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The Effects of Inflation on Homebuilding

Address by

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Inflation affects every American and every form of enterprise. But those who are engaged in the homebuilding industry have felt the impact of inflation with especially devastating effects in recent years. Therefore, I am truly pleased to share with this audience of mortgage lenders my conviction that we as a Nation are entirely capable of achieving sustained, noninflationary expansion of our economy in the future.

Since the early months of last year, homebuilding has experienced a significant revival from the drastic slump that began in 1973. The market for single-family housing has become quite active in many parts of our country, and the improvement has recently spread also to the multi-family sector.

The homebuilding industry, nevertheless, continues to face formidable problems. Extensive unemployment is retarding sales of both new and existing homes. Builders and developers are experiencing increased costs on account of zoning ordinances and delays on sewer and water hookups. Other regulations designed to maintain environmental quality are also proving costly. The rising cost of fuel and utilities is causing some hesitation among prospective homebuyers. Higher prices of gasoline, and lingering uncertainty about its availability, are tending to discourage building in outlying areas. Inflation has pushed interest rates on home mortgages to an extremely high level. On top of that, the cost of a new home has been soaring, so that a large and increasing proportion of our citizens now find it difficult -- if not impossible -- to achieve the traditional American goal of owning their own home.

Inflation is not a new problem for our Nation's home-builders. Throughout the past century, if not longer, home-building has tended to turn down when the general price level rose and credit markets tightened. In the first two decades after World War II, inflationary pressures were still of an episodic character, as they had been in earlier years. Once excess demand for goods and services was eliminated, the price level stabilized or actually receded. At such times, interest rates generally retreated on a broad front, and activity in the homebuilding industry soon rebounded strongly.

Since the mid-sixties, however, the general level of prices has kept going up in both good times and bad. The problem of inflation has thus taken on a new and ominous character. No appreciable slowdown in the advance of wages and prices occurred during the mild recession of 1970.

During the severe recession in late 1974 and early 1975, inflation did decline -- from an annual rate of about 13 per cent to 7 per cent. In part, this slowing of inflation reflected the absence of special factors -- such as the enormous increase of OPEC oil prices and the lifting of wage and price controls -- that had caused prices to skyrocket in 1974. But since mid-1975, despite continued high unemployment and much idle industrial capacity, there has been little further decline in the underlying rate of inflation.

I have on other occasions discussed at length the reasons why inflation has become chronic in our country. Large and persistent deficits in the Federal budget were directly responsible for the accelerating inflation of the late 1960's and early 1970's. Lack of discipline in governmental finances has thus been the dominant source of the problem. And as often happens in human affairs, laxity in national financial policies spilled over into private markets.

Many businessmen and financiers came to believe that the business cycle was dead -- that governmental policies could be relied upon to keep the economy expanding indefinitely. Canons of prudent management that had been developed through years of hard experience came to be regarded as old-fashioned or were simply forgotten. Hence, many investment projects were undertaken carelessly; and liquidity positions and equity cushions were allowed to deteriorate, while debts piled up at a rapid pace. In this environment, even as the productivity of our Nation's workshops languished, the resistance of business managers to demands for wage increases weakened, and trade unions used their growing power to push up wage rates far above productivity gains.

With business caution giving way to exuberance, speculative fever mounted. The first major wave of speculation, which began in 1965, resulted in numerous corporate mergers, including the formation of all sorts of conglomerates. This merger movement was reinforced, and to a degree made possible, by the speculative movement that developed in the market for common stocks. The volume of trading on the New York Stock Exchange doubled within five years, prices of many stocks shot up with little regard to actual or potential earnings, and the new breed of "performance funds" flourished.

A little later, during the early 1970's, another speculative wave engulfed the market for real estate. Merchant builders moved ahead energetically in response to easy credit and Federal subsidies. Single-family homes were put up well ahead of demand, and the inventory of unsold homes doubled between 1970 and 1973. Speculative activity was even more intense in the case of apartments built for renting, and particularly in condominiums and cooperatives -- which accounted for a fourth of the completions of multi-family structures by the first half of 1974. Vacancies in rental properties therefore kept increasing after 1970.

The speculative boom in real estate was not confined to residential structures. It extended to speculation in land, to building of shopping centers, and to construction of office buildings. By 1972, the vacancy rate in office buildings across the Nation reached 13 per cent, but this type of construction still kept climbing.

As the pace of inflation quickened, seeds of serious trouble were sown across the economy. Fearing shortages and further price increases, business firms frantically stockpiled industrial materials and other supplies during 1973 and early 1974. Interest rates climbed to unprecedented heights. Many of the major industrial corporations, and even some of our Nation's banks, found themselves in a somewhat precarious financial condition. The recession that inevitably followed was by far the most serious of the postwar period, and the collapse of housing production played a major role in the depth and severity of the general economic decline.

In the course of the recession, many of the imbalances that had developed among the various sectors of the economy were reduced. Determined efforts to cut costs and improve efficiency got under way. Inflationary tensions moderated, and the condition of financial markets improved.

These and related adjustments paved the way for a recovery of homebuilding and other branches of production. As conditions in financial markets eased and interest rates declined, the inflow of deposits to mortgage lenders -- particularly to saving and loan associations -- rose swiftly. Sales of new and existing houses increased, inventories of unsold units gradually moved down, and new housing starts began to rise. A full recovery of residential building has, however, eluded us -- and it will continue to elude us until our Nation makes further progress in freeing itself from the grip of inflation.

One of the most damaging results of inflation is the persistence of high interest rates. The basic reason for the high interest rates in our times -- particularly on mortgages and other long-term debt contracts -- is the relentless rise of the general price level since 1965. Inflationary expectations have by now become well entrenched in the calculations of both lenders and borrowers. Lenders reckon that loans may be repaid in dollars of smaller purchasing power, and they therefore tend to hold out for nominal rates of interest that are high enough to ensure a reasonable real rate of return. Borrowers, in their turn, are often less resistant to rising costs of credit, because they too anticipate repayment in cheaper currency.

The marking up of nominal rates of interest during periods of inflation is a process that is all too familiar to economic historians. Businessmen and laymen, too, have seen its recent manifestation in Great Britain and Italy, to say nothing of some Latin American countries. High interest rates are a companion of inflation, and both pose perils for the housing industry.

The underlying rate of inflation now appears to be around 6 per cent, and it could well increase as our economy returns to higher levels of resource utilization. Participants in financial markets are keenly aware of this. Although fears of inflation have lessened and long-term interest rates have fallen, they still contain a sizable inflation premium. For example, home mortgage interest rates have declined by 1 to 1-1/2 percentage points from their cyclical highs in 1974, but they still run close to 9 per cent at present.

The effect of these high mortgage interest rates on the ability of potential homebuyers to meet monthly payments has been compounded by the explosion of housing prices. The median price of a new home today is close to $45,000 -- nearly double the level that prevailed in 1970. Over the past six years, the prices of new homes have risen almost twice as fast as the average level of consumer prices -- and they are still increasing.

Other costs of homeownership have also skyrocketed. Since late 1973, the cost of fuel and utilities has risen by roughly 50 per cent. In the aggregate, property taxes and other costs of home ownership -- such as insurance, maintenance, and repairs -- have outstripped by far the average rise of family incomes.

For a time, increasing numbers of families sought to meet their housing needs by purchasing a modestly-priced mobile home. Sales of this type of dwelling rose by almost 50 per cent between 1970 and 1972. Since then, the average retail price of mobile homes has nearly doubled, rising to its present level of about \$13,000; the cost of buying or renting a site has also increased. For many families, the purchase of even a mobile home has become prohibitively expensive, and sales of these units are now proceeding at only a third of their volume four years ago.

The effects of inflation on homebuilding activity have been even more severe in the multi-family sector than in the markets for single-family homes. Starts of single-family houses -- although still somewhat below their 1972 level -- have at least shown a good recovery since early 1975. Starts of multi-family units, on the other hand, did not begin to rise until this summer, and they are still running at a level less than half that of four years ago.

Continued weakness in apartment construction partly reflects the overbuilding of condominiums and rental units in many parts of the country during the speculative boom of the early 1970's. Over the past year and a half, the demand for rental space has risen and the vacancy rate for rental units has generally declined. Nevertheless, the slump in constructing multi-family buildings has continued.

Inflation has created serious difficulties for developers and investors in the multi-family sector. In an inflationary environment, prospective construction costs are highly uncertain for a project that takes a considerable time to complete -- as is the case with apartment buildings. Moreover, high interest rates on construction and mortgage loans cut deeply into profits, and investors have become apprehensive about their ability to achieve a level of net income adequate to compensate them for the risks they must incur. In recent years, rent increases have lagged behind the rising costs of operation. Since mid-1973, average rents have advanced about 15 per cent, while costs of operating apartment houses increased over 25 per cent.

This lag in rents reflects the relatively long-term character of many rental contracts, besides some concern that rising rents may provoke angry protests from tenants. Rent controls have also become a limiting factor. They are presently in effect in over 200 communities in which 15 per cent of our urban population resides. Moreover, the fear of coming rent controls may be moderating rent increases in other areas -- where rent ceilings are permitted but not yet in effect, or where rent control is now being seriously discussed.

In view of the continuing difficulties confronting the multi-family sector, commercial banks and other lenders are still cautious in committing funds to builders and developers for apartment construction, or in providing the necessary long-term financing. Moreover, real estate investment trusts, which got into trouble during the speculative boom in multi-family residential construction, still face very difficult financial problems. For the past two years they have been liquidating mortgages, and few of them are yet in any position to make sizable new loan commitments.

Of course, progress has been made over the past two years in dealing with the many problems surrounding multi-family construction. That is why activity in that sector of the homebuilding industry is now moving up again. Realistically, however, we cannot expect a return to boom conditions in the construction of rental buildings or condominiums in any near future, and that -- I believe -- is fortunate. A gradual and sustainable rise in the volume of multi-family construction will do far more for the health of the housing industry, and also for the health of our national economy, than would a resurgence of speculative exuberance.

I hope that this preference for solid and sustainable progress will guide our governmental housing policies. When unemployment is as high as it is currently, policymakers face persistent pressures to pump up activity in housing and other industries through monetary and fiscal measures. Expansionist financial policies have considerable merit as a means of reducing unemployment when the price level is relatively stable or declining. But such policies are apt to be less effective when unemployment and inflation go together -- which has become our ordeal.

In practically every industrial nation around the world, the rapid inflation of the early 1970's led to larger precautionary savings, sluggish consumer buying, and a weakening of business confidence. In the present environment of deeply-ingrained inflationary expectations, the results of traditional policies of economic stimulation are less predictable and less dependable than they were in earlier decades. The risk is greater now that fears of inflation will intensify and substantially weaken the intended effects of expansionist policies on business investment and consumer spending.

I have been asked recently whether a tax cut is desirable at present. For the reasons I have already suggested, and also because I anticipate a resurgence of the economy, I see no advantage in a tax cut at the present time. My mind on this subject, however, is by no means closed. Later on, I will weigh the issue carefully if economic conditions or expenditure economies seem to warrant a tax reduction. I might add that if it appeared desirable to attempt to stimulate the economy through a tax cut, among other ways, I would be inclined to favor the type of measure that President Kennedy recommended in the early 1960's -- namely, a broadly-based tax reduction for both individuals and businesses. Such a measure, on a responsible scale, would minimize social conflict and have the best chance of producing lasting economic benefits for our country.

In the case of the housing industry, as in other sectors of the economy, we would be well advised to use the traditional measures of monetary and fiscal stimulation cautiously and to rely more on structural policies that can contribute to reduction of unemployment without risking a new wave of price increases or otherwise creating problems for the future. For example, much of the construction activity across our land is still subject to outmoded building codes and work rules that hamper productivity.

The wage provisions of the Davis-Bacon Act continue to escalate construction costs. And more realistic apprenticeship programs could certainly be developed to improve the supply of skilled labor in the building trades.

We also need to reassess the consequences of the various environmental regulations adopted in recent years. These regulations have introduced long delays in obtaining approval for building projects and have otherwise run up the costs of real estate development and operation. At the Federal level alone, a dozen environmental regulations may apply to any given housing project. Moreover, overlapping regulations at the Federal, State and local levels, besides causing confusion and delay, sometimes work at cross purposes.

Environmental regulations offer great promise for improving the quality of life; they are essential to human welfare in a modern society. But in our eagerness to improve the environment, we should try to avoid regulations that unnecessarily impede investment in housing and in business fixed capital. These too are essential to economic and social progress.

Structural reforms to smooth out the flow of mortgage credit would also be in the long-run interest of homebuilding. State usury laws are not now a major impediment to the flow of mortgage credit to potential home buyers. They were, however, a year or two ago, and they might again become a major obstacle in the future. We should continue to work for their removal. Further steps should also be taken to reduce the instability of savings flows to saving and loan associations and other financial institutions that supply funds for home financing.

In particular, I believe our Nation would be well-served by larger use of variable-rate mortgages, with attendant safe-guards, so that savings institutions could raise the rates they pay on deposits during periods of rising market interest rates and thereby sustain deposit inflows. Such a development would be beneficial to small savers as well as to the mortgage market, and it would diminish the need for regulatory interest-rate ceilings on savings deposits.

It has at times been suggested that the recurring financing problems of the housing industry would be relieved, if not actually solved, by contractual arrangements that make it easier to live with inflation -- such as mortgages whose principal is adjusted according to the cost of living, or savings deposits whose purchasing power is guaranteed. Such suggestions are neither sound nor practical. For one thing, there is no feasible way to renegotiate already outstanding mortgages or other long-term loan contracts. But unless that were done, the institutions that guaranteed the purchasing power of their deposits would expose themselves to intolerable risk. More important, if a nation with our traditions ever embarked on a systematic plan to make it easier to live with inflation, rather than to resist its corrosive influence, we would slowly but steadily lose the sense of discipline needed to pursue governmental policies with an eye to the permanent welfare of our people.

The single most important step our government could take to improve the long-run prospects for homebuilding activity -- and for the economy at large -- would be to gain better control over the forces of inflation. Restoration of reasonable stability of the general price level would lead to a sharp decline of interest rates on home mortgages. It would certainly reduce substantially the rise of construction costs, housing prices, and home maintenance and operating expenses. Residential builders would then be able to project their revenues and expenditures with greater confidence, as would also the ultimate investors providing capital for large-scale development projects. There can be little doubt that an environment of stable prices would assure a brighter future for homebuilding.

Bringing an end to inflation would be equally beneficial to other major sectors of our economy -- in particular, to business capital investment. Businessmen were unprepared for the slump in sales and production that resulted in 1974 and early 1975 from an inflationary process that got out of control and undermined the strength of our economy. In the aftermath of this harsh experience, the renewal of confidence needed for a new surge of investment activity has proceeded rather slowly. But once it becomes clear that the recent gains in the struggle against inflation are being extended, confidence in our Nation's economic future is likely to deepen, and business firms should begin to move forward more boldly with long-term investment projects.

Progress in reducing inflation must therefore remain a major objective of public policy, along with reestablishment of reasonably full employment and reasonably full utilization of our industrial capacity. Actually, these policy objectives are inseparable. The experience of other countries around the world, as well as our own, indicates that lasting prosperity cannot be attained in an environment in which expectations of inflation remain intense.

The principal contribution that the Federal Reserve can now make to the achievement of our Nation's basic economic objectives is to adhere to a course of moderation in monetary policy. That principle has guided our efforts to facilitate economic recovery and prevent a new wave of inflation. Firm adherence to a policy of moderation has helped to build confidence that inflation will taper off. And this in turn has made it possible for interest rates to decline even as economic activity has kept expanding.

Monetary policy alone, however, cannot solve our Nation's stubborn problem of inflation. We must work also to eliminate its primary source -- the persistent deficits in the Federal budget. And we need to give far more attention to structural measures for lessening the powerful bias toward inflation that has been created within our economy by imperfectly functioning markets and a host of governmental regulations that impede the competitive process and run up costs for business enterprises.

As we have learned, there is no easy way out of the inflationary morass into which we have strayed through negligence and imperfect vision. But we are making progress. I am confident that we will succeed if the American people, who are alert as never before to the danger of inflation, remain steadfast. This Association has in the past played a vital role in educating our citizens about the dangers of inflation and in encouraging government officials to pursue responsible financial policies. I strongly urge you to expand your educational efforts. For in the measure that we succeed in reducing inflation, we will restore the conditions essential to a stable prosperity -- for the homebuilding industry and for the economy at large. Triumph over inflation, I believe, is well within our means.

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