SHUT OUT

How a HOUSING SHORTAGE CAUSED *the* GREAT RECESSION *and* CRIPPLED OUR ECONOMY

KEVIN ERDMANN

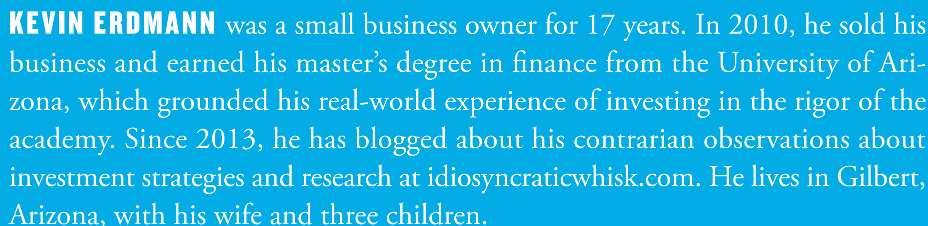
THE UNITED STATES SUFFERS FROM A SHORTAGE of well-placed homes. This was true, even at the peak of the housing boom in 2005. Using a broad array of evidence on housing inflation, income, migration, homeownership trends, and international comparisons, *Shut Out* demonstrates that high home prices have been largely caused by the constrained housing supply in a handful of magnet cities leading the new economy.

In this book, author Kevin Erdmann observes that the housing bubble has been broadly and incorrectly attributed to various "excesses." Policymakers and economists concluded that our key challenge was that we had built too many homes. This misdiagnosis of the problem, according to Erdmann, led to misguided public polices, which were the primary cause of the subsequent financial crisis. A sort of moral panic about supposed excesses in home lending and construction led to destabilizing monetary and regulatory decisions. As the economy slumped, a sense of fatalism prevented the government from responding appropriately to the worsening situation.

Shut Out provides a much-needed correction to the causes and consequences of financial crises and secular stagnation.

"ONE OF THE FEW TRULY NEW IDEAS IN THE DEBATE OVER THE GREAT RECESSION."

—**TYLER COWEN**, author of *Stubborn Attachments*


KEVIN ERDMANN was a small business owner for 17 years. In 2010, he sold his business and earned his master's degree in finance from the University of Arizona, which grounded his real-world experience of investing in the rigor of the academy. Since 2013, he has blogged about his contrarian observations about investment strategies and research at idiosyncraticwhisk.com. He lives in Gilbert, Arizona, with his wife and three children.

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Introduction

This project started as professional curiosity about the following question: What were the root causes of the housing bubble? The data I checked to confirm the story for myself increasingly shifted my conclusions away from those that were popular at the time. Like everyone else, I once believed that the period before the Great Recession should be characterized as a time of excess—an excess of houses, of money, of federal subsidies, and of activism.

Most of the debates about the bubble accept this characterization as given, and the debates revolve around the causes of the excess. One might blame federal influence—the government-sponsored enterprises such as Fannie Mae and Freddie Mac, the community activists that pressed for more universal homeownership in the 1990s, or the Federal Reserve that seemingly kept interest rates too low, pumped up asset bubbles, and lined pockets on Wall Street. Or one might blame private financiers—homebuyers caught up in the frenzy of a bubble, bankers grasping for higher fees and high yields on the backs of borrowers who were increasingly in over their heads, securitization that introduced moral hazard into the mortgage market, CEOs ignoring the long term in order to pad their fat bonus checks.

Yet my studies led, to my surprise, to the conclusion that these debates are framed around false premises. The evidence does not support all of those causes—it fact, it often contradicts them. The overriding challenge of the 21st-century economy has not been too much money, too much credit, or too many homes. To the contrary, at the heart of the housing "bubble," the sense of stagnation, and the sense of inequity is a distressing lack of homes.

How could this be? So much ink has been spilled over this topic. So many intelligent minds have toiled over these problems. I have been led to this conclusion because, time and again, as I have looked for ways to confirm the facts, I have found that they contradict the premises of the debate. On a topic that has developed upon such a strong consensus about the premises, it is easy to dismiss an oddball fact that doesn't fit the conventional wisdom. For instance, we don't question gravity when we see a helium balloon rising into the sky or a magician levitating. Gravity is a premise we hold with certainty, so these observations require other explanations. Reasonable people don't spend time second-guessing gravity every time something seems to contradict it. Gravity is canonical.

The concurrence of rising debt levels and various factors that could plausibly cause home prices to rise led to a consensus that some form of excess must have caused home prices to run up. Excess—from one source or another—became canonical as a cause of high home prices. But the canon is wrong. For a decade, explanations of the crisis have been constructed on a Ptolemaic platform where excess money, lending, or federal housing subsidies populate various epicycles meant to explain the housing market and the broader economy. But it is rising rent from a shortage of well-placed housing that is the giant gravitational force around which all else orbits.

We shouldn't ignore an entire body of evidence because of a single outlier. But what if we find one outlier, then another, and another? To understand this book's conclusion you will need to set aside the story that you think you know. This is exceedingly difficult, because there is so much of the story that we have seen with our own eyes, and that has filled us with anger, frustration, and a feeling that scores need to be settled.

Yet I think you will be frequently surprised by the evidence I present. You may come to the end realizing that there is little middle ground in which the conflicting stories can be reconciled.

WHY IS THERE NO MIDDLE GROUND?

The economist Scott Sumner often refers to the problem of "reasoning from a price change." Reasoning from a price change is problematic because, for example, if we think about a price increase in a market characterized by supply and demand, we can draw two potential conclusions: We can conclude that demand has increased, or we can conclude that supply has decreased. Yet these two conclusions suggest diametrically opposed causes and consequences.

Rising demand suggests growth while falling supply suggests deprivation. So it is important to understand the causes behind a price change. If the price of

rice is skyrocketing because there has been a drought, trying to fix the problem by decreasing demand would be the height of cruelty. Much of the developed world has been in a politically imposed housing drought, and when households frantically tried to access the housing that was available, we reacted by systematically removing their access to housing by restricting their access to mortgage credit.

This is the nub of the problem. It seems undeniable that from about 1998 to 2005, the housing market experienced an unsustainable surge in both prices and quantities. There was too much building, too much credit—too much demand. Were credit markets or monetary policy to blame for rising home prices? Surely they were, in the same way that oxygen in the air is to blame for a forest fire. We don't fight forest fires by fighting oxygen, yet this is how we have fought the housing bubble. The more appropriate way to fight the bubble would have been to build *more* homes instead of restraining the funding for them. I will demonstrate in the following chapters that there were never too many homes. In fact, there were never enough.

In any market, either cutting demand or increasing supply can pull an inflated price back down, regardless of the cause of the original rise. So, if cutting demand does bring prices down, this is emphatically not a confirmation that excess demand was the problem to begin with. With each year of rising rents and rising home prices, even in the face of a hobbled mortgage market, it becomes clearer that we have actually been suffering from a dearth of supply.

In the following pages, I will demonstrate how housing *supply* has defined the American economy of the past 20 years, not just through its effects on home prices, but also through its effects on monetary policy, wages, cost of living, income inequality, even global capital flows. Policies of housing *deprivation* are at the center of the major economic dilemmas of our time.

A BRIEF INTRODUCTION TO THE PROBLEM

To briefly review, from about 1998 to the end of 2005, on average across the US, home prices persistently rose while housing starts also continued to rise. This is the period I will refer to as the "boom" years or the "bubble" years. The market peaked around the end of 2005, when housing starts began to fall. After that point, home prices generally remained flat until the summer of 2007. Then a series of panics, a financial crisis, and a recession followed. I will refer to this period as the "bust" or the "crisis" period.

An important clue for understanding the housing market during the boom is to view housing markets more locally. National averages cannot convey

the fundamental drivers of the market during that time. When we look at the housing market locally, the apparent concurrence of both high home prices and active homebuilding breaks down. There were American cities with strong construction markets and moderate prices. There were also cities with the exact opposite, severely constricted construction markets and very high prices. And there were a few cities where these two regimes briefly collided. At the local level, *constricted* supply is what pushed prices up, and, just as oxygen is drawn into the burning forest by the rising flames, mortgage credit was drawn into those housing markets.

A narrow focus on credit and money has distorted our perception of what happened. We have failed to note many facts that contradict the standard story:

- Housing construction has been constricted in our most prosperous cities. The cities that have historically been sources of opportunity and landing points for immigrants are now so expensive that there are high levels of net domestic migration out of those cities, especially among households with lower incomes. To the extent that housing starts were elevated, they were elevated in cities in the country's interior, where incomes are moderate. In a reversal of the American ideal, families with lower incomes are fleeing prosperous, thriving cities because those cities have sharply curtailed new housing growth. The evidence belies the notion that a housing bubble was built on unsustainable mortgages to buyers with low incomes: in the cities with the most extreme home prices, few households with incomes below the median have mortgages, and families with incomes below the median have been moving away from those housing markets by the millions.
- Home prices in many developed countries rose at least as sharply as in the US. And most of those other countries, such as Canada, did not experience the subsequent sharp drop in home prices that the US did. It is the bust that makes us unusual, not the boom.
- Except during the most dire part of the financial crisis, when households were reducing their housing expenditures involuntarily (via foreclosure), rent inflation has been persistently high for 20 years. Rent for the average home has been rising faster than prices for other goods and services. Housing bubbles are supposed to collapse because home values collapse after overbuilding causes rents to fall. But in 2006 and 2007 (and today), rent inflation was still relatively high. It is difficult to argue that there has ever been an oversupply of housing, even at the national

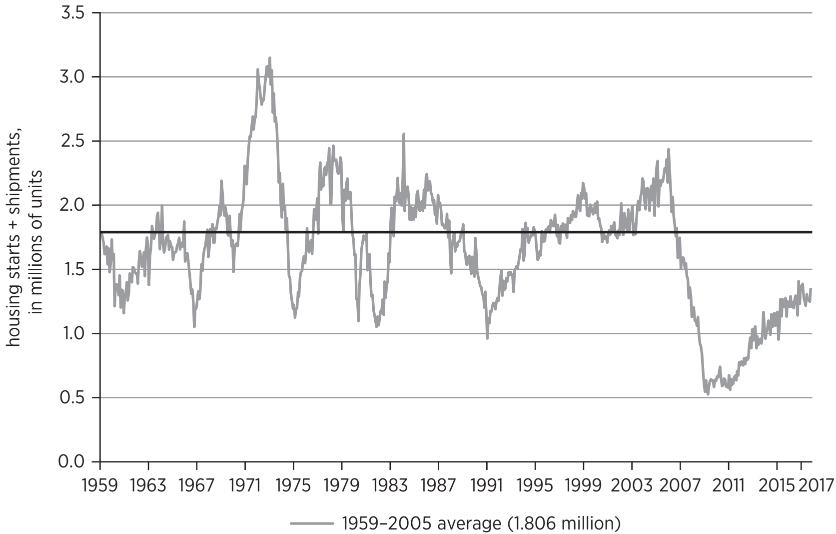
level, when rent inflation has been persistently above core inflation. Wouldn't an oversupply cause rents to decline?[1]

- Growth in real rent expenditures generally had been declining throughout the supposed boom period. In other words, even though we are spending a stable portion of our incomes on rent, this rental expense is buying less house over time. This is because the increase in rents in the expensive cities is inflationary. (The same housing units keep fetching higher rents.) And we can only build large numbers of homes in the places where prices and rents are moderate.
- During the boom, the relative income of the typical homebuyer did not decline.
- During the boom, on average, households that were homeowners did not increase their housing expenditures. (In other words, the rental value of their homes was not increasing, relative to their incomes. They were not "buying up.")
- Homeownership rates, even at their peak levels in 2004, among age groups under 65 years old, were no higher than homeownership rates had been in the late 1970s and early 1980s—this despite the fact that mortgage interest rates at that time had been well above 10%.
- As figure 0-1 demonstrates, when taking account of all types of housing, the number of new housing units never even rose very far above the long-term average. The truly important deviation from the long-term average has been the deep decline in housing starts since 2005.

These findings suggest that we did not have a housing bubble. We had a housing supply bust—first in the places where people want to live, in places where there is more economic opportunity. That supply bust caused prices to rise to extreme levels in those cities—most notably in New York City, Los Angeles, Boston, and San Francisco—metropolitan areas I call the Closed Access cities. After the turn of the century, millions of households flooded out of those cities because of the shortage of housing—so many that they overwhelmed cities in the main destinations for those households, such as inland California, Arizona, and Florida. Then we imposed a credit and monetary bust on the entire country in a misplaced attempt to alleviate the problem.

Because aggregate national housing starts were rising at the same time that prices in the supply-constrained areas were exploding, we assumed, reasonably but incorrectly, that this was excess demand—too much money and credit. We

Figure 0-1. US Housing Starts Plus Manufactured Home Shipments



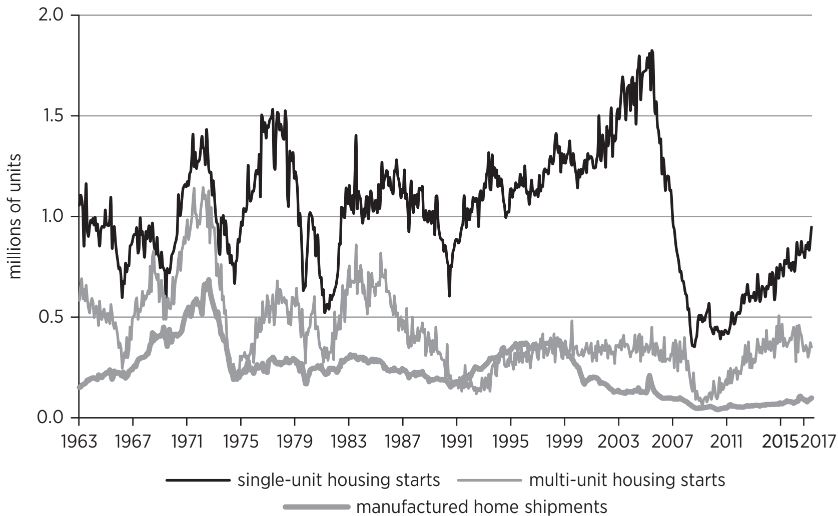
Note: The annual rates of housing starts and manufactured home shipments are seasonally adjusted.
Source: US Census Bureau, Manufactured Housing Survey, "Shipments of New Manufactured Homes: 1959–2017" data available at "MHS Latest Data," https://www.census.gov/data/tables/time-series/econ/mhs/latest-data.html, and data for new housing units started available at "Historical Data," https://www.census.gov/construction/nrc/historical_data/index.html.

experienced a moral panic about these false premises, and—as moral panics tend to do—this led us to create even larger problems while failing to address the root problems that triggered the panic in the first place. Now the supply problem has spread nationwide, and millions of American homeowners and potential homeowners have been needlessly harmed.

How could we have concluded that there was a housing bubble just because of that little blip of activity above the long-term average in 2004 and 2005? Figure 0-2 shows housing starts and shipments, disaggregated by type. Single-unit housing starts did look very strong during the boom period, and this is the measure we most often talk about, because this is where most homeownership happens. But multi-unit housing starts and manufactured home production were both at half the levels normally experienced during expansions.[2]

Housing construction appears even more inflated if we only look at new single-family homes built for sale. This is because homebuilding has become increasingly consolidated among tract homebuilders. This was the only type of homebuilding that was expanding, while the other housing conduits—multi-unit housing, manufactured home shipments, and single-family units built by owners or by contractors—were stagnant or falling. In other words,

Figure 0-2. US Housing Starts and Shipments by Type



Note: The annual rates of housing starts and manufactured home shipments are seasonally adjusted.
Source: US Census Bureau, Manufactured Housing Survey, "Shipments of New Manufactured Homes: 1959–2017" data available at "MHS Latest Data," https://www.census.gov/data/tables/time-series/econ/mhs/latest-data.html, and data for new housing units started available at "Historical Data," https://www.census.gov/construction/nrc/historical_data/index.html.

the perception of an oversupply of houses was enforced by a selective observer bias. All of that growth (relative to the 1970s and 1980s) was simply a shift of market share away from the other conduits for new housing units, which have increasingly been impeded by new regulatory barriers—especially multi-unit housing in the Closed Access cities.[3]

What's more, the extra new homes were built in cities where home prices were moderate. This isn't the picture of a speculative bubble. This is the picture of a distorted migration pattern, driven by limited access to urban opportunity.

We tried to solve that supply problem by imposing a demand bust. The demand bust succeeded so well that a decade later we are still mired in the most depressed period of homebuilding since the Great Depression. Since the demand bust didn't solve the supply problem—in fact, it made it worse—the problems we associate with the bubble are now worse. This has led to rising housing costs, income stagnation and inequality, and labor markets that have been slow to recover. We have put a lid on mortgage credit markets, spreading the supply bust to the entire country—and now families in coastal California and the Northeast, who are under economic stress *because of the housing shortage*, have even fewer options than they did before. We need stable

and growth-sustaining monetary policy and credit markets. Instead, for a decade, monetary and credit policies have been managed explicitly to reduce real investment, as if our problem were having too much—as if the investments we *were* making had been fake or unsustainable.

This book is not a defense of economic recklessness. It is not a defense of financial activities that are systemically destabilizing. And it is certainly not a defense of fraud or misrepresentation. But the existence of those factors when home prices were at their peak is not proof that those factors are the root cause of the high prices. Million-dollar bungalows in places like coastal California have not arrived at those prices because of unscrupulous lenders or speculators. Those high prices are tolls on opportunity. Families who would like nothing more than to live in a house worth a quarter as much must pay the toll for access to jobs and economic opportunities that are located near those houses. They must pay this toll because a handful of cities that are capturing the gains of the new postindustrial economy have virtual walls around them, creating a national divide between haves and have-nots. Americans have not, by and large, been taking out mortgages to fund unsustainable consumption. We have been taking out mortgages in a bid to go where the jobs are.

CHAPTER SUMMARIES

The chapters that follow are divided among three parts.

Part I: The Things We Didn't Know and the Things We Knew That Just Weren't So

Chapter 1 demonstrates that there was never an oversupply of homes. To the contrary, in a handful of cities where economic opportunities are numerous, there has been a severe shortage of homes. Among metro areas, high prices and high rents correlate strongly with the lack of housing supply. This was the cause of high home prices before the financial crisis.

Chapter 2 shows that, before the financial crisis, US housing prices were not particularly unusual compared to prices in similar countries, so there is no reason to look to domestic credit markets, monetary policy, or American federal housing policies to explain price behavior at that time. Sharply rising prices were not particularly related to rising homeownership rates, and where homeownership did increase, it was among professionals with college educations and high incomes. Furthermore, homeowners, on average,

were not buying "up," but were buying "down," frequently by migrating to less expensive cities.

Chapter 3 further outlines how, to understand the housing bubble, we must focus on the differences between cities. Research that seemed to point to credit supply for marginal homeowners as the root cause of rising prices ignored the differences between cities and focused narrowly on how rising home prices differed within cities between low-end and high-end housing markets. But the difference in price changes between low-end LA and high-end LA was a small fraction of the difference in price changes between, say, any area in LA and any area in Chicago. It is a lack of supply that makes LA different from Chicago. This is further confirmed by the realization that (1) first-time homeownership rates were declining at the height of the credit boom, and (2) prices in neighborhoods that seemed to have credit booms have remained high relative to those in other cities, even though mortgage markets have since become very tight.

Part II: What Really Happened

Chapter 4 shows that, in almost every city, before 2008 there was little difference in price appreciation between low-end markets that might have been stimulated by loose lending and high-end markets that would have been less dependent on lending standards. Viewed carefully, different rates of home price changes within cities actually confirm that limited supply was the cause of rising prices, and it was only after 2008, when public policy imposed extremely tight credit markets, that low-end prices collapsed compared to high-end prices. Low-end housing was not propped up by loose lending, and its collapse was not inevitable. In fact, the collapse was publicly imposed.

Chapter 5 shows that the housing bubble was an acceleration of the long-term segregation by income that American households are engaging in as a result of the deprivation of housing in coastal urban centers. Households with high incomes move into those cities, and they bid up both the rent and the price of the limited housing stock until a household with less financial means is forced to move away to the more welcoming cities in the country's interior. By 2005, this segregation had accelerated so much that migrants seeking more affordable cities overwhelmed places like Arizona and Florida. The housing bubble in those places was a bubble in compromised economic opportunity and exclusion. We had something more than a credit boom—we had a refugee crisis.

Part III: Symptoms of the Urban Housing Shortage

Chapter 6 explores the perverse reversal of the traditional pattern of free people moving toward economic opportunity, and how this is leading to a geographically segregated nation of haves and have-nots.

Chapter 7 explains how concerns about the economic power of firms are misplaced. The monopoly power that is claiming the income of workers is the monopoly power of real estate owners in housing-deprived cities, who exclude potential new housing and charge ever-rising rents. This situation means that workers are prevented from transitioning to new service-sector jobs that are available in these cities—and workers who are in these cities must fork over much of their income to the real estate owners.

Chapter 8 explores the international effects of the urban housing shortage. The effects of Closed Access may be at the root of the rising trade deficit and the inflow of global capital.

Chapter 9 provides a brief summary of perhaps the worst outcome of the housing shortage, which was the moral panic that ensued when high prices were blamed on speculation and lending. The US succeeded in bringing prices down with contractionary monetary and credit policies that did nothing to remedy the foundational cause of high prices. Contrary to conventional wisdom, the trigger of the financial crisis was not a surge of mortgage defaults among working-class homeowners. Losses among middle-class and working-class homeowners came late in the crisis, as a result of the recession and the disastrous monetary and credit policy decisions.

The epilogue uses notions of "open access orders" and "limited access orders," which were developed by the economists Douglass C. North, John Joseph Wallis, and Barry R. Weingast, as a conceptual framework for considering the difficult path ahead for cities that have lost the presumption of universal access and free entry for labor and capital.