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# FRBSF WEEKLY LETTER

July 6, 1990

## Real Estate Problems in the West?

During the 1980s, serious real estate downturns followed booms in Texas, Arizona, and the New England states. In each case, signs of overbuilding were apparent before the downturn. This *Letter* sorts out some of these signals, and then examines current conditions in California, Washington, and Nevada to see whether similar signals exist in those markets.

### Measures of market vulnerability

A common worry is that rapid increases in real estate values increase the risk of a real estate downturn. However, most downturns are associated with supply and demand conditions in real estate markets, and thus are not caused by high and/or rising prices alone. Prices generally fall when supply exceeds the market's ability to absorb it.

To determine whether a market is particularly vulnerable to a downturn, then, this article focuses on three simple measures of supply and demand conditions, called "measures of vulnerability." These are the office vacancy rate in a given area, the share of total employment provided by the construction sector, and the number of housing permits awarded for each new resident. Although these simple measures are not comprehensive, any one of these measures that is "high" can be a signal that there may be "too much" building in the region.

However, these kinds of statistics can only suggest whether a given market is vulnerable, and cannot accurately forecast whether it will experience a downturn. Robust construction activity may be entirely appropriate if the state's economy continues to grow rapidly. On the other hand, overbuilding could become a problem if the pace of growth were to fall below the optimistic expectations that generated the robust building activity. Overbuilding also could be a problem in a market that did not show early signs of vulnerability if actual growth were to fall significantly below the expectations embodied in the moderate construction activity. Thus, these signals can suggest which states' economies are less likely to live up to expectations, but

by themselves they cannot predict accurately where serious real estate problems will occur.

### A look at Texas

Many view Texas as the prototype of a real estate collapse, complete with "see-through" office buildings, declining property values, and failed financial institutions. A commonly held view is that the Texas economy was booming until oil prices declined sharply early in 1986. This impression, however, is not completely accurate. The Texas economy was growing at a healthy, but not spectacular pace during the early 1980s. During 1984 and 1985, population growth in Texas was still 50 percent higher than the national average, but this represented a slowdown from prior years. In 1985, moreover, employment in Texas grew at a 2.6 percent rate, which was healthy but less than the 2.9 percent growth seen nationally.

In this environment, signs of overbuilding emerged. First, the three Texas cities for which Coldwell Banker calculated vacancy rates in 1985 all earned the dubious distinction of being in the "Top Ten" nationally. Their vacancy rates ranged from 22 to 27½ percent, high even compared with the 19 percent nationwide vacancy rate in 1985. Moreover, construction accounted for 6.7 percent of all Texas jobs in 1985. This was significantly higher than the 4¾ percent national share, suggesting that construction activity may have been stronger than the state's more moderate economic climate could support.

At the same time, however, home-building activity was not out of line with population growth in Texas. During the 1982-85 period, two housing permits were issued for every three new residents in the state, a rate of home building very close to the national average. In sum, there were some signs of vulnerability by 1985 which, when coupled with the significant slowing in the state's overall growth rate, called for caution.

### Arizona

The situation prior to the downturn in Arizona was quite different from that in Texas. Until 1986,

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when construction activity peaked, Arizona's economy was growing at an incredible pace. Employment grew by 10 percent in 1984 and by eight percent in 1985, and population growth was consistently double or triple the national rate. In keeping with this growth, Arizona's real estate markets boomed, although home building activity was not out of line with the state's population growth. From 1983 through 1986, three housing permits were issued for every five new residents, a rate that actually was somewhat lower than the national average. In contrast, commercial markets appeared vulnerable, with Phoenix's office vacancy rate at a very high 27½ percent.

The most distinctive characteristic of Arizona's boom, however, was the important role construction played in fueling overall growth. Construction employment grew by more than 20 percent in both 1983 and 1984. By 1986, construction employment accounted for 8½ percent of Arizona's jobs, almost twice the national average.

With construction activity growing more rapidly than the overall economy, Arizona's real estate markets were vulnerable to even a modest slowing in overall growth. This occurred in 1987, when total employment growth slowed to a still-healthy two percent pace. That same year, construction employment began its sharp decline, falling by seven percent. But even as construction activity has fallen and loan losses have mounted, Arizona has continued to post overall growth. Thus, Arizona's real estate problems have occurred against the backdrop of a fundamentally healthy economy, in which real estate activity for a time outpaced even this fast-growing state's ability to absorb it.

## **New England**

New England offers yet another scenario for a real estate downturn. The New England states posted strong growth during the early to mid-1980s, due largely to success in the high-technology and defense sectors. But in 1985, manufacturing employment started to decline, falling by a total of 13 percent between 1984 and 1989. Yet the economy as a whole continued to do quite well.

The signs of vulnerability that preceded the downturns in Texas and Arizona were absent in New England. Construction accounted for five

percent of total employment, only slightly higher than the national average, and office vacancy rates in New England cities were considerably lower than the national average.

Nevertheless, one sign of vulnerability did exist. From 1985 to 1988, more than one housing permit was issued for each new resident in the region. This suggests that builders' collective expectations about future population growth may have been unrealistically optimistic. Thus, after economic growth in New England began to slow, it took several years for the construction and real estate sectors to adjust to the new reality of slower economic growth and reduced demand for housing.

## **The West?**

Real estate activity and construction currently are booming in many parts of the West. The hot markets previously seen in the San Francisco and Los Angeles areas are cooling now, while inland areas are reporting boom conditions. Nevada continues to post phenomenal growth. Activity in Washington remains strong. For each of these regions, some cooling is inevitable, but it is legitimate to ask whether boom times have made these economies particularly vulnerable to the kinds of serious real estate problems that have occurred elsewhere.

Between the end of 1987 and Spring of 1989, California saw a dramatic surge in home-buying activity, home prices, and construction activity. Nevertheless, there is no evidence that this frenzy of activity has created the kind of vulnerability that would increase the odds of serious real estate problems in California. Construction employment remains only 5.2 percent of total employment, just slightly higher than the national average and low enough to suggest that California's economy is not excessively construction-dependent. And home-building activity in California actually has been less intense relative to population growth than it has been nationally. During the 1985-1989 period, less than one housing permit was issued for every two people added to the population.

Moreover, of the ten California metropolitan areas surveyed regularly by Coldwell Banker, only four have office vacancy rates higher than the national average. And in three of those four cities, vacancies are only slightly higher than the

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19.9 percent national average. Only Bakersfield, with a 26.3 percent rate, seems vulnerable at present.

These figures suggest that, at least on the state-wide level, current real estate market conditions do not make California especially vulnerable to a real estate downturn. However, this does not preclude the possibility that some areas within the state may have imbalances in their real estate markets.

### **Washington and Nevada**

Washington (particularly the Seattle area) has been booming for the past few years, and real estate markets have been very hot for most of the past year. Nevertheless, none of the measures of vulnerability is high at present. During the 1986-89 period, only one housing permit was issued for every two new residents. Seattle's office vacancy rate is well below the national average, at 15 percent, and construction employment currently accounts for only 5.2 percent of total employment.

Thus, in Washington, as in California, the recent robust construction and real estate activity has not been out of line with general economic activity, suggesting that real estate markets probably will be able to adjust to slower economic growth without collapsing.

Although Nevada's boom has not received as much media attention as California's has, in most respects Nevada's story has been much more dramatic. Nevada has been the fastest-growing state in the U.S. for the past three years, with employment growth averaging 6.8 percent per year during that period.

This incredibly robust growth may seem like a perfect setup for a real estate collapse, but many of the statistics are encouraging. Las Vegas' 10.6 percent office vacancy rate is the second lowest among the metropolitan areas tracked by Coldwell Banker. The ratio of housing permits to new residents was three to five during the 1986 to 1989 period, somewhat below the national average. Among the measures of vulnerability examined in this *Letter*, the only worrisome one is construction employment, which accounted

for 7.5 percent of total employment in Nevada during 1989.

The apparent contradiction between a high level of dependence on construction activity on the one hand, and residential and office markets that do not appear to be overbuilt on the other hand, may be explained by the pace of casino building. Several large new casinos are being built in Las Vegas, raising concerns about whether the gaming market will be large enough to make these projects profitable as they come on line.

At any rate, Nevada's growth rate is likely to slow from the unsustainably rapid six to seven percent pace of the last few years. In an economy where construction is such an important component of the state's economy, building activity will bear more than its share of the adjustment to slower economic growth. This suggests that Nevada is more vulnerable to a real estate downturn than either California or Washington is, although the signals examined here are less ominous than they were for Texas or Arizona.

### **Encouraging signals, on balance**

The analysis presented here shows that in some regions that have experienced serious real estate problems, there were signs of vulnerability before the onset of those problems. Construction activity was robust enough that continued rapid growth would have been necessary in order to absorb the new space.

At present, neither California nor Washington show signs of this kind of vulnerability. This suggests that severe regional recessions (which most forecasters do not anticipate) would be necessary to create serious real estate problems in these states. In Nevada, office vacancy rates and the rate of home-building relative to population growth suggest that the region's construction boom is well within the economy's ability to absorb the new space. However, the high level of dependence on construction activity does suggest that a relatively sharp slowdown in construction activity may be necessary when the pace of general economic activity begins to slow.

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