Remarks by Governor Laurence H. Meyer

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Housing and the Economy: Sharing in the Prosperity and Broadening Its Base

I expect we have a very happy group of home builders here today. You should be happy. The economy is performing exceptionally well and the housing industry is both benefiting from and contributing to that performance. Indeed, I believe that the housing industry, more than any other, has benefited from effective public policy in recent years.

But I do not want to give more credit to public policy than it deserves. Perhaps the most important contribution of public policy has been to set a stable foundation for private sector decisions--specifically a balanced federal budget and low inflation--and then to get out of the way and allow the private sector to do what it does best--produce goods, innovate, compete and raise living standards.

I want to focus on two themes today. First, the housing industry provides a perfect example of the extraordinary fundamentals that have been driving the expansion and of the significant role public policy has played in promoting strong economic performance. Second, public policy has to be concerned with more than aggregate and average performance; it also has to pay attention to the degree to which the prosperity is being shared. In particular, I want to emphasize the important contribution that affordable housing programs are making in expanding opportunities for many low and moderate income families to achieve the American dream of home ownership.

The Housing Market and the Economic Outlook
The strength of the housing market has clearly paralleled the exceptional overall performance of the U.S. economy. We can see the role of strong fundamentals clearly in play in this market-- including robust growth in income and employment, increased wealth, low mortgage rates, ample credit, and high levels of consumer confidence.

As household income has risen and mortgage interest rates have fallen to levels only slightly above 30-year lows, the proportion of income that is required to finance a home purchase has decreased. Largely in response to this improvement in housing affordability, but also reflecting efforts to broaden access to credit markets, the home ownership rate has risen to 65.9% in the first quarter, which is the highest first-quarter reading in the thirty-four year history of the series.

In the first quarter of this year, new home sales were the highest in any quarter since the series began in 1963, except for one quarter in 1978. Sales of previously owned homes were at an all-time high during the first quarter. And, as builders know first hand, housing construction has been very robust. Construction of single family homes rose 9% in the first quarter to 1.24 million units, the highest quarterly average since late 1993, when mortgage rates were even a bit lower than they have been recently.

As expansions progress, it is not unusual for excesses to develop that increase the vulnerability of the economy to a downturn. These imbalances often include excess demand in labor and product markets that raise inflation, overbuilding in key industries, reductions in margins of safety in financing, reflected in easier underwriting and more aggressive loan pricing, and increased tolerance for or reduced appreciation of risk, resulting in increases in the price of risky assets relative to safe assets.

I do not believe we see much evidence of these developments in the housing industry to date. Increases in house prices have picked up, although only moderately. The price of a new home of consistent quality increased 3.3% on a year over year basis in 1997, exceeding the annual increase in the CPI for the first time since 1993. In the first quarter of this year, the constant-quality home price rose at a 3.9% annual rate. The price of constant-quality existing homes, proxied by an index based on repeat sales, increased a bit more rapidly. In the second half of 1997 they were up nearly 5% from the previous year. And judging from the historically low level of homes for sale relative to sales, builders appear to have been exercising considerable restraint with regard to their inventory, perhaps in an effort to avoid repeating past episodes of overbuilding.

To the extent that growth slows in coming quarters, as projected in consensus forecasts, some moderation is likely in the pace of housing starts and the slowing trend is likely to continue into 1999.

Just as it is useful to keep in mind a concept of long-run productive capacity and trend growth in evaluating the outlook for the overall economy, it is helpful to consider a similar concept for the housing industry. The relevant concept for housing might be the demographically justified increase in housing starts. In the long run, abstracting from cyclical swings in income growth and interest rates, housing starts track household formations and hence demographic trends. We have to allow as well for changes in the inventory of unsold homes and estimate the residual effect on housing demand of factors such as purchases of second homes, demolitions and casualty losses, and net conversions of units between the housing stock and nonresidential structures. The sum of these factors indicates the number of newly produced housing units, including both single and multi-family starts and mobile home shipments, justified by demographics and other long-run determinants of demand. Converting this to housing starts--by eliminating the projected trend rate of mobile home shipments--this cyclically neutral estimate for housing starts is in the vicinity of 1.4 million units per year.

While all the component parts of this estimate are subject to some uncertainty, the process is a useful one. It reminds us, and you, that housing production today is likely above the rate consistent with the underlying demographic trend. There is nothing very unusual or alarming about this, given that housing is a very cyclically sensitive industry and that above-trend growth has been very supportive of housing demand. But it does alert you to the prospect that housing starts are likely to be on a downward trend over the next couple of years, once growth slows toward trend, consistent with the NAHB forecast.

I noted earlier that the housing industry has benefited, perhaps more than any other single industry, from recent monetary and fiscal policies. To the extent that monetary and fiscal policies have contributed to the persistent strength in income and employment growth and increases in equity prices, housing benefits like all other sectors. But housing has likely benefited especially from the policy choices that have been made in recent years. Success in balancing the federal budget has reduced the competition of the federal government with the private sector for funds, thereby lowering real interest rates relative to what otherwise would have prevailed, and encouraging increases in investment, including investment in housing.

Monetary policy, by contributing to price stability, has fostered low nominal interest rates by reducing the inflation premium implicit in nominal rates. Because nominal interest rates matter directly for housing affordability, lower inflation may have a disproportionately large benefit to housing. As a result of both the fiscal and monetary policy contributions, the nominal rate on fixed-rate mortgages has, as I noted earlier, moved to near the lowest level over the past 30 years.

Broadening the Access to Home Ownership: Sharing Prosperity and Insuring Opportunity

Monetary and fiscal policies have not been the only public policies that have benefited the housing industry in recent years. Housing has also benefited from the broadening of access to mortgage financing and homeownership through affordable housing programs. This brings me to my second theme for today--the importance of affordable housing in the market mix and the opportunities it provides both to consumers and to you as homebuilders.

I have often noted that there are limits to what monetary policy can do. If we are clever, we can promote full employment and price stability, the two broad macroeconomic objectives Congress has mandated for the Federal Reserve. But even when times are good--when aggregate and average economic performance is excellent--as is certainly the case today, there remain nagging social problems. Partly, these reflect the reality that significant parts of our population are simply not sharing fully in the overall prosperity of the times. But these problems also reflect the reality that some parts of our population, especially those with low and moderate incomes, may need a little extra help to be able to participate more broadly in the American dream, including home ownership.

Providing extra help is not necessarily charity or giveaways, but it may involve some innovative ways of doing business in building, financing, and marketing. Properly organized and executed, a focus on affordable housing can be profitable business that is responsive to a legitimate market need and, in fact, to a significant segment of the market potential.

It may surprise some that the Federal Reserve has a strong interest in the promotion of affordable housing programs. When most people think of the Federal Reserve, they naturally think of monetary policy and the Fed's macroeconomic responsibilities. This is, after all, at the heart of what central banks do. But Congress, for a variety of reasons, has given the Federal Reserve wide-ranging responsibilities in bank regulation and supervision and in consumer and community affairs. I am very directly involved in many issues affecting affordable housing as Chairman of the Board's committee that oversees the Board's consumer and community affairs' activities.

Congress decided that it would be useful for the Federal Reserve not only to be sensitive to such issues, but also to contribute to their solution. The Federal Reserve plays a role in supporting affordable housing in a variety of ways. For example, the Federal Reserve assesses state member banks' Community Reinvestment Act performance and monitors their compliance with fair lending laws to ensure the equitable treatment of all applicants. The encouragement and incentives provided by CRA have, in my judgment, contributed to the expanded participation of depository institutions in affordable housing. In addition, principally through the community affairs programs at each of the twelve Federal Reserve Banks, the Federal Reserve has supplemented its bank supervision role with an expansive program of educational and informational activities designed to help banks and their communities understand the needs and potential of community development partnerships, including those for affordable housing. The Reserve Banks often play an important role in forming and supporting multi-bank community development lending organizations. Another example is the major initiative by six of the Reserve Banks to help identify and address barriers to equal access to credit in the home buying process. This program brought together key participants in the home buying process, such as Realtors, appraisers, property insurers, and lenders, along with community representatives, to discuss problems affecting minority and lower-income home buyers, and to help forge solutions.

It's important to note, however, that the Federal Reserve's activities are part of a larger picture in which public policy helps promote private sector participation in the affordable housing industry. Unlike the past, when public sector participation was dominated by large government funding programs, public policy plays an important role in this process in several more effective ways. Through the Community Reinvestment Act, it reminds depository institutions of their responsibility to meet the convenience and need of their local communities, including the low- and moderate-income neighborhoods. This Act mandates that depository institutions take affirmative actions to meet these needs. This has resulted not only in increased commitment of lending funds, but also in innovations in marketing and financing practices that have greatly benefited low- and moderate-income consumers and communities. Another important factor is that public policy now leaves key decisions in the hands of local communities, which makes private sector participation easier and more effective. Finally, public policy now encourages the leveraging of important, though limited, public funds with private dollars, and provides encouragement for active private sector participation in the process.

The results have been remarkable. In recent years mortgage originators, secondary mortgage market institutions (Fannie Mae and Freddie Mac, in particular) and private mortgage insurance companies have initiated a wide variety of affordable home loan programs intended to benefit low- and moderate-income households and neighborhoods. Affordable home loan programs generally involve four important components: targeted groups, special marketing, the application of flexible underwriting standards, and the use of risk mitigation techniques. These programs supplement and often build upon a variety of long-standing government programs, particularly those of the FHA and state and local housing authorities.

In many cases, the success of these programs has been fostered by the development of public-private partnerships. These partnerships usually involve local community nonprofit groups, federal and often state and local government funding, and lending institutions. In many cases, private sector participation goes well beyond lending institutions and includes builders, realtors, insurance companies and other businesses. They know that affordable home ownership programs are not only good business, they also help strengthen neighborhoods and communities.

Public funds are used, for example, to make the loans more affordable to the targeted groups by blending down the interest rates or by lowering downpayments, while allowing lending institutions to obtain market or near-market rates on their loans. The result of this leveraging of public funds with private funds multiplies the social rate of return on a modest commitment of public funds.

Community non-profit organizations play a very important role, side-by-side with lending institutions, in affordable housing programs. I have first-hand experience with this process through my participation on the Board of Directors of the Neighborhood Reinvestment Corporation. The Neighborhood Reinvestment Corporation was established by Congress in 1978 to help revitalize our low-income communities around the nation and make housing more affordable in these communities. The heart of this process has become the national NeighborWorks network, which now comprises 181 community-based nonprofit organizations providing a broad array of services in more than 560 communities around the country. These groups--many known to you as "Neighborhood Housing Services"--work to promote home ownership, reclaim abandoned and distressed properties, and help stabilize economically distressed neighborhoods and rural communities. With the backing of Congress, Neighborhood Reinvestment supports this national network with training programs, technical assistance, access to a secondary market for affordable housing loans, and funding.

The last day of 1997 marked the end of a 60-month NeighborWorks Campaign for Home Ownership. The campaign initially set out with a goal of producing 10,000 new homeowners and providing $650 million in investment. In fact, the program delivered 16,000 new home owners and a total investment of 1.1 billion dollars. Ninety-five percent of those buying homes were first-time buyers; 60% were minorities; and 42% were women. We hear so often of government programs that are poorly designed, inefficiently implemented and ineffective in achieving their goals. While I admit to being somewhat biased, I believe that affordable housing programs have been very successful in delivering stability for families and hope for communities.

Next week I will be in Chicago, with other members of Neighborhood Reinvestment's Board of Directors, to kick-off a second NeighborWorks Campaign for Home Ownership. We will announce new ambitious goals and introduce some of our private-sector partners who will work with our network of community-based nonprofits, lending institutions and other private sector players to build upon our past success and further increase the opportunities provided to low- and moderate-income families and underserved populations around the country. I and the other members of the Board of Neighborhood Reinvestment will be devoting considerable energy to this effort over the coming years.

The bottom line is that the new affordable housing team produces in communities throughout the country. It produces smart design and construction techniques, affordable financing, reasonable insurance, and provision of a host of technical assistance and home-buyer counseling. It's a good team to play on and, in fact, home builders around the country have been important players on this team. Let me give you just a couple of examples.

In Laredo Texas, Armadillo Homes (a member of NAHB) is developing a subdivision. It provides seven homes in that subdivision every year--at cost--to Laredo-Webb Neighborhood Housing Services.

Neighborhood Housing Services of Pueblo, Colorado is building a subdivision called Liberty Gardens. A local development company, Ridge Development Corporation (also a member of NAHB), donated land it owned next to the subdivision site so that the community non-profit could get the necessary easement to proceed with the development. A local home builder, J&P Construction (of course, another member of NAHB) is building the subdivision.

As I said, these are just a couple of examples of the much appreciated efforts of members of NAHB, but, I would also note that there is plenty of room for increased participation.

In addition to subdivision development, builders can be quite helpful in fostering home ownership in our inner-cities, especially in programs involving the rehabilitation of homes for sale to low- and moderate-income families or the production of urban in-fill housing; nonprofit groups cannot shoulder this market need alone. Larger builders can contract with nonprofit sponsors to do rehabilitation and construction. They can participate in joint purchasing arrangements with nonprofit groups to help reduce the costs for construction materials, or they can use their marketing expertise and muscle to help nonprofit groups sell rehabilitated homes. They can provide or support mortgage or home ownership counseling for prospective low- and moderate-income home buyers. Builders can also help support community-based development organizations in a variety of ways--by offering their expertise, participating on boards of directors, or even by making contributions for general organizational support.

Let me conclude by saying that if the NeighborWorks Campaign for Home Ownership proved anything, it is that there is a significant market for affordable home ownership. But we still need broader participation of all segments of the private sector, including homebuilders, to more fully spread the benefits of home ownership to those who, in the past, were bypassed. So, in the context of our current healthy economic conditions, I would encourage everyone here to continue to explore your options for involvement in your own communities.

In conclusion, I hope that the next time we meet that we will find both the economy and the home building industry as healthy as they are today and home builders even more actively engaged in providing opportunities for homeownership to low and moderate income families.

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