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MONEY AND HOUSING

Remarks

of

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Member
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MONEY AND HOUSING

Your chairman issued an invitation that was hard to refuse. In effect, he said, "Come over and simply repeat points you have made in the past. Our members will find the repetition worthwhile." I plan to take him at his word. For the most part, I will summarize in a bare-bones manner previous statements and revive a proposal particularly suited for dealing with current problems. Anyone interested in greater detail can ask my office for copies of the prior speeches.

Let me list five points which express the relationship between money and housing:

- Greater cyclical stability in housing production is one of the most promising avenues toward increased efficiency and lower relative costs. If the functioning of the money and mortgage markets were improved, the likelihood of achieving a reasonable degree of stability would grow.
- More stability in mortgage markets requires a better financial structure and policies. Fluctuations arise from shifts in the demand for resources and credit in the economy as a whole, and in the way changed demand passes through financial markets. Unstable movements cannot be dampened by superficial steps. Stability requires basic institutional changes.
- A long-run shortage of credit for housing is improbable. The demand for housing starts through the end of the '70's seems quite flat--around 2 million starts a year. Growth in the need for such credit should roughly coincide with growth in income. Whatever structural problems arise should be solvable either through normal market flexibility or minor fiscal adjustments.
- Short-run instability in mortgage and credit flows remains a major problem. Even as the mortgage sector has experienced significant improvement, total instability may have increased. As a result, still more effort must be placed on improving existing institutions, on creating new ones, and on analyzing possible procedures for future credit allocations.
- Improvements in the illogical manner in which existing housing subsidies are structured could help solve both long-run and short-run problems. These subsidies lower efficiency, render planning by builders and others difficult, and do not aid stability as much as they might. They should be altered.

Costs and Stability

For over 20 years, I have battled against the common view that housebuilding is "extremely inefficient because it is industrially retarded, organizationally incompetent, technologically backward, and subject to an unusual number of major cost-increasing restraints." It has seemed clear to me that such views could arise only from a basic misunderstanding of our free enterprise market system. I have asked--unsuccessfully--critics to explain how a major industry could withstand almost the identical criticism --world-wide--for over 100 years and still continue to operate in an ineffective manner with gross errors.

Failing to receive a satisfactory answer, I have pointed out that the type of free market which exists in housebuilding should guarantee an industry in sound adjustment with its basic institutional needs. We should expect evolution not revolution in any large industry.

However, efficiency could be significantly increased through greater stability. The availability of funds would improve. A more systematic approach to development and financing would become possible. Better systems should reduce costs. Such improvements are occurring and are bringing some of their hoped-for fruits. As a result, however, some are beginning to fear that the traditional shortage of equity money for development and construction is being replaced by sudden outpourings of speculative funds.

Perfect stability in building is unlikely. This unfortunate fact follows directly from a competitive and uncontrolled market. Builders are many and everywhere. Houses are durable. Nationally, production in a year amounts to only 3 or 4 per cent of the existing stock. Even if production halted completely, inventory of vacant units would allow the increment of families to be housed for the next year or two.

All of these characteristics mean that large fluctuations in the production of housing are to be expected. Roughly the same degree of instability can be found when we examine other series on durable production such as autos or that for business structures and equipment. This degree of instability for the production of durables is in contrast with that found in such areas as electric power production or retail sales of non-durable goods. Instability in these areas is less than half of that exhibited by housing, autos, or plant and equipment outlays.

Given basic instability, however, if movements in credit offset rather than increased the market's inherent tendency to fluctuate, all would gain. Such offsetting has not occurred in the past. Institutional changes should aim at making future credit movements decrease rather than increase housing fluctuations.

Money and Stability

For housing to receive a more stable flow of credit, the supply of savings and the level of investment demand throughout the entire economy must be smoothed out. In addition, housing must be able to compete for credit on sounder terms than it has in the past.

Shortages of housing credit have not been artificial or arbitrarily created. They have reflected the manner in which scarce commodities are rationed in our economy. Credit becomes tight when the growth of aggregate demand speeds up and either threatens to exceed or does exceed available resources. Such imbalances may arise from war, from too rapid business investment in plant, equipment, or inventories, from sudden spurts in consumption, or from too rapid an increase in housebuilding itself.

When a discrepancy arises, demand must be cut to fit supply. Such curtailments can occur through higher taxes, reduced government spending, curtailment in credit, or inflation. In fact, all four adjustment processes usually go together.

Availability of mortgage credit is more unstable than total credit because it suffers from unfortunate institutional handicaps. Mortgages are usually purchased by financial institutions. Because of their asset structure, these institutions find it difficult to compete for funds when short-term rates rise rapidly. In addition, attempts to aid mortgage borrowers have established long-term disabilities such as usury laws, fixed interest ceilings, complexities of loans, and problems of foreclosure. These make mortgages non-preferred loans. When demand is high, lenders can choose more preferred borrowers. Potential mortgagors are cut out.

It is occasionally proposed by some, ignoring the basic underlying problem, that housing's lack of credit be dealt with by creating additional money to fund mortgages either directly or indirectly. Unfortunately, funding mortgages through creating new money is likely to decrease rather than add more resources for housing, unless demand is curtailed elsewhere. Paradoxically, the more total credit expands, the less there may be for housing. Thrift institutions, the basic source of mortgage money, are always threatened by inflation. They cannot continue to function and invest in mortgages if inflation drives the value of equities up and that of debt instruments down.

Will There Be Enough Credit in the 1970's?

Some people worry about a basic shortage of mortgage credit in the 1970's. For such a shortage to occur, there would have to be either (1) a sudden and unexpected increase in the demand for housing, or (2) a great change in the underlying savings and investment structure of our economy, or (3) a major loss in competitiveness of mortgages in the credit markets.

While any of these developments is possible, I think all of them are improbable.

The demand for housing or mortgage credit is unlikely to outstrip the growth of the economy. On the contrary, the basic demand for private housing starts is now close to its expected level for the rest of the decade. Recent starts are within the range of normal variation around the projected average for the decade. The translation of starts into dollar volumes of construction and borrowing is difficult because of unanswerable questions of prices, costs, and efficiency, but I would be surprised if the demand for housing credit or resources changed much in either direction from their past increasing relationship to the remainder of the economy.

Similarly, with respect to the supply of savings and credit, it is possible that a series of massive policy errors could so disrupt the savings and mortgage markets as to produce a major mishap. Since I am a confirmed optimist, I place low probabilities on the likelihood of such extreme errors. Difficulties may, of course, exist with respect to the cost of credit to families with low incomes. This I discuss in my final section.

The Demand for Private Housing Starts

Table I shows a projected demand and supply for housing for the decade April 1970 to April 1980 based upon a preliminary analysis of available Census data. The picture may alter somewhat when final Census data appear.

The Census contained no surprises. It seems to me that it reconfirmed the view that private housing starts at an annual average rate of 2 million units a year during the 1970's could readily meet both actual market demand and the nation's housing goals.

A 2-million private starts level, according to the table, would more than adequately achieve the 10-year congressional goal of the construction or rehabilitation of 26 million units. In fact, with 20 million private starts total production or rehabilitation of housing units would be close to 28 million, or considerably above the stated goals.

Table 1

SUPPLY AND DEMAND FOR HOUSING UNITS,
1960 - 1980

(In thousands; annual rates)

	April 1 1960 to April 1 1970	April 1 1970 to April 1 1980	Δ '70's minus '60's		April 1 1960 to April 1 1970	April 1 1970 to April 1 1980	Δ '70's minus '60's
<u>Demand</u>				<u>Supply</u>			
1. Change in households	1040	1400	360	1. Private starts ^{1/}	1410	2000	590
2. Removals:				2. Public starts	40	70	30
Private	500	580		3. Mobile shipments*	210	400	190
Public	10	20		4. Private and public rehabilitation**	265	310	45
Mobile*	<u>105</u>	<u>230</u>					
Subtotal	615	830	215				
3. Vacancies:							
Normal (9%)	95	120					
Deviation from normal	-105	105					
Inventory under construction	<u>15</u>	<u>15</u>					
Subtotal	5	240	235				
4. Rehabilitation**	<u>265</u>	<u>310</u>	<u>45</u>				
TOTAL	1925	2780	855	TOTAL	1925	2780	855

^{1/} Includes subsidized starts.

* Based on assumed 400,000 mobile homes shipments annually and 10-year average life.

** Actual levels of rehabilitation are unknown. What is known is that sub-standard units as a result of market action decreased from approximately 37% of stock in 1950, to 18% in 1960, to 9% in 1970, or by about 10.6 million units between 1950 and 1960, and 4.5 million between 1960 and 1970. The indicated level of rehabilitation could further reduce the ratio to under 2% in 1980.

Yearly estimates for the decade show both demand and required production to be quite flat. The current level of starts and its various supplements are already cutting into the backlog of demand. If, as some predict, starts at the turn of this year reach 2 million, the goal for the following eight years could well be to maintain this level in order to obtain stability.

We should not, of course, overemphasize the probable accuracy of projections this far into the future. A continuation of war, economic events far different from expected, and atypical years toward the end of the decade would shift both demand and supply relationships. For example, the projections I made in 1962 for the past decade turned out to be 5 per cent too high--mainly because of the Vietnam war's effect. Still, even with such caveats, I would not expect the errors for this decade to exceed by much those of the last decade. Such a range (5 to 10 per cent) should not have a major effect on analysis or policy decisions.

Most of the table is based on standard assumptions. These include a fairly high rate of household formation with removals and rehabilitations growing somewhat faster than the housing stock. As a result, the table implies a steady removal of sub-standard units and continued improvement in the total housing stock.

The inclusion in the figures for demand of a large number of vacancies probably strikes the uninitiated as the most startling item in the table. The demand for vacancies is shown as 235,000 a year more than those which occurred in the 1960's. Clearly individual investors or builders want vacancies as low as possible. Why should they be included in demand?

The projection assumes that there is some level of vacancies (actually 9 per cent of the stock) that is normal if people are to have desired mobility, recreational units, and a relatively unconstrained choice of housing types.

Vacancies did not grow in the '60's. Because of over-building, vacancies grew at too rapid a pace through 1965, but since the war accelerated, the number of units started has been less than the growth in basic needs. We have cut into both the fat and sinew of vacancies. Normal and increased vacancies to make up for this shortage form a considerable share of the increased demand projected for the 1970's. The postponability of this demand creates a large likelihood of instability for starts.

The footnote of the table points out that very little is known about the supply and replacements of mobile homes and similarly of rehabilitations. We know only that in the past rehabilitations and mobiles have

been significant in housing new families and upgrading the stock. So far as these supply elements are concerned, the table uses rather conservative assumptions. It shows these factors adding less to net supply than other observers usually allow. As a result, many may believe that the estimate of 2 million private starts a year is too high. However, since movements in both mobiles and rehabilitations are somewhat self-limiting inasmuch as they create their own off-setting pressures in the opposite side of the table and vice versa, I prefer to stay with a conservative approach rather than lowering the projected starts.

The existence of a more or less steady demand for starts throughout the decade is unexpected. It results from the assumption that the sizable backlog of missing normal vacancies will be filled earlier rather than later in the decade. Household formation and need for replacements do, of course, rise steadily. On the other hand, the existing shortage in vacancies is over 1 million units. With starts at a 2 million level in 1972 and thereafter, this source of demand would decrease as the others rose.

The fact that basic demand is likely to be so stable does not, of course, lead to a similar prediction for starts. It does mean, however, that the goal of finding policies to decrease production fluctuations is not inconsistent with the basic underlying forces. Stability in supply may not be achieved, but it is both possible and worth striving for.

Mortgages and Savings

I have not changed my past analysis of the long-term availability of mortgage funds. Most projections of savings and investment show that significant problems could arise only if our economy started to operate very differently from the past. Such a critical shift is possible, but unlikely in the coming eight years.

Some observers are concerned because they believe mortgages will not be able to compete with other financial instruments. They fear either too much competition from the stock market or that financial institutions, through a self-defeating attitude towards innovation, will lose their market shares.

Competition. I assume that some logical relationship must exist between equity and debt yields. At some point, the mortgage market will be able to attract necessary funds.

The fact that deposit institutions must compete with other markets for savings is one of the reasons why the form of the mortgage should change. Variable interest rates, equity participations, differences in amortization schedules are all ways of allowing deposit institutions to

bring their assets into line with their liabilities. Unless innovations are made, they will not be able to compete with other investments nor will they hold or expand their share of savings.

While a decline in deposit institutions' share of the financial flows would slow adjustments, it need not cause a shortage of mortgage money. The history of financial institutions is that new ones arise if existing ones fail to adjust. One can picture many ways in which the mortgage market could continue to operate even if the share of deposits in total financial flows fell. The fact that governmental sponsored agencies raised more than half the money for the net growth of mortgage funds in the last half of 1969 is a good example of how the system achieves an adjustment.

Total Savings. While the additional resources needed for a desired equilibrium between savings and investment do not appear large, given the size of past programs and the economy, a specific effort may be required to achieve them. The important requirement is that the level of savings, including that produced by the Government's surplus or net lending, equals the desired level of investment. When such an equilibrium occurs, most of the problems of the residential mortgage market will disappear.

The really critical variable in determining that these total funds are sufficient will be the action of the Federal Government, just as it has been for much of the past. This is because obtaining an adequate pool of savings is primarily a question of fiscal policy, that is to say, of government spending, tax, and lending programs in relation to general economic activities.

Short-Run Instability

We have noted that fluctuations in the availability of mortgage credit have increased rather than decreased the basic instability of house-building. Can this be turned around? Can credit act to improve stability? I think so.

Part of the problem arises when the total demand for credit and resources exceeds the supply and as a result mortgage credit gets squeezed out. As many in your industry now recognize, improved fiscal policies are almost certainly the most direct method of correcting the problem. At times, however, the problem may arise primarily from an excess credit demand in a specific sector. In that case, the correct solution may be to raise the marginal cost of borrowing in this sector through such devices as taxes, decreased tax exemptions, or direct additional charges for borrowing.

A problem also exists, however, because the mortgage system itself causes the availability of funds within it to fluctuate far more than desirable. Mortgages fail to compete adequately for their share of the general credit supply. Changing existing institutions or creating new ones may correct this problem.

The Government must play an even more dominant role in the search for stability or contra-cyclical policies in the housing and mortgage market than it does in the long-run markets. The Federal Government is by far the largest factor in this market through its tax and subsidy programs, its guarantee and insurance procedures, its sponsored agencies, and its programs for direct lending and grants. If the Government desires to achieve certain housing goals, devising the necessary programs requires some technical skills not impossible to secure. The critical problems are in the final analysis primarily political. The Government must determine what priority housing is to have in our national scale of objectives. It must then translate this priority into actuality by a proper selection of policies.

I think more and more people are coming to realize that the attempts through an almost bewildering array of laws and regulations to place mortgage borrowing in a special market with slightly lower rates may have done more harm than good. Such efforts have magnified normal instability. They have not attempted to separate markets by need. Great improvements might be possible if we allowed those who are willing and able to do so to bid freely for funds in the market. At the same time, those who are rationed out by high rents or high prices from adequate shelter should be offered direct government aid or other assistance to enable them to enter the market for funds also.

One method of allowing mortgages a fair crack at the general supply of credit has been through the establishment of lending agencies such as FNMA (Federal National Mortgage Association) and FHLB (Federal Home Loan Banks). These agencies form part of an evolving general program of developing money and capital market institutions capable of integrating mortgage finance more closely into our financial markets. Such evolution will continue to lessen the dependence of mortgage lending on the more traditional sources of funds, such as savings and loans and insurance companies.

Variable interest rate mortgages offer another way of making mortgage investments considerably more attractive for lending institutions. The fact that lenders' income would move more closely with current market rates would insure the ability of financial institutions to compete more effectively for funds as rates change. They also would make mortgages a less risky and, therefore, more valuable investment. Variable interest rates need not alter the borrower's monthly payments but rather could increase or decrease the amount of repayment on principal made each month and therefore would lengthen or shorten the ultimate term of the mortgage.

Subsidies and Stability

There may be times when the flow of mortgage money should be increased by additional subsidies. The Government may desire to improve the allocation of credit compared to the haphazard allocations which result from the mixed price and non-price elements of our financial structure, or it may want to increase flows for stabilization purposes.

Unfortunately, as I see it, current procedures, in addition to being haphazard, waste a good deal of the government's money. High or moderate income households receive too large a share of subsidy funds. Proposals to subsidize mortgage borrowing in general are likely to make matters worse. Beyond the fact that benefits are not being distributed in accordance with needs, our existing incentives have created too much instability. Families are pushed in and out of the mortgage and housing market through both rationing and prices. Our current knowledge of the extent to which the Government aids the mortgage and housing markets, and the distributional impact of this aid is woefully deficient. A considerable effort, both empirical and theoretical, is badly needed to provide the necessary information for the development of rational, effective housing programs.

Costs, Forbearance, and Subsidies

I would like to discuss a proposal to improve the situation somewhat. The section 235 subsidy is, I believe, a major step forward. It increases housing efficiency by utilizing the power of ownership and do-it-yourself. Its future, however, seems threatened by high costs and certain basic but unnecessary inefficiencies. I believe the program should be strengthened by the introduction of Home Ownership Promotion Enterprises to work with the salesman, the government, the mortgagee, and the owner. Concepts of this type were included in the original Percy Bill in 1967. I think their omission from the final Act should be reconsidered.

Many people concerned with housing for low or moderate income groups fail to differentiate three separate problems. The first involves reducing real housing costs to a minimum. The second relates to subsidizing those real housing costs which in the public's view exceed the maximum a family can pay for housing from its income. The third has to do with matching a family's monthly payments to its cash income.

Real costs and financial costs can differ greatly. The real costs of living in a house include: any loss or gain in its capital value (i.e., depreciation); interest on the investment; maintenance and operating costs including taxes; transfer costs of purchase and final sale. Financial costs differ from real costs depending on the down payment; on the degree to which amortization exceeds depreciation; and on transfer costs which may entail a large lump sum at the end.

Problems with the 235 program arise from the fact that it was grafted on as a supplement to existing mortgage programs rather than as a separate housing program. No one is responsible to see that costs are as low as possible or that the purchaser-owner gets a fair deal. At the same time, the government subsidy is not related to real costs. The Government pays for amortization rather than depreciation. Transfer costs are high. This is particularly so if a foreclosure occurs. Past studies of FHA foreclosures show that such costs can eat up between 25 and 40 per cent of the value of a house.

Under the existing procedures, inexperienced families buy houses with little understanding of values. They are given but slight aid in learning how to maintain the value of their house and in meeting necessary payments. Wasted transfer costs are large. The drain from the Government current budget for subsidies is heavy.

In the case of both new and used houses, I would interpose between the owner and the seller, mortgagee, and government, Home Ownership Promotion Enterprises (HOPE). They would be continuing non-profit, cooperative, or limited dividend corporations with an incentive to minimize real costs. The incentives could be provided through profits, bonuses, or the right to larger future participations in the program.

The function of HOPE's would be primarily to aid the individual owners. They would find potential owners for eligible housing, or inspect and approve any housing potential owners wanted to buy. They would hold titles as a fiduciary for the beneficial owners and serve as the mortgagor. Purchaser-owners would pick a house and show it to a HOPE. The HOPE would take title to the house and enter into a contract of sale with the new owner. The contract would be based on market interest rates and normal amortization, but it would include a forbearance clause giving the owner the privilege of delaying payments either through extending the life of the contract or until the time of sale. The purchaser would have the right to convert his ownership to a standard form anytime he desired. The HOPE would aid the owner through advice on maintenance, budgeting, etc. The Corporations might be a useful vehicle for the introduction of mortgage insurance to cover monthly payments in cases of death, disability, and loss of income.

The Home Ownership Promotion Enterprises would borrow the money for the initial purchase of the unit (as in the current 236 program). They also would enter into a contract with the Government with respect to each unit. The Government would agree to advance necessary interest and amortization payments on outstanding mortgages to the extent that payments were not fully covered by the payments made by the owners on their contracts of sale. As under 235 and 236, the difference between the amounts

paid by the owner and those due on the mortgage would depend on the income of the purchaser. At the time any contract terminates because the owner sells the house, takes out a standard mortgage, or is evicted because of a failure to meet payments, the HOPE would settle its account with the owner, the mortgagee, and the Government. The income from the sale would be used first to pay off the mortgage, and then to pay off the advances previously made by the Government to the extent possible. Any shortfall would be written off by the Government as a subsidy. Any gain would, of course, go to the owner.

While this procedure may sound complicated, it is no more so than the current procedure. Yet, it should greatly decrease both the real costs and the subsidy involved in the 235 program. Moreover, it could enormously increase its effectiveness.

As I visualize it, the owner gets skilled help in purchasing and maintaining his property. The HOPE has an incentive to aid the owner in working out of any payment difficulties. This is far less true for a traditional lender under current procedures. At the same time, most of the very high costs of foreclosure to both borrowers and lenders are avoided.

Rather than an outright monthly gift, the owner receives under this plan a forbearance of some amortization and interest payments. If, as should occur in well-maintained units, the real cost turns out to be one within the owner's income because values have risen, he would not require a subsidy. The mortgage principal could be paid from the sale of the house rather than by the government.

The number of eligible families is increased by the amount that the Government saves in its costs. The housing choices of a family as well as its chances of becoming a successful owner are greatly increased by the aid of HOPE.

Conclusion

As I promised at the start, I have primarily repeated concepts discussed previously at greater length. These points are I believe vital to your industry.

- For greater efficiency construction requires more stability.
- For greater stability, credit flows must become more even.
- Because projections of future demand show no large shifts, there is unlikely to be an over-all long-term shortage of mortgage credit.