For release on delivery
(Approximately 10:30 a.m., EST
Tuesday, December 28, 1965.)

CREDIT AND REAL ESTATE DEMAND

Remarks of

SHERMAN J. MAISEL

Member
Board of Governors
of the
Federal Reserve System

at the

First Annual Meeting of the
American Real Estate Association
in conjunction with
Allied Social Science Associations

New York City

December 28, 1965

CREDIT AND REAL ESTATE DEMAND

I am pleased to participate in this inaugural meeting of the American Real Estate Association. For the past twenty years, my work in the fields of money and banking and urban real estate economics has been closely related to the problems with which this Association is concerned.

While I have been well satisfied with the personal challenge offered by these fields, a nagging source of discontent has persisted. We seem no closer to solutions for our urban problems than twenty years ago. In fact, I would say that the opposite is the case. Our urban needs have multiplied faster than the resources devoted to them and more rapidly than our ability to deal with them.

I think most persons would agree that except for the problems of peace our urban environmental problems are as critical as any we face. Noise, dirt, and confusion of urban life grow apace. All too often we find it more difficult to obtain pure air to breathe. We are hard pressed for enough water of adequate quality. Our use of space appears esthetically poor. Many fear to walk at night in our urban centers. Space for recreation... for housing...for education...all seem to decline relative to our needs.

The intellectual, economic, physical, and moral resources required to solve this crisis of urban growth are tremendous. Our crises, unless faced directly, will continue to grow. I know that the members of this new Association can be counted on to contribute their own skills. I trust that the prestige of the Association itself will bring still others into the fray.

Improvements in Urban Life and Monetary Policy

Several months ago, I picked the topic "Credit and Real Estate Demand," in order to emphasize some qualitative questions raised by the rapid expansion of mortgage credit. But circumstances changed, and events this month have spotlighted a different aspect of the topic: what are the relations between changes in interest rates and changes in the rate of construction and urban development?

Clearly, because real property is so important both in current production of durables and in current financing, a close relationship must exist. Based on past data, at least, we should expect that a policy of curtailing credit expansion and raising interest rates will have its greatest impact in reducing new investment in private and public real property.

Some people argue that because the social costs of delaying urban investment are high, the impact of monetary policy in this area should be offset by selective countermoves through such media as FNMA, FHA, FHLBB advances, or public subsidies. The problem is difficult, however, for clearly if a policy of cutting over-all potential demand is to be successful, particular parts of the economy must grow more slowly or contract.

An associated impact may affect the quality of credit. Usually one would expect better quality with restricted lending, but there is a possibility which must be faced up to that the opposite might occur.

Credit and Construction

First, let me highlight a few of the relationships between real property, construction, and mortgage credit, recognizing that some construction is financed elsewhere in the capital market than in the mortgage sector. Over the postwar period, new construction, both private and public, has been equivalent to between 10 and 12 per cent of the total value of the nation's output of goods and services. (See Table 1.) Moreover, this form of capital formation has totaled more than half the aggregate expenditures on all other types of durable goods combined--including such durables as business equipment, consumer automobiles, household furniture and appliances, and durables purchased by the Government for defense and other purposes.

Table 1

TOTAL EXPENDITURES ON NEW CONSTRUCTION,
TOTAL DURABLE GOODS, AND ALL GOODS AND SERVICES 1946-64
Dollar Totals for Five-Year Periods
(Billions of dollars)

	New Construction	Durable Goods Excluding Construction	Gross National Product	New Construction As a Per Cent of GNP	New Construction As a Per Cent of Total Durable Goods	New Construction As a Per Cent of Other Durable Goods
1946-1950	128.4	239.8	1238.7	10.4	34.9	53.5
1951-1955	211.5	385.5	1801.3	11.7	35.4	54.9
1956-1960	272.0	463.4	2295.0	11.9	37.0	58.7
1960-1964	255.0	447.5	2298.3	11.1	36.3	57.0

Source: Office of Business Economics, Department of Commerce, Survey of Current Business, August 1965.

Real property, of course, is a major type of wealth. The latest available estimates for 1958 show that private and public structures and land together accounted for two-thirds of the nation's aggregate tangible wealth. (See Table 2.) Nonfarm structures alone represented half of the nation's total wealth.

Credit secured by private residential and commercial property has been rising sharply. As a result, mortgages now constitute the largest single type of long-term public or private indebtedness. During the current business expansion alone, mortgage debt outstanding has increased by some $127 billion. (See Table 3.) That was about double the amount of increase in outstanding long-term debt of all Federal, State, and local governments and private corporations, combined.

The rise in mortgage debt becomes even more dramatic when seen over the last decade. Since 1955 mortgage debt has expanded by $200 billion. Its growth has been equivalent to four-fifths of the expansion in gross national product--one rough index of aggregate ability to service outstanding debt. These records considerably surpass the results for the decade immediately before when the economy was emerging from the aftermath of war.

Table 2

STRUCTURES AND LAND COMPARED WITH TOTAL
TANGIBLE NATIONAL WEALTH OF THE UNITED STATES
(Billions of dollars)

Year	Total National Wealth	Structures	Land	Structures and Land	Structures and Land as a Per Cent of Total
1945	570.1	285.6	115.3	400.9	70.3
1950	1,054.6	507.3	189.3	696.6	66.1
1955	1,384.0	683.6	238.2	921.8	66.6
1958	1,682.9	833.7	290.9	1,124.6	66.8

Source: Raymond W. Goldsmith, The National Wealth of the United States in the Postwar Period, Princeton University Press for the National Bureau of Economic Research, 1962. Data exclude Alaska and Hawaii and should be regarded as approximate only.

Table 3

NET EXPANSION IN MORTGAGE DEBT
(Billions of dollars

	Total	Nonfarm			Farm	Per Cent Increase in Total During Period	Expansion Total as Per Cent of Expansion in GNP
		Total	1-4 Family	Multifamily and Commercial			
Dec. 30 to Dec. 30							
1945 - 1950	37.3	36.0	26.6	9.4	1.3	104.9	34.4
1950 - 1955	57.1	54.1	43.1	11.0	3.0	78.4	54.7
Decade	94.4	90.1	69.7	20.4	4.3	265.5	44.4
1955 - 1960	77.0	73.1	53.0	20.1	3.8	59.2	81.4
II 1960-II 1965[a/]	127.5	119.8	69.0	50.9	7.6	64.2	79.1
Decade	204.5	192.9	122.0	71.0	11.4	157.4	79.5
Memo: Total Outstanding							
IV 1945	35.5	30.8	18.6	12.2	4.8	---	17.0[b/]
III 1965	334.0	313.3	209.0	104.3	20.7	---	49.3[b/]

a/ June 30 to June 30.
b/ Total outstanding as a per cent of GNP.

Source: Federal Reserve estimates.

The Transmission Process

Monetary policy as an instrument of economic stabilization policy must depend on the relationships between the credit and production spheres. The reasons why credit restraint or ease affect outlays for construction more than any other sector of the economy are readily comprehended.

In the first place, existing stocks of real property embody potential flows of services that extend far into the future. Postponement of new construction, therefore, need not materially cut back current utilization of services. As a corollary, because annual new production flows are small relative to existing stocks, small changes in the demand for services tend to magnify fluctuations in current construction. This is, of course, a variant of the well-known acceleration principle.

Secondly, we have noted that purchases of real property are heavily financed by borrowing. Because the assets are durable and the financial instruments long, interest costs bulk large in total user costs.

In the past, while investment in most real property has varied in response to changing credit market conditions, this sensitivity has been especially evident in residential construction. It is perhaps worthwhile recalling just how large the swings have been. (See Table 4.) Measured in terms of expenditures for nonfarm residential structures, in constant dollars, declines during periods

Table 4

EXPENDITURES FOR NONFARM RESIDENTIAL STRUCTURES
PEAKS AND TROUGHS

Quarter	Expenditures* Billions of 1958 Dollars	Dollar Change	Per Cent Change
1953 - IV	18.4		
1955 - II	25.1	+ 6.7	+ 36.4
1958 - II	19.0	- 6.1	- 24.3
1959 - II	24.7	+ 5.7	+ 30.0
1960 - IV	20.2	- 4.5	- 18.2
1964 - I	25.1	+ 4.9	+ 24.3

Source: Office of Business Economics, Department of Commerce, Survey of Current Business, August 1965.

*Seasonally adjusted quarterly totals at annual rates.

of tight money have been as large as 24 per cent from peak to trough; increases stimulated in part by easy monetary policies have been as much as 36 per cent from trough to peak.

The effects of changing credit conditions on outlays for new private residential construction are obvious to the naked eye. For other areas of spending, including business outlays for plant and equipment and State and local construction, refined statistical methods are required to find the degree of interest elasticity. Finally, there is little evidence of a direct impact on outlays on consumer durables from changes in general credit conditions--probably because consumer credit terms are less influenced by monetary policy. Thus the statistics seem to confirm the view that construction outlays bear the heaviest impact of credit policy.

Savings and Financial Institutions

I have elsewhere described at length the path by which credit influences construction. This is from monetary policy to the mortgage market, and from there to construction spending.1/ The process begins with changes in the lending and investing capacity of commercial banks brought about by Federal Reserve control over bank reserves. One link to the mortgage market is direct. In periods when they had ample lendable funds, commercial banks accelerated their mortgage acquisitions. When loanable funds were short relative to customer demands their appetite for mortgages declined.

1/ cf., S. J. Maisel, Financing Real Estate (McGraw-Hill, New York, 1965), Chapters 4, 11, and 13.

As a result of banks becoming more competitive for savings in the 1960's, a new pattern may have developed. In this current economic upswing, a different sequence of events has emerged. With time deposits rising rapidly, commercial banks have continued to extend real estate loans in volume.

Monetary policy also influences the mortgage market through its effect on the share of the savings flow captured by nonbank financial intermediaries. Because these institutions lend on long maturity instruments with fixed rates, the income and therefore the interest or dividend rates they pay tend to be rather inflexible in the short run. In periods of tight money, market rates of interest rise faster than rates on the depository-type claims they issue. Individuals decide to channel their new flows of savings into higher yielding market securities. Growth rates of deposits at mutual savings banks and savings and loan associations are thereby moderated. Because of the heavy commitment of these institutions to the mortgage market, changes in the inflow of funds to these institutions are of critical importance to the supply of mortgage money.

This effect of rising market interest rates has been augmented in the past when banks have increased the rates they pay on time deposits. In recent years, the ceiling rate banks may pay under Regulation Q was raised with each increase in the discount rate. Banks took advantage of each change. The resulting effect on

savings flows through nonbank intermediaries has been noticeable this year. Savings and loan shares and mutual savings bank deposits together have been growing at about an 8 per cent annual rate thus far in 1965--compared with about 11 per cent in 1964. Growth of time deposits at commercial banks, on the other hand, has accelerated. Commercial banks put some of the savings they bid away from other institutions back into the mortgage market, but they do not commit anywhere near as high a percentage of their earning assets directly to mortgages as do their major competitors in the savings field. Indirect support for construction, of course, has come through the purchase of municipal obligations, FNMA and FHHLB securities, and through loans to business.

Monetary policy is transmitted to the mortgage market in still a third way through a substitution between mortgages and long-term corporate securities by nonbank lenders. When monetary policy puts upward pressure on rates of interest, new corporate issues become more attractive relative to mortgages, and the supply of mortgage money is restrained.

Because mortgage financing requires commitments of funds at fixed rates well into the future, adjustments in this sphere work themselves out more slowly than in other credit markets. The first three quarters of 1965, for example, showed little evidence of significant changes in yields on home mortgage lending, despite marked increases in other rates of interest and a slower growth pace for savings and loan shares and mutual savings bank deposits.

However, these reported terms primarily cover loans under past commitments. New funds apparently are being committed at higher rates. A further stiffening would be expected from recent monetary action.

Credit and Resource Allocation

As you know I opposed the increase in the discount rate early this month. Among the reasons for my opposition was a belief that higher interest rates might cause an undesirable reallocation of resources. Monetary restraint to be effective must take its biggest bite out of the construction of private and social capital. Given our present critical problems in the area of urban development, this is capital that we can ill afford to lose. If restraint was needed it seemed to me that fiscal measures tailored to curb socially less urgent expenditures would have been more appropriate.

While I was concerned with the need for expansion of our urban resources, I do not agree with the arguments made by many who contend that Regulation Q ceilings should not have been raised. At least some of them seem to propose a most dubious and even dangerous use of Regulation Q. The Federal Reserve was given the duty to set interest rate ceilings on deposits for the purpose of maintaining the safety of banks and of our monetary system. Is this the purpose that these individuals have in mind when they argue that banks should not be allowed to pay savers more for their money? Are they really concerned primarily with the possible imprudence of bankers?

Many seem to be urging the Board to bend the use of our statutory authority to purposes for which it was not intended. They appear to want fixed Q ceilings in order to influence or control any or all of the following decisions which appear in the past to have been biased when Regulation Q established ceilings below the market.

1. The allocation of resources between savings and consumption.

2. The allocation of resources between housing and other goods.

3. The competition between banks and other financial institutions.

4. The amount and rate of interest paid to the small saver for his hard-earned savings.

Let me first consider the reasons why it is dangerous to use Regulation Q to change the allocation of resources and the payment to savings and then go on to say a little more about the regulatory and supervisory problems which might arise if banks were to use improperly the enhanced flexibility allowed them by the new ceilings.

The logic of those who believe in our free enterprise system and the importance of private saving within it and yet argue for an artificial ceiling on the amount of interest that can be paid to individuals who are willing to substitute saving for consumption is hard to understand.

It seems to me that the whole concept of containing expansions in demand through credit restraints calls for taking all possible action to shift as much demand as possible from consumption to saving. While many economists doubt the effectiveness of higher interest rates in increasing saving, enough people believe that the price mechanism works in this market also to give it a trial. Nonprice policies of greater advertising, special savings bonds, and other promotional steps may also be useful. However, many people have used as a major argument for raising interest rates such actions' ability to attract savings and lower the demand for goods. Any attempt to hold down rates paid to savers must be in direct conflict with this goal.

I also recognize the economic advantage to financial institutions of a policy of price discrimination. Still in seems to me inequitable to pay at the expense of the small saver higher interest rates to families or corporations that can accumulate large amounts of saving. In the past our national tradition has been to attempt the reverse, i.e., we have preferred to pay higher rates to the small savers. I think our past traditions have major advantages over these new-fangled concepts both from the point of view of individual equity and from the point of view of more effective monetary policy.

Furthermore, I object to the idea that we should have retained the previous Regulation Q ceiling in order to keep down normal competition among financial institutions. I feel certain that this is not the purpose of the Federal Reserve Act. In addition I believe that such action would have meant an unnecessary interference with our free market system. Setting rates to curtail rational competition imposes an artificial barrier obstructing the movement of funds to their most profitable uses.

I recognize that the market cannot determine certain desirable social uses of our national resources. Clearly this is why we use taxes and subsidies in an attempt to improve our urban life. I do believe, however, it is far better to place resources in socially desirable areas by direct action through a vote of Congress rather than through the indirect regulation of interest ceilings paid by financial institutions. The ways in which such regulations influence resource allocations are very difficult to determine and evaluate. I find no indication in the legislative history that Congress meant to delegate powers to be used for such purposes to the Federal Reserve and FDIC.

It seems to me that it would be much better for those who argue that market mechanisms are not working properly first to identify the social objectives that are being left unfilled. Then they should estimate the possible costs and benefits of their proposals to interfere with the market. When this has been done,

specific policies devised to move us directly toward our goals are more likely to be successful than indirect measures through interference with competition among financial institutions.

Quality of Credit

While some objections to the increase in Regulation Q ceilings have arisen because of the fear of a misallocation of resources, others seem to stem from a feeling that it is too dangerous for some financial institutions to compete freely in the market for savings. Those who object on these grounds to the recent increase in the Regulation Q ceiling are basically arguing, I believe, that financial institutions cannot be allowed to participate fully in the free enterprise system. These persons feel that excessive competition among these institutions was the cause of many of the difficulties of the 1930's. They also feel that present methods of regulation and supervision are insufficient to control such competition. Since I am now in the business of regulating, I obviously have some sympathy with this point of view.

I must point out, however, that this argument is incomprehensible to many. They note that there are three main risks in credit extension: 1) individual random risks that are particularly strong in new loans, 2) a risk of a downturn in economic conditions, and 3) the risk that lenders will lower their standards in granting new loans.

Clearly one would expect that in a period of credit restraint all three of these risks would be decreased. The supply of credit is being reduced below demand. Lenders can be stricter in their choices. In fact I have heard many arguments in the past six months for the need to tighten credit in order to improve its quality, based on this reasoning.

One clear concern about the quality of mortgage credit has arisen from the past record of exceptional growth. Within only the last three years, at least $175 billion in mortgages have been put on the books, assuming (very conservatively) that it takes two dollars in gross lending to increase outstanding debt by one dollar. More than half of all mortgage credit outstanding today, in other words, has yet to pass the early years of testing when difficulties most often appear.

This fear has not impressed me because it will always be true that the larger the growth, the greater the volume of untested credit. Only by reducing growth to below zero could we do away with unseasoned debt, and only then at the expense of creating other more serious problems. Moreover, the difficulties that have emerged in terms of rising foreclosures still appear to be at quite modest levels. It also seems clear that if tighter money succeeds in decreasing mortgage flows then the danger from this risk of expansion will be less.

A similar statement can be made with respect to those who feared the construction of real property was outrunning the demand for it and that we might experience another 1929. Again this was not an argument that I found convincing. Most recent work seems to indicate that the problems of the 1930's were far more results of reductions in demand after 1929 than from the prior expansion in supply. They resulted from the Great Depression and fall in income. While particular markets can be disorganized by too great supply, there is little indication that such difficulties become critical unless they are accompanied by a major downturn in total demand.

I, therefore, did not fear that too much building was taking place. I recognized the social needs for a better urban environment. In a forward-moving economy, we could absorb the new additions to our stock of real property. Now since monetary restraints will reduce the rate of expansion of supply, the risks of an over-supply should fall accordingly. Only the risks that total demand may not continue to expand have increased, but these risks would have been still greater if Regulation Q had not been changed.

I would judge then that people must be worried about the third point. They must fear that instead of lenders using the opportunity of tighter money and higher interest rates to improve the quality of their portfolios, they will succumb to greed or ignorance and make more marginal loans than they have in the past. Many people seem to assume that the increase in the Regulation Q ceiling may put the most aggressive mortgage lenders in a position of being able to

pay exceptionally high rates on time deposits by reaching out for loans that yield high returns. If this temptation becomes too strong to resist, some lenders may get into trouble by failing to exercise proper caution in making their loans.

Individual lenders will need to continue to exercise particular care in determining what rates they can pay savers and in making loans. An escalation of rates above the true market would be inefficient and dangerous. Now is no time to be carried away in a search for the highest yielding mortgages to justify higher dividends on savings. As a supervisory authority, the Federal Reserve will obviously try to continue to see that the credit extended by individual banks meets acceptable standards. With more true savings in the economy and demand lowered through higher interest charges this should be easier than in the recent past.

What is necessary is that every lender be prudent. But prudence must be combined with the ability to foresee the real opportunities for constructive lending which the needs of urban growth present. The attention that members of this Association give to these problems should increase our understanding of the process of growth in real property. They should also help to assure that what growth takes place in the future will be of a quality of which we can all be proud.