

Long-Run View of Construction Financing

Darryl R. Francis, President
Federal Reserve Bank of St. Louis

The chief problems of construction financing over the next decade probably will center in the housing area. Business firms, assuming they have adequate capital and favorable prospects, can generally attract sufficient funds for their projects by paying competitive interest rates.

The housing industry is particularly vulnerable to economic fluctuations for several reasons. Financing costs represent a substantial portion of the total costs of a home since most loans are made for extended periods, and hence, interest rate increases have a relatively large impact on the total cost of home ownership. Then, too, market impediments make it difficult for home purchasers to compete for funds when interest rates are relatively high.

Interest rates are likely to remain high in the next decade, in part because of massive fiscal actions necessary to provide government services that are being demanded and in part because of inflationary pressures that are likely to persist. For example, in order to encourage economic recovery, the Government has increased its expenditures markedly and reduced taxes. In the fiscal year ending

next June 30, the deficit in the national income accounts budget is estimated to be about \$70 billion, compared with an average of \$27 billion in the two previous years. Financing the huge deficit may be expected to place strong upward pressure on interest rates. To the extent that this upward pressure on interest rates may be dampened in the short-run by money creation, inflation will be intensified, ultimately causing interest rates to move still higher later.

Many Government programs, such as social security and food stamps, provide funds to those who probably save a smaller portion of their income than other families. These programs are financed by taxes levied on those families who might otherwise save and invest a portion of their larger disposable incomes and by borrowings in the capital market in competition with private borrowers. As a result, cost of lendable funds for home financing tends to be increased.

As interest rates rise, home financing is generally placed at a disadvantage relative to other borrowing because of a number of market impediments. In many states, usury laws limit the allowable interest rates charged on residential real estate loans more severely than the rates on loans to corporations. Hence, when market interest rates rise above the usury ceilings, available funds tend to

flow to business borrowers or to states with less restrictive laws. Also, thrift institutions, which finance the bulk of home purchases, are limited by law in the rates they can pay depositors. When market rates rise above these limits, thrift institutions lose deposits and fewer funds are available for housing.

The chief problems that I foresee for the financing of housing in the future could be eliminated at minimal costs to society. In fact, the general public, as well as the homebuyer, would be benefited. The major problem for the *financing of the* housing industry, as I see it, is high interest rates which are caused in large part by inflation. Reducing the rate of inflation could be accomplished if Government spending were reduced and the growth rate of the money stock were moderate.

Also, home financing at the anticipated higher interest rates could be facilitated if some of the market constraints were removed. Not only would potential homebuyers be better able to compete for the lendable funds, but small savers and lenders would also have a greater incentive to provide more funds to finance housing.