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REAL ESTATE: ITS STAKE IN SOUND DOLLARS

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at the 50th Annual Convention
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REAL ESTATE: ITS STAKE IN SOUND DOLLARS

In a recent speech to the Iowa Real Estate Association, your president was reported to have said that sound real estate investment is the best guard against possible inflation. His statement might be rephrased as a question: "If we do not guard against inflation, will real estate investment be sound?" The key word is, of course, "sound". Sound investments and sound dollars are of mutual concern. Unless one subscribes to the philosophy that a steady upward push of costs and prices is inevitable, then the answer to my question must be "no". Otherwise, the downward adjustment of real estate values that has tended to follow sharp increases hurts thousands of families and businesses with equities acquired during unsustainable booms.

To minimize wide swings in real estate and in economic activity generally, is the proper concern of us all. The fight to maintain stable values in a high level economy, however, is not an easy one. Even though there may be signs that the threat of unbridled inflation may have disappeared, at least temporarily, the upward pressures still call for vigilance.

Every battle worth fighting has its price, and the battle for stability is no exception. In financial markets that price takes the form of higher interest rates, of increased difficulty in borrowing, and of differential impacts on economic sectors. Some worthwhile projects of business and government alike have had to be postponed as sharply increased demands for funds have outdistanced the large, though inadequate, supply.

In this race the winners have been those able or willing to pay the increased price for credit. The allocative function of the market place has operated to weed out those unable or unwilling to pay the increased price resulting from demands that exceed supply. Even if it had desired, the

Federal Reserve would have been powerless to influence this process of credit allocation, because its role is limited to influencing the total supply of money and credit, not its components.

Rigidities in real estate markets

Because of the worsening relation of yields on federally underwritten mortgages to those on other loans and securities, it was inevitable that a large sector of the real estate and construction industries could not compete for limited funds as effectively as other industries. The inflexibility of interest rates on FHA-insured and VA-guaranteed mortgages has placed them at a distinct disadvantage in attracting investors' funds during a period when interest rates and yields on competitive investments have been rising. This disadvantage was partially alleviated by resorting to market discounts,--a procedure that has created certain problems for builders, realtors, lenders, and administrators. In contrast to conventional mortgage rates, the inflexibility of FHA and VA rates has interfered with the smooth operation of mortgage and real estate markets. Flexible rates for real estate mortgages are just as essential as flexible yields on corporate securities to the proper functioning of the capital market. Mortgage borrowers, whether they are interested in VA, FHA, or conventional loans, should be able to compete with non-mortgage borrowers for available savings.

The record of the past two years shows clearly that the decline in residential construction from unusually high levels has been almost entirely in units financed with federally underwritten loans. Those purchases of houses, both new and existing, that have been financed with conventional mortgages, whose rates have been free to move with other capital market yields, have shown relatively little change. Moreover, when the record of the full postwar decade is examined, the evidence points to the fact that interest rate inflexibility has been a primary factor underlying wide fluctuations in the flow of funds into FHA and VA financed real estate transactions. The ebb and flow of such funds has coincided with diminishing and increasing spreads between fixed FHA and VA contract interest rates and flexible conventional mortgage and bond yields. It is ironic, to say the least, that Federal mortgage underwriting programs, introduced ostensibly to provide a measure of stability to residential real estate markets, have tended at times to contribute importantly to instability.

Whatever the underlying causes and factors, it is clear that the Federal government has come to play a more strategic role in real estate markets than in any other sector of the non-farm economy. Well over half of the credit extended for new house purchases and about one-fourth of that extended for existing house purchases in recent years has been financed with federally underwritten mortgages; over two-fifths of the total home mortgage debt outstanding is federally guaranteed or insured; the Federal National Mortgage Association holds nearly $4 billion of mortgage loans; and the Federal Home Loan Bank System has over $1 billion in loans outstanding to member savings and loan associations.

Some important specialized sectors of the real estate and mortgage industry have come to depend even more heavily than these figures suggest on Federal mortgage programs. I quote from a recent study prepared for the National Bureau of Economic Research by Mr. Saul B. Klaman of the Board's staff. In the years 1953-1955, between 75 and 80 per cent of loans closed and 90 per cent of those held by mortgage companies were federally underwritten. There is no doubt that the extraordinary growth of the mortgage banking business in the postwar decade is related directly to the introduction and expansion of Federal mortgage insurance and guaranty. This great dependence on Federal programs has made mortgage companies, and indeed the entire mortgage and real estate business, particularly vulnerable to unpredictable statutory and administrative changes that at times have not been based on economic realities. The time may well be at hand for the real estate, construction, and mortgage industries to do some renewed soul searching in evaluating their role in the economy and their relationship to and reliance upon Federal support, whether direct or indirect.

Certainly, the solution to your marketing problems will not be found in expanding bank credit sufficiently to meet all credit demands, weak as well as strong. That route can lead only to outright inflation with all its attendant hardships and indiscriminate evils. Rather the answer is to be found in making free markets work. A basic step towards this end is to remove institutional rigidities, such as legal limitations on interest rates payable on mortgages and on school bonds. If we have free markets in combination with sound monetary and fiscal policies, the long-term social gains from the economy will depend on the quality of decision making by business, by labor officials, and by individual consumers.

Aspects of monetary policy decision making

With respect to the wisdom of decisions on monetary policies, the Federal Reserve lays no claims to omniscience. The System operates within a framework of the best obtainable economic intelligence relating to foreign as well as domestic affairs. In the light of this information, it seeks to make a balanced assessment of the course of economic events, a course that is seldom obvious.

The making of monetary policy, moreover, does not hinge on the precise determination of turning points; it is made in the light and anticipation of constantly shifting forces and changing events. At least one certainty among these uncertainties is that the System should never commit itself to a fixed course of future action. Always, it must stand ready to adjust its policy to the needs of the economy if stability and sustainable economic growth are to be attained. Such flexibility of policy has been evident during the past two years at times when the System has relaxed or increased the degree of credit restraint. The underlying forces operating in this period became evident when these relaxations were followed by such a quickening of inflationary pressures as to indicate the continued need for restraint.

In its constant review of monetary policy, the System has access to three main instruments which it uses according to the gradation of refinement and delicacy desired in influencing economic conditions. Changes in open market operations and in rediscount rates have the delicate touch of a plane or chisel. Adjustment of reserve requirements, on the other hand, is a blunter instrument. Inasmuch as Federal Reserve policy is formulated by humans and not machines, error in judgment is inescapable. It is human to err, of course, but it is also human to benefit from past experience.

In this respect it seems true in the wisdom of hindsight that credit was probably made too easily available in 1954, leading to excesses and overexpansion in certain areas of the economy in the succeeding two years. This seems particularly to have been true of the home-building and real estate industries during 1955. The subsequent decline in residential real estate activity from unusually high levels has reflected in part the increased competition for the large, though limited, supply of savings from other sectors of the economy, including business, consumers, and governments. In part, also, the decline reflected rising building material prices and construction costs.

In this setting of maximum utilization of men and materials, neither investment in, nor consumption of the products of construction could have been expanded further simply by inflating the flow of money with additional bank credit. The only result of additional credit would be a further bidding up of costs and prices. Moreover, even if total credit were expanded there is no guarantee that market forces would have directed the increased flow toward the real estate industry. It cannot be stressed too strongly that it is not the task, nor is it within the power, of the Federal Reserve to allocate credit to particular economic activities, or to favor some groups of borrowers over others. The System is concerned primarily with the total volume of credit, and with total production and total incomes in the economy, and only indirectly with component parts. New savings for investment in housing, or in real estate, or in business plant and equipment, or in the construction of schools and roads, can come ultimately only from the people of our nation willing to withhold a part of their current income from consumption.

If the economic situation is in fact changing so that available savings are becoming more adequate to meet investment demands, then housing may receive a larger portion, and may provide underlying strength to the economy. The fact that some demands for housing, for schools, for highways, for consumer durables, have had to be postponed in the setting of credit stringency means that they may stand ready to absorb investible funds when demands for plant and equipment slacken and credit eases. This process of demands rising in some sectors and falling in others has often been described as one of rolling adjustment. It contributes to overall sustained growth in the economy.

Recent real estate and mortgage trends

During the recent period of rolling adjustment, construction activity other than residential has been rising since 1955; home building has been declining. This decline represents in part a reaction to the very high rate of starts in early 1955, and in part consumer resistance to high construction costs. Important also, as I have stressed already, has been the inflexibility of interest rates on FHA and VA loans which has interfered with the normal functioning of free competitive markets. Since the market for existing houses has been less dependent upon FHA and VA loans, transactions in this market in 1956 exceeded 2 million. This volume equals that of

1955, and is greater than in each year of the previous half decade. Although 1957 sales of existing houses have declined somewhat, they are still relatively high.

Reflecting the continued large volume of activity in existing house markets and the building of larger, better equipped houses at higher prices, the gross volume of home mortgage credit generated in 1956 was only 5 per cent below the extraordinarily high level of 1955. This year the extension of credit on new and old houses has been at a rate some 10 per cent below the year-ago volume. Despite a continued heavy volume of mortgage repayments on all types of real estate, the 1956 expansion in total mortgage indebtedness was close to $15 billion, a rate exceeded only in 1955. This year, total mortgage debt will probably increase by about $11 billion, which is much greater than that of any other single debt category, short or long, private or public.

This brief review of recent developments in real estate and construction suggests that, despite some declines from very high levels, the overall picture is one of underlying strength and active markets. Moreover, the present position of the real estate industry must be evaluated against a background of longer term developments. Since the end of the war, we have built more than 12 million private housing units representing an expenditure of some $150 billion or over one-fourth of the total value of all private investment in this country during the past 12 years. Over $95 billion of mortgage funds have been absorbed by the housing industry and another $22 billion by nonresidential building and real estate activities. This net volume of mortgage borrowing exceeded by a wide margin the combined net volume of long-term borrowing by corporations and by State and local governments. It was equal to about two-fifths of the entire expansion in all forms of public and private indebtedness.

Significance of real estate and construction in the economy

This tremendous postwar expansion in absolute and relative terms has served to emphasize the bigness of the industry of which you are a part. Although our measures are not precise, they indicate that building construction is probably the most important single industry in the United States; that real estate represents by far the largest component of the nation's wealth; and that mortgage debt is the largest component of the nation's debt structure. Translated into human terms, home ownership is the most important asset of many American families and home mortgage debt is their greatest liability. For the small merchant, also, store ownership usually represents his principal asset.

The importance of real estate wealth, of construction activity, and of mortgage debt stems in part from their magnitudes; in part from their intimate relation to the personal affairs of our citizens. Changes in real estate values have a far-reaching influence also on the solvency and liquidity of those financial institutions that hold mortgages. The sharp reduction of equities and the inability of small businessmen to liquidate real estate holdings were important factors compounding the economic debacle of the 'thirties. Through the years, wide swings in building activity, in real estate values, in rents, and in the soundness of mortgage investments have been recurrent.

If these swings are to be reduced, then public policy should be directed towards restraining total demand when it becomes overexuberant, thereby minimizing boom-time excesses and painful aftermaths. The adoption of policies to stabilize economic activity generally is probably the most important single step that can be taken in this direction. If governmental influence is used only to stimulate markets, regardless of economic and real estate conditions, then it will contribute to economic instability by encouraging overexpansion.

The struggle for stability is a struggle against extremes; it needs to be directed with equal intensity against inflation and deflation, by both private and public policy-makers. If public policy, together with business and labor policies, are pursued courageously and wisely, there is no reason why we cannot provide a steadily improving scale of living for our mounting population. To achieve this goal by avoiding economic imbalances is a proper concern of us all.