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THE REAL ESTATE OUTLOOK

Remarks of

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the

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The Real Estate Outlook

The outlook for the construction and real estate industry varies from favorable to disastrous depending on one's assumptions and assessments on the primary factors influencing the health of this great industry. In a very fundamental sense the construction industry is pricing itself out of the market. The construction cost alone for most houses, condominiums, and apartments has now gone beyond the reach of the average consumer. This price of the basic housing construction has risen steadily over the post-war period and in recent years at a very rapid rate. Since 1969 the medium sales price of new single family homes has risen more than $12,000 or nearly 50 per cent. In addition, in some years the financing cost has added even more to the final price and there has been a secular uptrend on the interest rate.

Perhaps as an overview we should look at the primary elements of cost pressure in this industry. Certainly the basic land itself has become a prime upward influence on the final cost of new construction. Land, a product which has a definable, and in certain areas a very limited, supply, has been increasing in price as availability declined. As land development projects brought more land into production for housing the industry was forced to move further and further from the primary centers of population. Until 1973 this did not appear to be a major problem but,with the advent of the energy crisis, the resistance of people in moving further and further from their place of business changed the whole outlook in a very short period of time. Now, however, this concern appears to be moderating somewhat and the longer trips to the suburbs do not discourage the land developers. In fact, to some extent, with the movement of shopping centers and even business offices away from downtown areas in many cities, the attractions of suburban living have grown to a greater extent. But land near a major city within commuting distance in accordance with the developing housing patterns of the community is usually rather limited and highly identifiable. Consequently, until such a time as the actual development occurs, there seems to be a pattern of development ownership trading which fosters steadily higher prices and enlarges the cost to the home builder or apartment developer.

Recently also, the environmental controls being placed on land development have added to the costs of construction. Not only has the Federal Government imposed restrictions on air, water, and potentially even land pollution, but cities and states have also strengthened their zoning and building codes. For example, many cities have steadily upgraded the character, placement, and quality of utility and street construction. To the home buyer this provides, of course, a material improvement in quality of the services and utilities of his subdivision. But it is not too often the type of thing which will support a sharply higher cost of a home nor is it the type of thing which would greatly enhance the resale value of that home. In virtually all areas of the land developer's business, government has steadily encroached upon his flexibility, eliminating his choices and to a considerable extent increasing his basic costs of the land development.

Another important cost input in the construction industry is the material going into the building of the home or other project. It is no surprise to you that virtually all basic raw materials going into construction have been on an exponential curve in pricing, especially such items as lumber, steel, aluminum, plastics and copper. To some extent this upward price pressure in the raw material field is due to the steady erosion of U.S. supplies of such goods and the increasing dependence of this nation upon foreign sources of supplies. For some of these products, as in the case of energy, foreign cartels with price control and production constraints have encouraged steadily higher prices. Moreover, even in the particular materials where the U.S. still provides the primary source of supply, the costs of mining, concentrating, and refining of ores has been sharply increased by the environmental regulations and by the transportation costs due to energy use.

Another of the primary upward pressures on prices in the construction industry has been its labor costs. There is no reason to dwell on the impact of this cost since it is well known to you, but we should at least point out that in many recent years the construction industry has led all other industries in the rate of wage and salary advances. A part of the reason for this more rapid advance in construction industry labor wages can be found in the interruptible work schedules of construction workers, and in many places in their strong union ties. Aiding and abetting these forces have been the governmental impacts from the Davis-Bacon Act, the safety restrictions of the Federal law, the fragmented character of the industry, its spot project operations, and finally, the extreme pressure which owners place upon the construction industry to complete their projects. Now most of us are pragmatists when it comes to labor costs and we look for no retrenchment in these wages. But productivity can reduce costs if productivity can be improved in the construction of the various types of projects. However, construction productivity is again one of the reasons for the high cost of the projects since productivity has been declining and in the nature of the industry it is hard to achieve and difficult to maintain. Random evidence suggests that unit labor costs in the construction industry have increased at an annual rate sharply higher than that in the entire non-farm sector.

Finally, we should look with some considerable interest at the financing costs of the industry. Beyond a doubt financing has been a long-run source of upward pressure in the construction price picture though interest rates have moved up and down contracyclically in an ever-increasing degree of volatility. The very nature of the long maturity fixed rate mortgages restricts the ability of the financing institutions to meet their obligations when their deposit costs are moving upward so rapidly. Similarly, it is of no surprise to any in this room that one of the first impacts of a policy of monetary restraint hits hardest on the thrift institutions that provide much of the housing mortgage financing in this country. The problem of disintermediation of funds or the movement of savings out from under the thrift institutions is a matter of considerable concern to the industry and to those of us in the financial regulatory area. To a moderate extent the impact of this has been ameliorated by government programs to provide long-term financing or to provide a market within which the thrift institutions may sell their mortgages during periods of disintermediation. But the primary impact still remains and it will require innovative and creative thinking on the part of the financial leaders of this nation to work out arrangements whereby the financing needs of the construction industry can be met in a more stable fashion. But from the broader standpoint of national economic stabilization, the cold facts of the matter are that unless some demand is screened out of the capital and credit markets of the nation when the economy is advancing at an unsustainable pace, there will be no restraint and the economy will continue to accelerate to a bursting point.

The sum of what I have said thus far obviously is pointed to the cost of inflation. Inflation is the primary enemy of the real estate developer, the construction industry, the builder, the homeowner, and certainly the thrift institutions attempting to meet the demands of the industry. So to seek the fundamental course of the real estate outlook, we must look to the future of inflation. Recognizing that the United States, and indeed the world as a whole, went through a traumatic experience in 1973-74 in the quadrupling of energy prices and in the impact of the energy and transportation costs in the prices of most goods, one could, with some degree of validity, question whether inflation is really as difficult a future problem as it was in the past. But I submit that the international causes of inflation, including the instabilities of exchange rate patterns, the pressures on the dollar abroad, and the quadrupling of oil prices, accounted for less than half of the 12 per cent rate of inflation we suffered in 1974. Our inflationary problem had been building for years. Not only have we consistently over-spent our revenues at the Federal Government level, but we have consistently exceeded our export revenues in terms of our expenditures for imports and for capital investment abroad as well as for gifts, grants and military aid to foreign nations.

With increasing frequency we have been coming back time and time again to the same well-worn path of excessive stimulus leading to inflation which then brings recession. In recession unemployment increases and some interest costs decline, but the basic price level seldom dips at all, and in a few instances has climbed straight through the recession. To those of us who watch the statistical changes in the economy, it has been of considerable interest to see short-term interest rates almost double from peak to peak in each inflation since the early 1950's.

Certainly inflation has been a major tax on the people of the United States. But it has also been a material disrupter of business and a significant hazard to those of you with long-range construction projects. So to appraise the future of the real estate industry, we need to examine the primary factors in the future containment of inflation. First let me say that we have found no panaceas to this problem. We know of no immunization shot which could protect an individual, a corporation, or a nation from the impact of inflation. Even the thermometer reading of inflation can vary from place to place and from industry to industry. In a complex industrialized society such as that of the United States today, there are no individual single rules of thumb which can guide policymakers or prevent the development of inflation.

This is particularly true in the field of monetary policy. There are those who today would like the central bank to follow a single statistical guide to monetary policy, one which is couched in terms of the currency in circulation and net demand deposits of the bank, called M_1 or the money supply. There are others who believe that the monetary base should be the sole guide to policy. And still others think that the interest rate pattern or the conditions of the market or the rate of reserve injection should be a sole guide to policy. Governmental leaders appear to center their policy guidance on such items as the rate of housing starts, the rate of unemployment, or the growth of the gross national product. All of these measures are important. In fact, every point mentioned has some validity in measuring the general health and welfare of our economy. But no single measure can hope to evaluate either the appropriate policy for the future nor the health and welfare of the entire economy.

But before we get bogged down into a discussion of the esoteric and minutiae of statistical measurements, let us turn to the outlook for inflation. Despite all the problems of the recession, in virtually all cases, a recession does slow the rate of inflation. Competition develops for labor, slowing the rate of wage increases. Funds are made available because of a lower demand for credit, and interest rates decline. The pressure on raw material sources subsides, and order books slip away. Thus in a major recession, there are corrective forces which bring the economy back closer to balance. But we never quite get there.

We, as a nation, are compassionate people. We do not like to see the hardship and suffering of people unemployed. We don't like to see our people lose their homes for an inability to pay the mortgage. We don't like to see the community disruptions created by mass plant closings or large-scale unemployment. Therefore, our legislators in response to our demands hurriedly try to offset recessionary tendencies, and try to move as rapidly as possible toward a restimulation of the economy. This inability to tolerate the downside has left the price structure moving steadily upward and has built an ever-increasing base of higher costs from each inflationary recovery, never countered by a recessionary decline. In addition, we have steadily run to Washington with more and more of our local problems. Consequently, the Federal Government has had to find the solutions to these problems and the regular expenses of Federal Government have risen rapidly.

The current effort to correct this recessionary problem apparently is going to be little different from the attempts in the past. We have already seen actions by our Federal Government, by the President releasing impounded funds, and through Congress enlarging the unemployment compensation benefit time and now protecting against the loss of home through the payment or loan of interest. The efforts of Congress are similarly evident in their attempts to stimulate the sales of present housing and of course the very major tax cut and investment tax incentives. All of these are leading to massive deficits by the Federal Government for this year and next. In fiscal year 1975 the current estimates point toward a deficit upwards of $50 billion and for fiscal year 1976 the estimated deficit ranges from $70 to $100 billion. Deficits of this magnitude obviously will create major distortions in the capital markets, as the Treasury comes to market with the issues necessary to finance the deficit. Net new borrowing by the Treasury from now through June 30 in this fiscal year still will require $10 billions of new financing and for the last half of calendar year 1975 net new financings will probably exceed $50 billion.

And yet for the short run we should not be excessively discouraged. Private demand for credit has subsided. Bank credit requirements of business are being funded into the long-term area and the demand for bank credit has slipped away as inventory liquidation proceeds. Thus, if the private demand stays relatively quiescent, there will be room to finance these large deficits of the Federal Government without excessive pressure on interest rates. While most economists and Government leaders look for a recovery this summer, the shape and configuration of that recovery is far from clear. If it is to be a slow recovery, then there are high possibilities that the Government's new financings can be accommodated with only modest central bank support and a relatively small rate impact. But if the recovery is rapid with early generation of new and strong credit demands, then the competition for funds will indeed be intense. There are possibilities that some of the Federal Government's deficit could be financed by sales of new issues to foreign holders and there are possibilities that even the traditional savings sources might contribute considerably toward the purchase of these net new financings. The financing problem will be a matter of considerable importance, for if savings and investments are not sufficient with the present supplies of credit to accommodate both the Federal Government and the private demands, then the only answers appear to be a monetization of debt by the central bank and/or a dampening of the demand by higher and higher interest costs. You know the impact this will have on your industry.

For my part, I am basically optimistic that such debt can be financed without an extreme upsurge in interest rates, and that we can accommodate the demands of the Federal Government for new financing through the remainder of 1975 and into early 1976. One of the reasons I am hopeful of this outcome, is that the recovery I expect later this year will improve the revenues of the Federal Government and because if recovery becomes truly visible there will be fewer pressures on Congress to pass additional stimulative legislation. In my fondest dreams, I can even see Congress pulling back from the present legislation which will yield these high deficits.

Let us translate the probable practicalities into our basic theme of the future of inflation. The central point I've been making is that Congress is not likely to be a focal point of economic stabilization. Its efforts to improve the economy and to maintain the health and welfare of the citizens during recession, is perceived to a large extent as the spending of Federal funds regardless of the level of deficit. Neither can we as a people look toward a voluntary contraction of inflationary pressures by the private segment of the economy. Individual businessmen and consumers cannot by their own actions be sufficiently effective to dampen the inflationary pressures. In our complex, free enterprise economy the motivation is profit. There is little motivation to act as an economic statesman to the detriment of your own personal self-interest.

Nor can we expect much help from abroad. The conditions of the markets in foreign nations are similar to our own. Moreover, most major industrial nations are on a coincident cyclical path with the United States and this has exacerbated the problem. Thus there is little capacity for special help from abroad, although there is a possibility that the U.S. may reduce its presence in military and aid programs as a result of the recent problems in South Vietnam.

In essence then, as it has over the post-war period, this nation appears to be relying solely upon its central bank as the one source of resistance to inflationary pressures. To those of us in monetary policy roles, there is some resistance to this isolated role because we do not believe that monetary policy can handle the whole job of economic stabilization. From our perception, the problem from time to time has been exaggerated by the legislative process, particularly by the timing and impact of actions designed as counter-cyclical measures. To a considerable extent these measures seem to hit late in the recession periods adding to the fuel for recovery at a time when recovery has already commenced. But since there seems to be no other effective activity toward countering inflationary pressures, we at the Board of Governors do take our role seriously and attempt as best we can to provide the counter-cyclical pressures which this nation requires.

Unfortunately, today, there are developments in Congress and elsewhere which seem to point toward a diminution of the ability of the central bank to act in this role of the prime counter-inflationary force. The Federal Reserve has been under extreme criticism the past few months, partly for a publicly perceived position of failing to provide sufficient credit for the early recovery of the economy, and because of this, a pressure to restructure and limit the freedom of the central bank. But this need not happen. Congress has already passed a resolution requiring the Federal Reserve to declare its monetary policy goals for the coming year, and providing for Board presentations of objectives and plans for the coming months. The provision for committee hearings is not a new matter. In fact, the Chairman of the Board of Governors is repeatedly testifying before Committees of Congress. What is new about this resolution is the requirement that the Federal Reserve declare in advance its goals and objectives for the monetary and credit aggregates. Some of this activity appears to reflect the acceptance of the monetarists' approach to monetary policy. This resolution is not sufficient to materially damage the ability of the central bank if it goes no further than the present provisions. It may produce days of hearings and debate over the central bank's goals and objectives, but there is no reason to conclude at this point that the System's capacity for exercising independent judgment will be diminished.

However, with the other proposals in Congress, in the effort to place the System under General Accounting Office audit and rules, with the new bill recently introduced to shorten the terms of the members of the Board of Governors and make them coterminous with that of the President, and with the broad financial investigation just recently launched by the Chairman of the House Banking Committee, there is a pattern which appears to be developing which could impair the effectiveness of this nation's central bank. If indeed all of these bills are passed, and short-run political pressures are brought to bear on the central bank, there may be a material diminution in the ability of the central bank to respond as it has in the past with a flexible policy to counter-recessionary and inflationary pressure in this economy.

To me this is a primary danger to the long-run outlook for the real estate industry. If the central bank as the only effective resister to inflationary pressures is to be undercut by political pressures, then the nation will have lost its primary line of defense. It will be a surprise to me if Congress can effectively handle monetary policy especially with its track record of handling of fiscal and debt ceiling policies. One may wonder aloud why this nation would be willing to reshape its central bank in a way that would vitiate the independent judgments necessary for effective economic stabilization.

So my message to you today is that the near-term real estate outlook can be favorable given certain assumptions about the rate of recovery and the impact of that recovery on capital markets. But for the long haul the outlook could be disastrous if the policy-making of the primary defender against inflation is subjected to political pressures. I hope you and your industry will speak out vigorously on the question of central bank independence. If you believe, as I do, that inflation is the overriding problem facing the real estate industry, you have a personal as well as a national stake in insuring that the central bank remains a truly independent, deliberative body.

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