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Remarks by

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Chairman, Board of Governors of the Federal Reserve System

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I welcome this opportunity to speak to you today. These are difficult times for many, and most particularly for the homebuilder. Your industry, and those dependent upon it, has had the most depressed year in decades. And there are insidious, if partly hidden, social costs as housing construction falls behind the needs of our growing population.

Nothing I can or want to say can gloss over those hard facts. What I can do -- and what I will try to do -- is "tell it as it is," as we see it from the Federal Reserve. And, for all the evident difficulties today, I believe there are also signs of promise for the future.

Vulnerability to tight money and cyclical forces has been a recurrent story in your industry. At other times, and particularly when inflation took hold in a serious way in the 1970's, you seemed -- for a time -- to benefit from the inflationary process. Home prices rose twice as fast as the general price level. For a long while, interest rates didn't really keep up with inflation and interest costs are, of course, tax deductible. In the circumstances, house purchases for many began to be looked on as a good inflation hedge or as a kind of speculation as well as shelter. The houses got bigger and second homes, if far from a norm, became less exceptional.

In retrospect, it's easy to see that such artificial stimulu couldn't last forever. And there are parallels for the economy as a whole.

After a while, when people come to expect inflation, it no longer acts as a kind of stimulant or pep pill. Instead, the distortions, uncertainty, and fear it generates undercut efficiency and growth. If homeowners seemed to benefit as inflation accelerated, residential real estate lenders turned out to be among the big losers; it was natural that they, along with other long-term lenders, came to demand, by historical standards, extraordinarily high interest returns. The pressures on thrift institutions and financial markets generally were bad news for housing, and for the economy generally.

Years of growing concern about inflation and related poor economic performance led to a kind of national consensus that restoring price stability had to be a matter of high national priority -- that success in that effort was a key to restoring sound and sustainable growth. The job, in effect, fell to monetary policy.

In one important sense that was appropriate, because restrained growth in money and credit is necessary to turn back inflation. But I think it's also fair to say that absence of consistent help from other policies can make the job more difficult, with more pressures and risks for financial markets than otherwise necessary.

Whatever the particular instruments, with the inflationary momentum so strong and so deeply embedded in behavior and expectations, turning the tide could not be a quick or easy matter. There has been a profound skepticism -- founded in past experience --

about the ability and the will of the government to see an anti-inflation effort through. That skepticism has been reflected in part in a reluctance in wage bargaining or pricing policies to, in effect, "take a chance" that inflation will subside. Too often, bets have in fact been placed in the opposite direction -- that inflation would accelerate, and that kind of behavior can for a while be a self-fulfilling prophecy. Of direct and immediate concern to you, that thinking has led to a great reluctance to commit funds for long-term investment. Interest rates have remained extraordinarily high, even relative to the current rate of inflation. In effect, the widespread assumption or fear that inflation would continue tends to maintain its momentum.

But now we can see multiplying and encouraging signs that inflation has begun to subside -- that we are turning the corner. It is far too soon to claim victory. Any slackening of our commitment to see the effort through could only jeopardize prospects for full success. But with that continuing commitment, I also believe we can look forward to fundamental changes in expectations and in behavior that will work to unwind the inflationary process, perhaps faster than most economists have assumed. That prospect in turn will build a solid foundation for sustained growth in the years ahead, and unlock the impasse in financial markets. No industry, in my mind, has more at stake in the success of that effort than yours, just as you have borne the brunt of the transitional pain.

As you are well aware, no sector of the economy is more sensitive to conditions in the credit markets. Strong inflationary expectations, against a backdrop of monetary restraint and large Federal deficits, have produced high and volatile interest rates in all markets and across the maturity spectrum. For you the situation has been further aggravated by the particular problems of the long-term markets, and by the extraordinary pressures impinging on a key source of mortgage financing -- the thrift institutions. The lending and deposit-gathering practices of those institutions have been dependent, as no others, on a relatively stable financial environment, and therefore particularly vulnerable to inflationary distortions.

I must add that financing problems are not the only element in the calculation of the affordability of a home; the inflationary process seems to me to have contributed to your problems in other ways. In the years of strong demand, house prices persistently rose faster than most other prices, and the units got larger.

Lack of growth, or actual declines, in the real income of the average wage earner in the late 1970's didn't help. You know the statistics better than I about how the average payment on a new mortgage -- because both interest rates and principal were higher -- came to require an ever larger share of the typical family budget. For too many, the "dream" of home ownership has had for a time to remain just that.

But you and I are more interested in what we can learn from the past -- how housing can again become more affordable and competitive -- than in reciting the history. You are the experts in the design of your product -- in the type, size and location of the house; in construction methods; and all the rest. My comments are directed elsewhere -- toward the external factors that affect the cost and financing of the house.

Slack demand has been reflected in dramatically lower prices for some materials. Land prices in some localities have softened, and certainly rapid increases are no longer common. But I realize that a part -- and perhaps a large part -- of those more favorable cost trends at this point can be attributed to the pressures of general recession and depressed building activity. No anti-inflation program can be successful if it rests on recession and slack; the key test will be sustaining the gains during a period of recovery and expansion. That, in turn, is dependent on bringing down the trend of costs over time.

The challenge to business managers -- to find ways to improve productivity, to take advantage of new technology, and to design and produce more efficiently -- is evident in home-building as elsewhere. And, of course, the process of wage bargaining and negotiation is critical, too; in the economy as a whole, wages and salaries account for two-thirds of all costs.

As a matter of analysis, higher wage costs did not spearhead the inflation of the past decade. Labor and management were in large part reflecting inflationary forces originating elsewhere, and many workers had fallen behind in real income. But once strongly underway, the momentum of higher wages is a powerful force keeping the inflationary process going. And in a number of areas, faced with strong domestic and international competition, exceptionally rapid wage and cost increases have directly jeopardized jobs. In the construction area itself, major union contract settlements were as large, if not larger, in 1981 as in more prosperous and higher inflation years. I realize those contracts may not have been characteristic of homebuilding generally. But they are symptomatic of the difficulty of changing an inflationary process that has been underway so long, and obviously pose an obstacle to making the product more competitive.

Now, as we look across the economy, we do see multiplying signs that business and labor are beginning to deal more realistically with the cost and price problems afflicting many industries. You, I am sure, can cite as many examples as I. The faster that process spreads, the brighter will be the prospects for sustaining the progress against inflation -- and for financial markets. And, the fact is, paradoxical as it may seem on the surface, a slowing trend in <u>nominal</u> wages through the economy offers the prospect of higher <u>real</u> wages. The reason is that slowing of cost pressures and inflation will help immensely in speeding the recovery process, and unlocking potential gains in productivity.

It is the changing trend in this area that provides the strongest evidence that we are, indeed, turning the corner on inflation, and setting the stage for continued improvement. In that respect, as others, 1982 will be a critical year for "building in" a clear trend toward reducing inflation. A number of key collective bargaining agreements are being negotiated now, or will be negotiated in coming months. Restrained settlements not only would do much for the fortunes of the particular industries involved and help maintain their employment levels, but would also establish healthier norms for wage decisions throughout the economy.

No one can be satisfied that these favorable changes in the inflationary trend have been accompanied by such severe costs in unemployment and output. We all would like to see recovery begin. But even more crucial than the precise timing of that recovery is that growth be sustainable for years ahead. It is in that context that I am convinced we cannot let up now in our anti-inflation effort. To do so would only jeopardize the gains against inflation that we see. The pain we have suffered would have been for naught -- and we would only be putting off until some later time an even more painful day of reckoning. The early stages of recovery must not be a signal that it is an "open season" on expansionary policy or aggressive pricing. Indeed, I believe a sense of retreat on inflation would jeopardize prospects for recovery even in the relatively short run.

My conviction on that score reflects the fact that improved conditions in credit markets are a key to recovery and sustained growth. That is most obviously true in those areas of the economy that have been most hard pressed by high interest rates -- with housing at the head of the line.

In a direct sense, high interest rates are a major element in your difficulties. They are also a symptom -- a symptom of concern and uncertainty about whether inflation will in fact be brought under control, and whether the constellation of public policies necessary to restore price stability and avoid market congestion will be sustained. It is those deeper concerns that need to be addressed -- and I believe are being addressed -- to assure the more favorable financial outlook you need.

The central point is that inflation needs to be brought down if lenders are to return in force -- and remain -- in the long-term markets. I have already reviewed the progress on that score. But policy directed toward that end cannot be an "on again-off again" thing.

The fact is the burden of that anti-inflation effort has fallen on monetary policy and the Federal Reserve. In the circumstances, few would question the need for the central bank to prevent excessive growth of the money supply if inflation is to be stopped. We can, of course, debate what the precise monetary targets should be. But the notable thing about that debate, to me, is that the range of "advice" we get has been relatively narrow. The record now seems to me clear, in any event, that the Federal Reserve has been applying restraint to monetary expansion. In doing so, I believe we are also laying a major part of the essential groundwork for lower interest rates on a sustainable basis.

But I would also emphasize conditions in financial markets are determined not just by monetary policy, but by the interaction of all policies. Some evidence can be found in recent developments. Short-term rates peaked as long ago as last July. But long-term rates continued to rise for a time, at least in part out of investors' fears about potentially large future deficits. All interest rates fell sharply as the recession took hold last fall. But renewed concern about deficits remains one factor in market concerns and hesitancy.

Your Association has been in the forefront of those recognizing that the outlook for interest rates -- and for those sectors of the economy that rely on credit -- is dependent on discipline in fiscal policy. A temporary swing toward deficit is expected and natural during a recession. The real question is the extent to which heavy Federal financing demands extend well into a period of business expansion, preempting the money you and others require to finance your business.

The Federal Reserve has no way of offsetting the financial market pressures associated with excessive deficits. Pushing more money into the system simply to finance the Treasury would only serve to heighten fears about inflation and the future course of interest rates. But restraint on the money supply implies there will not be enough to finance both huge deficits and the financing needs of business during recovery. The straightforward way -- and ultimately the only effective way -- to escape the dilemma is to reduce the size of the deficit significantly and strongly as the economy expands. Indeed such a development seems to me a key to producing the financial environment that will make recovery possible. The Administration and the Congress will need and deserve all the support that you can muster to assure that result.

Disciplined monetary and fiscal policies are crucial to your industry and financing prospects. But you are well aware that we are also in the midst of tremendous changes in the nature of mortgage instruments and lending patterns, reflecting in part the desire of lenders to protect themselves from uncertainty and volatility. You and I may prefer the older way of doing business -- and with success in our anti-inflationary efforts, we can see it again. But in the practical circumstances we face, new forms of financing are a simple necessity, and can make a real contribution to your recovery. Indeed, it is virtually impossible now to conceive of insulating the mortgage market from forces elsewhere in credit markets -- and those forces reflect international as well as domestic developments.

To take one major example, the current problems of the thrift institutions have raised questions about their ability to play their historic role in housing finance. I realize, too, that the discussion of sweeping changes in the regulatory and statutory framework within which such specialized intermediaries have operated has raised doubts among some of you about the financial support for housing, even when more stable conditions return to the credit markets generally. I have repeatedly expressed my own view about the need to move forward with legislation that would better equip the Federal agencies to deal with the difficulties of troubled thrift institutions. I also believe that technological and market developments require some changes in institutional powers. Nonetheless, it has not appeared either desirable or likely to me that we move now to the total "homogenization" of financial institutions. But if relatively specialized lenders are to survive and protect themselves from risk, those institutions will have to adapt and innovate, including the use of "alternative" mortgage instruments -- those with adjustable rates or shorter maturities.

I know that homebuyers are not uniformly enthusiastic about this development; they are naturally concerned about the risks potentially shifted to their shoulders. The recent volatility of market interest rates -- not to mention their pronounced uptrend through the years -- is fresh in their minds. The experiments with different methods of smoothing changes in monthly payments are still somewhat confusing to the general public, but more uniform and acceptable approaches are likely to develop out of experience. In the end, there is reason to believe that these instruments can help importantly to place housing finance on a more solid foundation, especially compared to the limited availability or relatively high rates on fixed-rate mortgages.

In the end, the development of new mortgage instruments to finance housing can, of course, only be secondary -- and distinctly secondary -- to the effort to relieve the strains and volatility plaguing the credit markets generally today. That will only be achieved by restoring a sense of conviction that we can -- and will -- return to price stability.

I would repeat that the role of monetary policy is essential to that effort. I know of no "quick fix." And any sense that we are abandoning control of money could only raise fresh questions about inflation, and undermine the prospects for the very progress on the price front and lower interest rates upon which you depend.

Monetary policy is no panacea. There are some who would assert that monetary control alone is sufficient to restore price stability and low interest rates. The fact is we need a broader prescription if the burden is not to fall exclusively on industries like yours.

I know this all may sound like an old refrain to many of you. You want -- and need -- results. Let me say, for the first time in years, we are now seeing the kind of turn in inflation that can lay the base for a more hospitable financial environment and sustained recovery. That's the setting in which I would rather be addressing you -- and I firmly believe we can achieve it.

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