A Housing Deficit Is Driving Inflation, But Higher Interest Rates May Not Be Enough to Tame It

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The Consumer Price Index (CPI), the barometer of inflation, is the highest it has been in 40 years, and housing costs—both homeownership and rental—are higher than ever. In response, the Federal Reserve Board of Governors has begun a series of increases in interest rates, expected to be one-half of one percentage point (50 basis points) per increase through the end of the year. Short-term rates could rise as much as 350 basis points.

The Federal Reserve Bank’s strategy is to gradually reduce demand, thereby reducing price increases and ultimately inflation, all without causing a recession. This approach is known as the “soft landing,” and it is not easy. If they get it wrong, inflation will continue to rise and build momentum. Consumers typically adapt to rising costs by spending money now rather than saving it, concerned its value will depreciate further. With labor markets so tight, the impact of rate increases on wage growth may be blunted, putting further pressure on consumers. Another risk is that consumers and businesses may cut back too sharply, sending the economy into recession. Worst of all, we could end up with inflation and a recession, known as stagflation.

It is possible that raising interest rates will not impact inflation. In this pandemic-driven economy, Housing Underproduction is the biggest driver of housing prices. Demand is already constrained by record-low inventories of available and affordable homes. One possibility is that rising rates could add to inflationary pressures by increasing the cost of buying and renting a home, inflating the shelter cost number in the Consumer Price Index because there is not an adequate decrease in demand. Since housing price increases lag CPI, shelter could become an even larger driver of inflation as other pandemic-related supply chain back-ups resolve. The less supply, the more likely this outcome becomes.
Housing Deficit (cont)

We have already seen mortgage rates increase from less than 3% a year ago to nearly 6% in June. Mortgage rates could climb to 8% before they peak. Higher interest rates impact housing in two ways. First, as the cost of buying a home increases, homeownership becomes less attainable, particularly for first-time homebuyers and Black Americans. The cost of the monthly mortgage payment on a typical single-detached home goes up about $200 per month for every one-point rise in mortgage rates. Since May of 2021, mortgage rates have been on a steep climb. If rates reach 7% by the end of the year, that is an increase of almost $800 per month.

Another way high interest rates impact housing is that the cost of new homes increases with the cost of financing new construction. Today's housing market is unique in some significant ways that could alter these assumptions. First, housing inventory is still at record low levels compared to demand, while at the same time, housing starts are at capacity. Housing inventory has more than halved since the start of the pandemic, from just over 1 million active listings in January 2020, to 409,000 in April 2022 (Realtor.com, 2022). These numbers have begun to improve but remain well above historical norms. While the time it takes to sell a listing may get longer and price increases may flatten, it will be much harder to reduce home prices given the pent-up demand.

Housing Underproduction has more than doubled from 2012 through 2019, reaching a deficit of 3.8 million needed homes across 47 states and Washington, DC. Homebuilders in high growth places like Texas and Florida have seen spikes in their underproduction far in excess of California.

Yet, builders are already constructing as many homes as they can. Privately-owned housing units authorized by building permits in April were at a seasonally-adjusted annual rate of 1,760,000. The capacity to build more is constrained by a tight labor market, building supply shortages, and local zoning restrictions that continue to keep land costs high. Many approved projects have yet to break ground due to supply chain problems and material and labor costs. According to economist Bill McBride of the housing economy blog, Calculated Risk, the inventory of homes under construction at 266,000 is the highest since 2007 (2022). The inventory of homes not yet started is at a record 106,000, and housing supply costs account for most of the difference.

If higher interest rates reduce production more than demand, prices will remain high. Falling production in today’s market is likely to exacerbate our housing affordability crisis, fueling increases in rents as homeownership rates fall. Higher rates will also do nothing to reduce the price of oil or the supply chain disruptions impacting commodity prices like lumber, steel, and copper, essential elements of new home construction that have already experienced huge price increases.
While the ability of the President and Congress to influence inflation is limited, they do have tools at their disposal to address housing supply. Several policy proposals could improve single-detached and multifamily production. These bills have broad bipartisan support and offer all Members of Congress the opportunity to vote on two important issues among voters: housing costs and inflation. The President’s recent plan to address housing production is very encouraging, but it must be followed by tangible action across agencies and in Congress.

If we fail to address shortages in housing supply, we run the risk of fueling the fires of inflation rather than extinguishing them. The result could be stagflation, a word many of us have not used in a generation and some of us have never experienced. This would devastate the housing economy and only exacerbate our current housing supply challenges. Housing is a continuum. Lower homeownership rates lead to higher rents where demand exceeds the already severe shortage of housing affordable to the lowest-income households. This, in turn, may increase houselessness among those already struggling to afford shelter. Failure to act effectively hurts everyone. Tangible change will have widespread tangible impact.

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How the Federal Reserve’s decision affects home mortgage and construction loan rates

Interest rate increases are decided by the Federal Open Market Committee (FOMC), comprised of the members of the Board of Governors of the Federal Reserve System, the president of the Federal Reserve Bank of New York, and four of the remaining eleven Reserve Bank presidents, each serving one-year terms on a rotating basis. They vote on changes to the Federal Funds Rate, the interest rate that banks charge each other to lend Federal Reserve funds overnight (Amadeo, 2019). This overnight interest rate is used as a benchmark for other short-term rates like the Prime Rate, which is often used as a foundation for other types of loans (hence a rate of “prime plus 2”). The cost of these funds greatly influences 30-year fixed mortgage rates, which generally rise or fall with the Prime Rate. So, while the Federal Reserve Bank is not directly increasing mortgage interest rates, it is increasing the cost of funding most mortgages. Anticipation of rising short-term rates can increase long-term rates as investors prepare for increased funding costs.