Form No. 131

Office Correspondence

FEDERAL RESERVE BOARD

Date April 9, 1935.

To Governor Eccles

From Lauchlin Currie

Subject: N. I. C. B. article.

New residence building as an investment.

R.C.

I asked Mr. Garfield, our "specialist" on construction, to make some comments on the N. I. C. B. article, and I append his memo. I have also looked into the method of compilation of various cost and rent indexes. The general conclusion is that they are all more or less unsatisfactory. About all we are safe in saying is that, taking the country as a whole, it is more profitable to buy or rent than it is to build. Data simply does not exist to enable us to say how much building will be stimulated by 20, 25 or 30 per cent subsidy. I feel pretty strongly that the N. I. C. B. figure of 38 per cent is too high. In addition to the points made by Mr. Garfield, it may be noted that the base year from which comparisons are made, 1923, was a year in which the cost-rent relationship made it unusually profitable to build.

I should like to add that the unsatisfactory nature of the material available in this field is but typical of economic data in general. If, in the future, we hope to do a decent job in formulating monetary policy it is absolutely imperative that we get much better information all along the line than now is available.

Form No. 131

Office Correspondence

FEDERAL RESERVE BOARD

Date April 6, 1935

To Mr. Currie

From Mr. Garfield

Subject: N.I.C.B. article, "New Residence Building as an Investment"

16-852

The impression I get from this article on "New Residence Building as an Investment," based on a comparison of net rental income and of building costs, is that the return on investment in new residential building is smaller now than at any other time during recent years and that, therefore, the prospects for revival of private investment in new residential construction are at a new low level. It seems to me clear that costs and rents are highly important factors to be considered in gauging the prospects for new residential building but that many other things also should be considered and that the exact figures used are subject to some qualification. In general an analysis based on consideration of a wide variety of factors in the situation would indicate that the prospects for a revival of residential building are now considerably more favorable than in certain earlier periods during the depression.

Details of N.I.C.B. study

The National Industrial Conference Board attempts to measure the return on investment in residential properties by estimating changes in net rental income and in building costs. The net rental index is arrived at from the gross rental index of the National Industrial Conference Board for properties rented by wage-earners in about 175 cities, with allowance for changes in expenses, including taxes and repairs. The index of building costs is a composite of the National Industrial Conference Board index and the index of the American Appraisal Company. The index of return on investment is calculated by dividing the net rental income index by the index of building costs. The comparisons are made on an annual basis, using the first nine months of the year for 1934.

The result shown on the chart is that the return on investment in 1934 was 62 percent of the 1923 level as compared with about 65 percent in 1933, 79 percent in 1932, and higher levels in earlier years.

Comments

(1) Even if the figures shown accurately represented the facts, it would still be necessary to take into consideration the general decline in interest rates and yields on long-term investments before drawing any conclusions about the prospects for building activity. If long-term rates were also at 62 percent of their 1923 average the prospects according to this method of analysis might be as good as in 1923.

(2) Availability of funds is an important factor to be considered. During the past two years there has been a substantial improvement in the position of certain lending agencies, such as life insurance companies and commercial banks. New mortgage loans on city properties by life insurance companies since the middle of 1934 have been larger than in the corresponding period a year earlier.

(3) The establishment of the Federal Housing Administration may be a factor in reducing prospective costs to the borrower and losses to the lender and may, therefore, encourage the making of new loans.

(4) The situation with respect to outstanding urban mortgages has been considerably improved by the taking over of $2\frac{1}{2}$ billion dollars of the mortgages on small properties by the Home Owners' Loan Corporation, which has lowered costs to the borrower and has removed certain pressure from the real estate market. Foreclosures continue at a high rate, however.

(5) Many important developments are reflected in rent figures only after a considerable period of time. Among developments in the past two years which tend to make the outlook considerably more favorable than this study indicates are

(a) a continued increase in population, important even though the rate of increase is smaller than in earlier years,

(b) a moderate increase in incomes,

(c) a substantial increase in occupancy, with only moderate increases in incomes, indicating that rents are at a level which encourages increased use of space,

(d) a small volume of new construction and continued demolition of old structures to avoid taxes and for other purposes,

(e) a decline in rent concessions which is not reflected in an index of rents charged,

(f) a decline in rent delinquencies,

(g) a reversal in some localities of the downward movement in rents charged, offset in large part in a general index by small declines in other communities

(6) Comparisons on an annual basis tend to show the return in 1934 on a less favorable basis than would comparisons for the end of the year, if the same rent and cost indexes were used. The course of rents indicated by the National Industrial Conference Board index is shown on Chart I.

(7) The indexes used to measure net rental income and building costs are at best only approximations. The decline shown for net rentals from 1923 to 1934 is 48 percent as compared with a decline of 36 percent in gross rentals as measured by the National Industrial Conference Board index. The difference is due to an allowance for expenses which are estimated not to have changed at all between 1923 and 1934. This estimate is one that should be checked most carefully before it is used. The only two gross rental indexes available are shown in Chart I. While they show the same general movement, changes in the National Industrial Conference Board's monthly index seem to come a little earlier than changes in the index of the Bureau of Labor Statistics.

The cost index shows 1934 costs as 84 percent of the 1923 level and also of the 1929 level. Actually this may not be far from the facts but we can not be certain because all of the available building costs indexes are highly unsatisfactory, for a variety of reasons. They do not reflect accurately changes in non-union wage returns, "kick backs," and efficiency of labor. They show marked differences in movement, as indicated in Charts 2 and 3. Moreover, no single index for the nation can be satisfactory to describe situations in different localities which vary widely from each other. At the present time a unit set up by the Central Statistical Board is studying this problem and in the future more adequate data may be available.

Detailed comments on the indexes can be prepared at a later date.

BUILDING COST INDEXES

1926 = 100

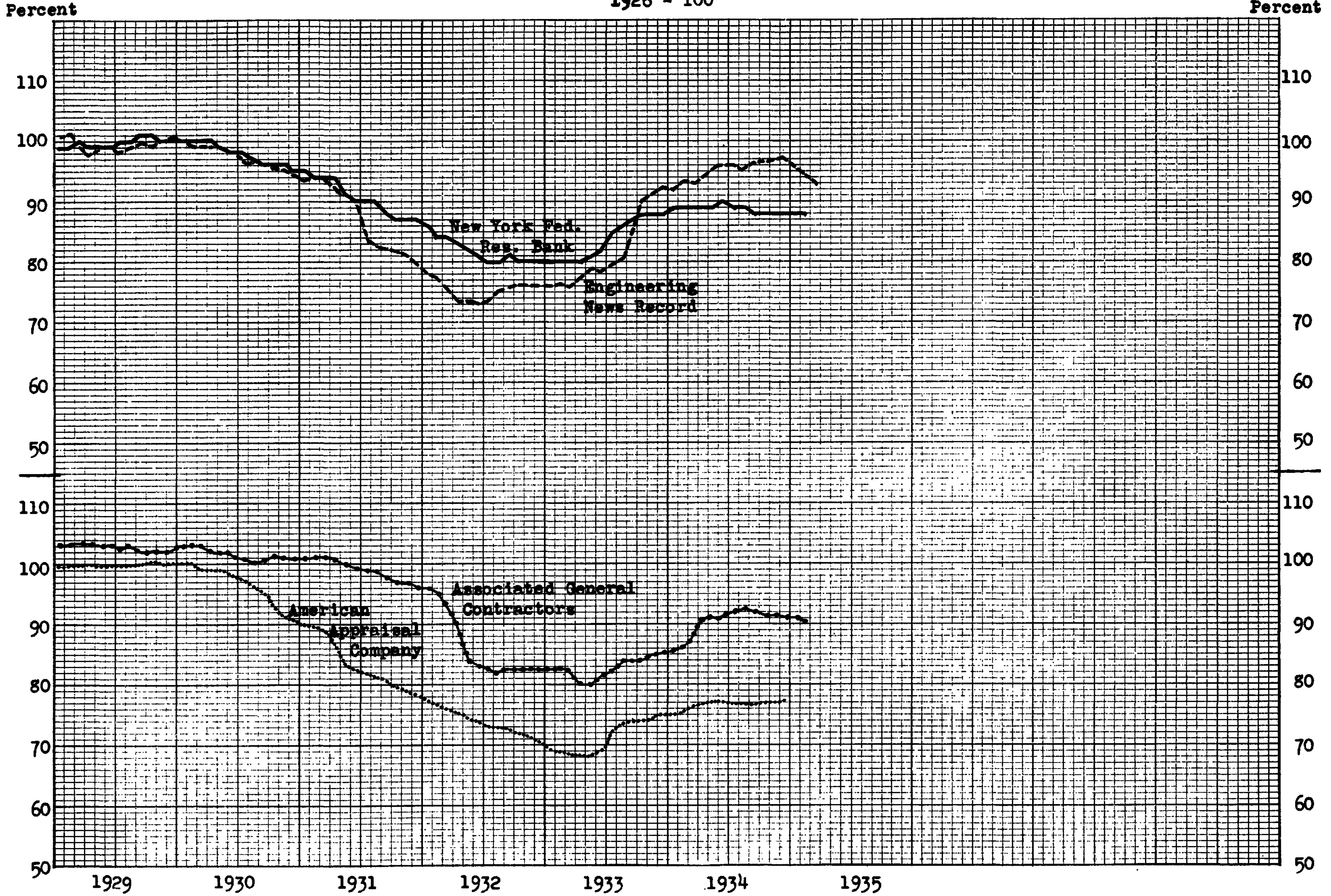
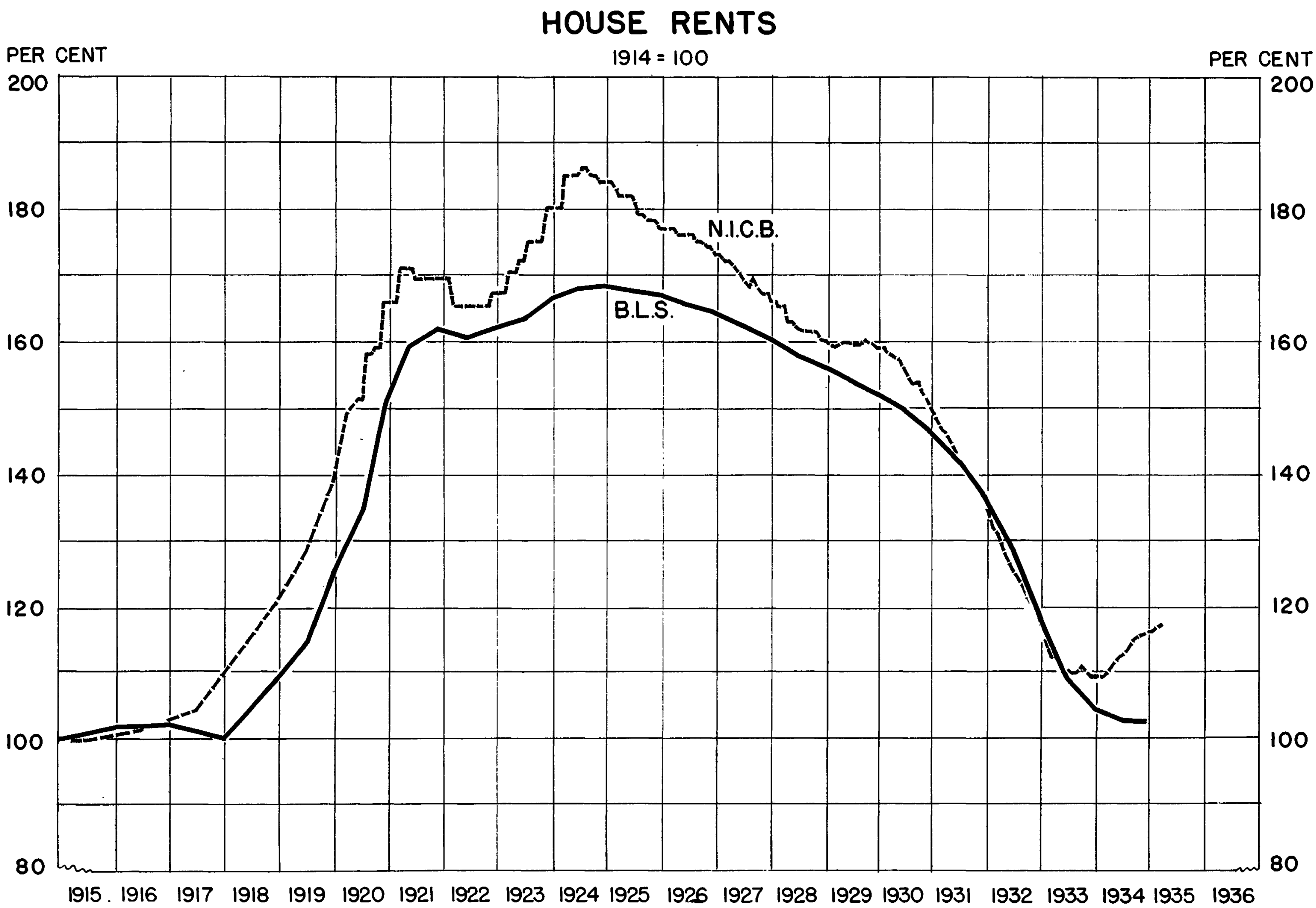


CHART I



HOUSE RENTS
1914 = 100
PER CENT
PER CENT
200
180
160
140
120
100
80
N.I.C.B.
B.L.S.
1915
1916
1917
1918
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