

~~Federal Reserve Bank~~
of San Francisco

AUG 9 1990

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Seattle Economists' Club Luncheon
for delivery May 1, 1990
12:00 noon PDT

~~Monetary Policy~~ and Real Estate Investment

- I. It's always a pleasure to come to the Pacific Northwest, particularly when the hills around the San Francisco Bay are already starting to turn brown.
 - A. It's also nice to have such an accommodating audience: you've given me carte blanche regarding my topic today.
 - B. So, what I'd like to do is talk about real estate -- a subject that's near and dear to just about every resident of the West.
 1. I have a number of reasons for choosing this topic.
 - a. First, the real estate sector now is facing significant challenges, particularly in New England and Arizona.
 - b. Second, many are suggesting that the slowdown in these markets could spread to other markets, including California and Washington.
 - (1) You may know, for example, that the FDIC recently put together a list of the real estate markets that are most "at risk" in this country -- and Seattle got top ranking in the residential category.
 - (2) Seattle also was mentioned in the commercial category (ranked 34th out of 40).
 - c. Moreover, many are worried that both the cautious stance of monetary policy and the thrift restructuring are compounding the real estate sector's problems by making construction financing more expensive and scarce.
 2. Unfortunately, none of these concerns is likely to disappear anytime soon, but they do mask some favorable longer-term developments.
 - C. So, today I'd like to talk about:
 1. Current approach of monetary policy;
 2. And what this means for the real estate industry's outlook nationwide and in the state of Washington;
 3. Finally, I'd like to make some observations on the key structural changes that have taken place within the real estate industry in recent years.

- II. Turning first to monetary policy, let me say emphatically that Fed is committed to controlling inflation and bringing it down.
 - A. Unfortunately, I continue to see troubling signs of inflationary pressures:
 - 1. Recent surges in consumer prices and GNP deflators are a concern;
 - 2. However, some of this is due to recent spikes in prices of energy and food.
 - a. But even when you take these factors out, CPI inflation came in at a disturbingly high $7\frac{1}{2}$ annual rate in first quarter.
 - 3. And what worries me is that economy continues to operate at very high level.
 - a. In particular, labor markets are tight.
 - b. This situation is putting upward pressure on wages and, in turn, on prices.
 - 4. Our forecast suggests that even though economy is slowing, the core rate of inflation won't begin to moderate quickly.
 - B. To reduce inflationary pressures, economy needs to back away from levels of activity that strain capacity.
 - C. Put bluntly, this means we need an extended period of relatively slow growth.
 - 1. Our Research Department projects real GNP growth of about $2\frac{1}{4}$ percent in 1990, slightly below the economy's potential rate.
 - a. Not stellar, but not a recession, either.
 - 2. Key contributor to growth will be consumer spending.
- III. These policy concerns imply several things for real estate.
 - A. First, real interest rates are likely to remain high by historical standards. This will be a deterrent to real estate investment.
 - 1. Real rates will remain high as long as U.S. economy continues to operate at relatively high level.
 - B. A second point is that the sluggish growth in income I anticipate also will have dampening effect on real estate investment.
 - C. Finally, declining inflation in medium- to longer-term may tend to

slow rate of appreciation in real estate values.

D. Obviously, this is not a rosy picture.

1. In the area of residential investment:

a. Nationally, there was a short-lived bounceback in residential construction in the first quarter of this year -- in response to drop in mortgage rates last year.

b. But recent uptick in mortgage rates probably has already limited extent of bounceback.

2. For commercial and industrial real estate investment, I expect almost no growth for the year.

a. Overbuilding has been a significant problem in many areas.

b. And problems with the availability of construction financing may have an impact.

IV. That's my outlook for the nation. But what about the state of Washington? Is a real estate-led slowdown going to hit the Northwest?

A. As I mentioned a few minutes ago, the FDIC placed the Seattle residential market at the top of its watch list.

1. That's because (median) housing prices in this area rose 37% last year (Q4-Q4), outpacing every other market in the country, even Honolulu's.

B. FDIC also is watching Seattle's commercial real estate market, because of unfavorable combination of rapid growth in new office space, relatively slower growth in downtown employment, and recent rises in office vacancy rates.

C. However, I'm not convinced there's great cause for concern yet, although caution certainly is called for.

1. For one thing, the Washington economy is in good shape.

a. The Pacific trade has been and will continue to be a source of strength.

b. Aerospace manufacturing also is robust, although Boeing probably won't provide much additional growth during the next couple of years.

c. Finally, population growth remains strong. This should also help to keep the state's economy in general -- and housing in particular -- healthy.

2. Moreover, it's important to note that the construction sector isn't the primary engine for growth in this state.
 - a. Real estate slowdowns have caused problems in areas like New England and Arizona, where building activity got way ahead of demand and became the primary impetus for economic growth.
 - b. I don't see that happening here.
 3. Based on anecdotal evidence, activity in this state's real estate markets may be beginning to back off the heady pace of the past year or so.
 - a. That's certainly what a number of forecasters are expecting.
 4. Such a slowdown can be considered healthy and doesn't necessarily mean that the real estate sector here is in trouble. And it certainly doesn't mean that the state's economy as a whole is at risk.
- V. Regardless whether or not the outlook for specific markets is bright, I think it's important to note that certain recent developments, particularly in residential investment, are generally encouraging.
- A. First, housing investment is now more resilient to interest rate shocks than in the past.
 - B. Second, housing finance and, I would argue, real estate finance generally is now less subject to credit crunches and other dislocations.
 - C. Third, interest rates themselves have been less volatile in recent years.
 - D. Let's look at these developments in more detail.
- VI. Historically, housing investment has had close relationship with cycles in interest rates.
- A. When interest rates rose, housing investment took a nosedive.
 1. Rising interest rates raised cost of investing in housing.
 2. Also they tended to restrict supply of mortgage credit, making financing not only more expensive, but just plain harder to obtain.
 - B. So, when Fed tightened monetary policy, real estate tended to be the first sector affected.

- C. In recent years, however, the link between real estate activity and interest rates has become weaker, particularly in the housing sector.
- D. What accounts for this change?
- E. In a nutshell, financial deregulation and innovations in housing finance.
 - 1. Prior to deregulation, supply of housing credit suffered from bouts of disintermediation whenever interest rates rose.
 - a. Disintermediation occurred because traditional mortgage lenders (banks and S&Ls) weren't allowed to raise deposit rates to keep up with rising market rates.
 - b. Below-market returns prompted depositors to seek higher yields elsewhere -- typically in T bills.
 - c. This, in turn, left lenders temporarily without the funds to make mortgage loans, and prompted periodic credit crunches.
 - 2. Beginning in the early 1980s, deposit rates were deregulated.
 - a. As a result, disintermediation and mortgage credit crunches have become a much smaller issue.
 - b. Funds flows now appear to be relatively uncorrelated with interest rates, whereas in 1960s and 1970s, there was strong negative correlation.
 - 3. Another factor that has led to weaker link between housing and interest rates is deepening of secondary markets and relaxation of regulatory restrictions on mortgage instruments.
 - a. Secondary mortgage markets have been a boon because
 - (1) they have tied housing finance into national credit markets, and
 - (2) have made supply of credit less dependent on deposit flows.
 - b. ARMs also were a watershed for housing finance.
 - (1) ARMs offer interest rate-risk management tool that enables lenders to increase supply of mortgage credit.
 - (2) From borrowers' perspective, ARMs also improved affordability picture.

- (a) Prior to authorization of ARMs, spikes in interest rates created problems for affordability.
 - (b) ARMs reduced these problems by giving lenders more flexibility to change loan features to accommodate borrowers' changing needs over rate cycle.
 - (c) The fact that ARM issuance (as a share of new mortgages) moves in lockstep with interest rate fluctuations shows how ARMs are helping alleviate cyclical affordability problems.
- F. For all these reasons, then, housing finance has become less prone to credit crunches, and housing investment, in turn, has become less sensitive to interest rate cycles.
 - G. In addition, interest rate cycles themselves have become less pronounced.
 - 1. In recent years, the level of interest rate volatility has declined and is now on a par with the best periods of the 1960s and 1970s.
 - H. Thus, as a result of both a weaker interest rate/housing link, and less volatile interest rates, cycles in investment have been dampened.
 - 1. Peak-to-trough swings in housing starts are in the half-million unit range today, versus the giant, 1.5 million unit swings we saw in the 60s and 70s.
 - I. Bottom line is that monetary policy is not having the same impact on residential investment that it has had in the past.
- VII. These developments have implications for the way the current restructuring in the thrift industry will affect housing and real estate investment.
- A. To be sure, the thrift crisis is restricting the supply of credit.
 - 1. However, banks are picking up some of the slack.
 - 2. But even banks are being more selective these days.
 - 3. Such limitations on the availability of credit no doubt are having an impact on the level of activity in the real estate industry.
 - a. This is good to extent it is helping to promote more rational and prudent investment.

- b. But credit restrictions may be having an impact on financing for sound projects, as well.
 - 4. Fortunately, these adverse influences are only temporary.
 - a. The deregulation of deposit rates, the deepening of secondary markets for mortgage instruments, and the introduction of new mortgage instruments will help to minimize dislocations caused by thrift restructuring.
 - b. Also, because financial markets are now more resilient, the loss of even a sizable number of lenders should not create long-term problems for the supply of credit.
 - 5. And with the demise of "go-go" lending by weak thrifts, I think we can look forward to a stronger real estate industry in the long run.
- VIII. In conclusion, 1990 isn't going to be a banner year for the real estate industry.
- A. Fed's commitment to eliminating inflation means a slow-growth environment for some time to come.
 - B. Fortunately, the real estate industry is no longer quite so tied to interest rate cycles and changes in Fed policy.
 - C. Consequently, if you compare the industry's prospects in 1990 with its performance in prior economic slowdowns, the outlook isn't too bad.