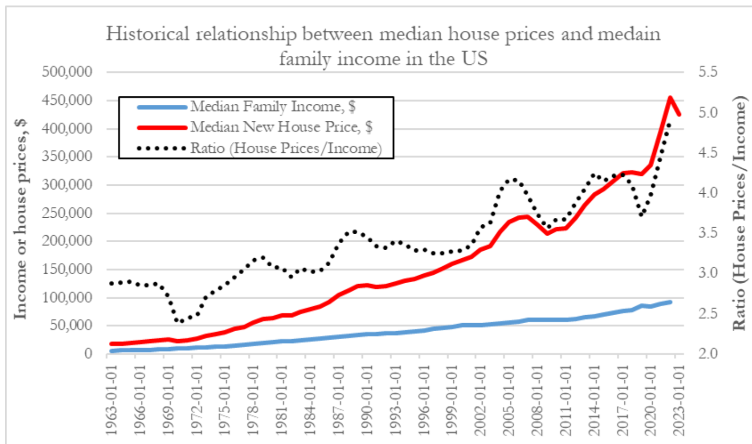

Figure 2 – Historical median family income, median new house sales prices and the respective ratio in the US. Source: St Louis Fed Fred[2]

Some economists argue that higher homeownership rates are associated with an "ownership behaviour" where when individuals have "skin in the game" they are incentivised towards improving their local neighbourhoods. Creating incentives for easier access to homeownership could also be a catalyst for addressing the lower-than-replacement birthrates that are a demographic problem in many developed countries. Consequently, over time, different US administrations have put forward measures for incentivising home ownership, and subsided government-guaranteed mortgages are an effective tool for such purposes[3].

The actual problem that prospective house buyers are facing is that not only are house prices extraordinarily high, but mortgage rates are also currently at very high levels (6.69% as of 2024-1-25), similar to those last observed around 2000, as shown in Figure 3.

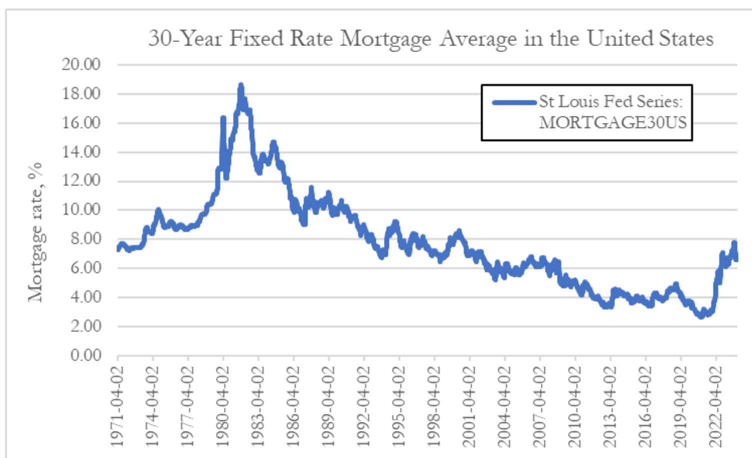

Figure 3 – Historical fixed rate 30y mortgage rates from 4/1970 to 1/2024. Source: St Louis Fed Fred, Series: MORTGAGE30US.

Current high mortgage rates are leading to lower homeownership rates and the decision to rent by younger individuals, who postpone (or indeed abandon) the decision to buy a property. Higher rental demands are leading institutional investors to step into the gap and acquire housing assets for rental income, first in multi-family housing and lately the focus is turning towards single-family housing[4]. These schemes at first glance appear as positive developments as they provide a wider scope of investment assets for institutional investors,

[2] U.S. Census Bureau and U.S. Department of Housing and Urban Development, Median Sales Price for New Houses Sold in the United States [MSPNHSUS], retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/MSPNHSUS, January 29, 2024. Fed Plot: https://fred.stlouisfed.org/graph/?g=1cjFN

[3] https://www.nber.org/system/files/working_papers/w18821/w18821.pdf

[4] https://finance.yahoo.com/news/jeff-bezos-backed-real-estate-151102586.html
https://www.kennedy24.com/rfk_jr_warns_corporations_buy_every_single_home_in_america

but they have the hidden downside of reducing homeownership and the "ownership economy", and incentivise instead a "rental economy"[5]. A more liquid housing market where it is easier to exchange asset ownership could be positive in increasing mobility of the workforce, but needs to be balanced carefully with individuals' property rights and a sense of participation in their local economies. In particular, the disenfranchisement of younger individuals from the "ownership economy" could have detrimental social effects.

2. Great policy ideas could lead to bad outcomes.

After this short contextualisation of the real estate problem, this leads us to RFKs economic proposals[6] to address the "housing problem". His economic team's main proposal for tackling the problem is: "that the government should assist first-time home buyers by offering them discounted 3 percent mortgages, financed by selling tax-free U.S. Treasury bonds".

At first glace I was well impressed with such a proposal. As previously mentioned, subsidising access to mortgages is known to be an effective means of increasing home ownership. By financing the mortgages with tax-free bonds, this scheme would be financed by the private sector. By targeting first-time buyers, the measure would target the younger age-cohort and support the rest of the housing market.

I then started thinking in broader terms and in particular the wider picture shown in Figure 2. It shows that from 1963 to 2023, the ratio of house prices to household income (dotted line) has been rising systematically from a value of 2.8 in 1963 reaching a maximum of 4.9 in 2023. The steady rise in the ratio occurred both in periods of high inflation and low inflation.

Consequently, reasonable government measures to incentivise homeownership by younger individuals might inadvertently lead to guaranteeing that the individuals who take the incentives will be stuck with a large debt burden for the rest of their lives. These individuals would be incentivised in taking a fragile economic position, where any future problems from changing employment conditions to health issues could lead these individuals to desperate situations. This would result in a situation that is even worse than the "rental economy", it would be akin to a "debt-servitude economy".

In my view, the solution to the real estate problem in the US (and other developed countries) is to have economic policies that reduce the ratio of house prices to household income. This could be achieved by a reduction in house prices or an increase in household income. As household incomes tend to change slowly over time, and are ultimately related to workforce productivity, the immediate solution is by houses becoming cheaper, which typically occurs through the supply/demand equation and the regulatory environment. Once real estate prices are less of a burden to households, then incentivising mortgages might lead to a renaissance of the "ownership economy".

3. Why do we spend more and more resources on housing?

The focus of this report is not to delve into the micro solutions that could tackle high house prices. Real estate is local, and solutions will vary from place to place. Here, I rather focus on the macro trends and in my view the underlying imbalances that are at the core of many social tensions we observe.

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[5] This reminds of the 2016 article "Welcome To 2030: I Own Nothing, Have No Privacy And Life Has Never Been Better" by Ida Auken, a WEF contributor. Link: https://web.archive.org/web/20230315010940/https://www.forbes.com/sites/worldeconomicforum/2016/11/10/shopping-i-cant-really-remember-what-that-is-or-how-differently-well-live-in-2030/?sh=65f103471735

[6] https://www.breitbart.com/politics/2023/09/04/exclusive-robert-f-kennedy-jr-use-govt-bonds-to-help-first-time-home-buyers/

With this in mind, I must speculate on answering the question: why do we spend ever more resources on housing?

As the ratio of house prices to household income is a real measure of the burden that housing has on households, I'll use it as a measure of resources we spend on housing.

The rise in the resources we spend on housing is a conundrum. With the rise in productivity over time, and in particular since 1960, we would expect that the burden of housing would be lower over time. Houses being built with better amenities and comfort, insulation, heating is one explanation to this conundrum. Another explanation is that a rise in population has led to higher prices for building materials and land.

However, these explanations break down if we consider that, as we've shown in a previous post, after adjusting for inflation, lumber prices have declined over time and oil prices have not varied significantly from 1970 to 2023[7]. Additionally, population increases lead to a larger market, and economies of scale tend to work towards deflating prices of raw materials. The rise in urbanisation makes it difficult to explain how rising population would have led to overwhelming pressure on land.

The most likely factor that seems to be contributing to the increased burden of housing for households is the trend in increasing size of houses, with median house sizes (for new single-family homes) in the US increasing by about 50.8% since 1973, as shown in Figure 4 - Left. When adjusting the ratio of median house prices to household income by the house size (as shown in in Figure 4 – Right), we observe that house valuations have been relatively stable, with a declining trend from the 1970s to about 2019. This makes sense in the context of increasing productivity and efficiencies I previously mentioned.

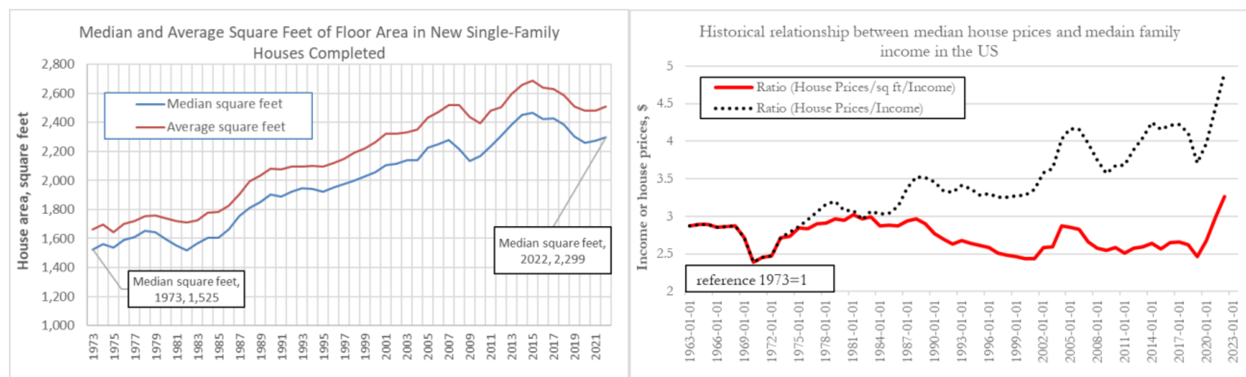

Figure 4 – Left: Median and average house floor area in the US. Right: Ratio of House prices and income adjusted and unadjusted for house floor area (baseline = 1973). Source: St Louis Fed Fred, US Census Bureau.

Finally, even though houses have become larger over time as shown in Figure 4, the trends since 2015 appear to be towards smaller houses, which coincided with a large rise in house prices from 2020. These two recent trends led to house prices divided by incomes and adjusted by house size reaching a historical record level (since 1963); about 30% above "normal" (compared to 2019 values).

The size of the house one purchases, and consequently the economic "burden" associated with housing, is to a certain extent a personal choice. However, incentivising purchasing a house at current house price-to-income ratios should be avoided, as this policy could inadvertently result in detrimental individual and social outcomes, where first time buyers are used to support frothy house prices and end up in a debt prison.

Efforts should be made towards providing more affordable housing for first time buyers at the same time as they are incentivised through subsidised mortgages.

[7] https://www.linkedin.com/posts/carlos-alegria-b68878a_post-14-deflation-scare-is-around-the-corner-activity-7147959414669434880-rIiv?utm_source=share&utm_medium=member_desktop