

# UCLA ECONOMIC LETTER

## REAL ESTATE AND THE MACROECONOMY



*A partnership between the UCLA Ziman Center for Real Estate and the UCLA Anderson Forecast sponsored by the Ziman Center's UCLA Rosalinde and Arthur Gilbert Program in Real Estate, Finance and Urban Economics*

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Monthly condensed analyses of crucial real estate and economic issues offered by UCLA Anderson Forecast and UCLA Ziman Center for Real Estate. In this Letter, UCLA Anderson Forecast Director and Senior Economist Jerry Nickelsburg recommends California policies that could arrest some of the worst economic impacts of COVID-19 by incentivizing development of new and affordable housing.

## Out of the Ashes: Pandemic-Induced Policy Possibilities for Housing

*By [Jerry Nickelsburg](#), Director and Senior Economist, UCLA Anderson Forecast; and Adjunct Professor of Economics, UCLA Anderson School of Management*

Recession has come to California with implications for the Golden State's housing affordability and homelessness. The economic backdrop is still uncertain as a sharp decline in the nation's production of goods and services continues, and the severity and duration of the pandemic remain unknown. For California, a decline in employment well in excess of 2 million jobs is expected<sup>1</sup>. Though some jobs will come back when shelter-in-place policies are eased, there will be extended unemployment for many. This unemployment is heavily weighted in the service industries, notably leisure and hospitality, retail, and personal care services. These are sectors with lower wages on average, and therefore, the burgeoning rolls of the unemployed are disproportionately Californians who were pre-recession shelter-cost burdened.

*"California state and local governments could induce the conversion of idle retail space into residential properties. They would subsidize, perhaps heavily, the demolition of the existing property and the preparation of the land for residential construction."*

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<sup>1</sup> Jerry Nickelsburg. "The 2020 Recession." *UCLA Anderson Forecast*. March 2020.

Importantly, the recession will also affect new home construction; the supply side of the housing affordability issue. Going into the recession, net of wildfire recovery rebuilding, California was at an annual rate of new home production of about 100K units. This is only 60% of what is needed to keep up with normal population gains and one-third of what is needed to begin to make a dent in affordability<sup>2</sup>. As it is expensive to stop midstream, mothball, and re-start at a later date most new homes already under construction will likely be completed. But follow on projects may be limited. Our best estimate is that they will be less than half of the immediate pre-recession levels.

The fall-off in new home construction is a direct consequence of the perceived risk associated with new development. Crucial to the investment plans of developers is the rental or sale of the homes once completed. Will the pandemic come back in 2021? Will there be sufficient income to purchase or rent the homes at prices that permit repayment of construction loans? And if the recession is disproportionately hitting the middle to low income portion of the California population, is it not riskier to build homes for these cohorts? These considerations weigh on developers and their financiers alike.

This scenario sounds like a worst case outcome for a state in which the production of new homes and the pathway to shelter for the homeless are critical issues. So, is there any good news in all of this? There actually is some. The construction labor constraint on home building which was being experienced prior to the recession<sup>3</sup>, will not be binding as we move out of the recession. In addition to the anticipated 200K existing construction workers waiting to be re-employed, workers from sectors that will be slower to return to previous levels—read retail, manufacturing and hospitality—become potential entrants to the construction labor force.

Additionally, the cost of building materials has declined. For example, lumber prices are down 25% from their peak earlier this year and copper prices have fallen by 17%. With the sharp decrease in the demand for building supplies, a concerted program to bring production of home building materials manufactured in China back to normal<sup>4</sup>, and some easing of regulatory burdens, there are now additional incentives for developers.

## CALIFORNIA POLICY RECOMMENDATIONS FOR NEW AND AFFORDABLE HOUSING

The fly in the ointment is the aforementioned uncertainty about the expected returns earned when certificates of occupancy are ultimately issued. Absent an effective vaccine with widespread vaccinations, it is difficult to put that uncertainty aside and push forward with building. Even with more regulatory easing, adding significant new housing in the near-term is therefore not likely if the private market is left to its own devices. But there is room for an innovative policy induced reversal of the flagging construction of homes. Below are a few ideas that take advantage of the recession.

The first leverages the state's limited funds with rate-of-return backstops. These should be reserved for middle to low income housing, as that is where the critical need lies. The way in which this would work would be for a developer to propose a project which meets pre-set policy criteria. The required rate of return for such a project would be determined by an analysis of investment markets. The state would then take two financial positions with respect to the development. First, it would provide a guarantee to the developer of earning at least the specified rate of return. If the market does not deliver this return, the state is on the hook for only the difference between what was earned and the guarantee. If the guarantee is drawn upon, then a contingent claim by the state is created. When the property is sold, the rate of return is recalculated and conditional on the asset appreciating enough to exceed the return guarantee, the state would be entitled to partial or full refund. Second, the state can provide guarantees for the construction loan. This will both bid down the cost of the loan, and at the margin, make funding available that might not otherwise be there. If the developer defaults, the property devolves to the state. At some point it would be sold, and the net cost to the state would be the differential. These are not new ideas. The U.S. Ex-Im Bank has used this kind of financing for many years to promote exports of capital goods including airliners and heavy equipment destined to where the risk of default is difficult to quantify; and the U.S. Department of Energy's Loan Programs Office has used backstop financing to leverage \$50B in infrastructure projects.

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<sup>2</sup> One estimate of the number of units required can be found in "California's High Housing Costs: Causes and Consequences." *California Legislative Analyst's Office*. March 17, 2015.

<sup>3</sup> Scott Littlehale. "Rebuilding California: The Golden State's Housing Workforce Reckoning." *SmartCitiesPrevail.org*. January 2019.

<sup>4</sup> Mike Bird, Joe Emant and Shan Li. "China is open for business, but the post-coronavirus reboot looks slow and rocky." *Wall Street Journal*. March 26, 2020.

A second policy to encourage home production stems from the contraction in the retail sector. It has been long known that this is a sector with excess physical capacity. The Allen Matkins/UCLA Anderson Forecast survey of retail space developers has reflected this sentiment for the past three years. In the latest UCLA Anderson forecast there is the expectation that by the middle of 2022 there will still be more than 10% of existing retail space idle. Ultimately, it will be converted to other uses. One incentive package California state and local governments could use to induce that conversion into residential properties would be to subsidize, perhaps heavily, the demolition of the existing property and the preparation of the land for residential construction. Obviously, there would need to be guarantees on the part of the property owner to follow through with the construction of a sufficient amount of housing units aimed at the appropriate market segments, but, such a policy would improve the economics relative to the development of the property for industrial, entertainment, or luxury housing uses.

The other opportunity this recession provides relates to the provision of shelter for California's homeless population. In an effort to combat the spread of the coronavirus pathogen, the state is taking up empty motels and hotels for the lodging of the homeless<sup>5</sup>. With tourism coming back slowly, this points to a heretofore unavailable option for supportive and transition housing. By continuing the use of these venues post-pandemic, the state might begin to make a dent in its burgeoning unsheltered homeless population.

To be sure, the acquisition of these properties will require state and local resources. However, the purchase price and associated fit-out costs for many will be below the cost of building new supportive housing, and this avenue increases the stock of units' available beds much more rapidly than new build shelters. For example, as of April 13, 2020, LoopNet lists motels in Los Angeles for sale at prices between \$130K and \$170K per room. The downturn in tourism will likely result in a reduction of these asking prices. Suppose, for the sake of argument that an average fit-out were to cost \$70K per room inclusive of its share of the common area refurbishment<sup>6</sup>. An audit by the Controller of Los Angeles found that the current cost of building a new unit in the city would be approximately \$600K. With the sale price of many motels and hotels dropping due to the dearth of tourists this year and next, this is an avenue to obtain a 3:1 benefit.

Let's not minimize the cost of this pandemic. Besides the suffering and tragedy of the disease, business, economic activity, and employment will be lost forever. The state's unemployment rate will soar from 3.9% to a peak above 17%. The state budget will be impacted and valuable programs lost. Nevertheless, there are opportunities, particularly in housing, that if new policy reaches out to grab, can address some of the more vexing problems in the state; home affordability and homelessness. And, if the opportunity is lost, the economics clearly point to decreased housing affordability throughout the state.



<sup>5</sup> <https://www.gov.ca.gov/2020/04/03/at-newly-converted-motel-governor-newsom-launches-project-roomkey-a-first-in-the-nation-initiative-to-secure-hotel-motel-rooms-to-protect-homeless-individuals-from-covid-19/>

<sup>6</sup> For an overview of motel conversions see: Sara Ventiera. "Check In Time: Run down motels are becoming cool condos." *Realtor.com*. December 20, 2018.