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Remarks by

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I. Introduction

I am pleased to be here today to participate in this meeting of the Real Estate Conference Group. As many of you are aware, I have a keen interest in real estate and housing markets, so I welcome this opportunity, not only to speak to you, but also to learn from you and listen to concerns of people active in the field.

In my remarks today, I would like to share with you my assessment of major trends and challenges facing the housing industry as we enter the 1990s. Recent years have been characterized by broad regional disparities in housing market conditions, as well as changes in the financial environment. To fully appreciate the aggregate, we have to dig down into the set of unusual factors that have determined regional changes.

II. Aggregate Housing Trends

Viewed from a longer-term perspective, the housing sector as well as the economy generally have enjoyed good times since the downturns of the early 1980s. Single-family housing starts topped 1 million units in each of the past six years--a remarkable record of good performance. A wide variety of factors fueled this expansion. Undoubtedly of critical importance was the downward movement in mortgage interest rates, from their peak of 18 percent in 1982, to a nine year low of about half that amount by 1987. Along with lower mortgage rates, higher household income made housing more affordable, releasing demand pent up from previous years. In the Sunbelt especially, robust economic growth provided a particular boost to construction. Demographic factors also played an important role in the 1980s. Household formations rose in the aftermath of the cyclical downturn, stimulating housing construction.

The post-1982 expansion of housing activity no doubt has been aided by new financial instruments. In the primary market, adjustable-rate mortgages, which were offered at initial interest rates well below those of their fixed-rate counterparts, helped make housing more affordable. The development of the secondary mortgage market--especially the "securitization" of large numbers of home mortgages in the form of both pass-throughs and new derivative securities--broadened the base of mortgage finance and, in so doing, reduced housing's vulnerability to credit constraints that had plagued the housing industry in the 1960s and 1970s.

Nevertheless, since 1986, aggregate housing activity has slowed. The decline in starts has largely reflected a fall-off of more than 40 percent in the multifamily sector. As many of you are well aware, the 1986 tax reform bill sharply reduced returns to multifamily rental investment, and as investment demand inevitably fell, many areas of the country have been saddled with a significant overhang of multifamily dwellings. While some builders simply left the multifamily market, others shifted into the construction of upscaled and more expensive rental units, boosting the relative supply of high income rental units. This increase has outpaced demand and in recent years we have seen vacancy rates for upper-end units at double-digit levels. It now appears that the biggest drop in multifamily construction is behind us, and multifamily living has become an increasingly attractive option in areas of the country where affordability problems are the greatest.

But, on the whole, the multifamily market remains overbuilt, suggesting somewhat damped construction rates for some time to come.

In the single-family market, construction activity has been relatively well-maintained. In this sector too, however, starts did trend down in recent years, to a pace just below 1 million units (SAAR) in mid-1989, but have scored a moderate rebound according to our latest monthly reading (October.)

III. Regional Developments

Much of the contraction in the overall number of starts is attributable to a marked slowdown in the Northeast. In fact, housing markets in the Northeast have shown a striking cyclical pattern over the course of the recent business expansion. Single-family starts in that region moved up by more than 20 percent annually during the 1984-86 period--gains far in excess of those recorded in other regions--but since have fallen back considerably. House price inflation in the Northeast has fluctuated in tandem with construction trends, moving up strongly during the mid-1980s before dropping sharply in the last two years. As housing demand has weakened in the Northeast since 1986, inventories of new homes for sale have risen to more than a year's supply, far in excess of the national average.

The upward movement in prices and construction in the Northeast was due, in part, to strong demand-side fundamentals. Economic restructuring and diversification spurred employment and income growth throughout the region. By the mid-1980s, per-capita personal income in New England was about 20 percent higher than the national average, making that area the most affluent in the nation.

Northeast housing demand was further spurred by investment considerations, as the rapid house price growth in that region no doubt raised homebuyer expectations of further capital gains. Indeed, a 1988 survey of recent homebuyers sponsored by the Federal Reserve Bank of Boston showed that a majority of respondents in so-called "boom" markets viewed investment as the primary consideration in their home purchase decision. Survey findings also suggest that anticipated investment returns heavily influence the prices that potential homebuyers are willing to pay.

More recently, a variety of factors--including affordability problems, an overall slowing of the regional economy, reduced expectations of housing capital gains, and an excessive overhang of new homes for sale--have induced a drop in Northeast construction activity. The sharp runup in New England house values brought quality-adjusted prices far out of reach of the typical household. Not only did mortgage-servicing expenses in New England rise to about twice the U.S. average by 1988, but downpayment burdens were similarly quite high. Moreover, the sharp slowing of New England house price inflation that finally set in lowered homebuyer expectations about prospective capital gains, working to further damp housing demand in that region.

Although housing activity has recently slowed some in other regions as well, the adjustments in most markets have not been as great as in the Northeast. With the exception of a number of metropolitan areas in the Sunbelt, the overhang of new home inventories remains largely isolated to the Northeast. Further, most other areas of the country--with the exception of California--have not witnessed the apparent surge in speculative homebuying which has characterized some major Northeast markets. In markets outside the Northeast and California, house prices have generally remained well-aligned with household income.

California real estate markets bear some similarity to those of the Northeast states, but they are also characterized by some important differences. While the California market for the moment continues to bolster aggregate construction activity, reports I have seen suggest that the mood of this market has changed dramatically in recent quarters. Apparently the urgency to buy has diminished in previously red-hot markets--with many buyers waiting on the sidelines in expectation of better deals in coming months. The easing of demand has been most noticeable at the upper end of the market, reflecting in part an imbalance between asking prices and household income.

The high costs of housing likely have made many metropolitan areas of California less attractive to households and firms. In fact, analyses recently undertaken by Board staff attest to the importance of high house prices as a deterrent to household in-migration. Reports from the full set of participants in California real estate markets--from lenders to realtors to developers and buyers--suggest that affordability problems likely are working to constrain housing activity in many parts of the state.

Nonetheless, the California economy remains relatively robust, and there is a distinction to be made between California and other areas. The California economy, in particular, remains more diversified, buttressed by light manufacturing, tourism, and a growing trade with

Pacific Rim countries. In San Francisco last year, for instance, three new jobs were added for each new housing start. In such an environment, one could expect to see continued strong demand for housing. I don't have to tell California builders and developers that localities in this state have been among the pioneers of the slow-growth movement. Although those policies have oftentimes kept prices higher than they would have been in the absence of development constraints, they also have helped maintain a balance of housing demand and supply at a time when housing activity has been slowing. We should also note that median home prices in California's inland valleys compare very favorably to those in the high-priced coastal communities; the more affordable housing has likely contributed to the spurt of population growth which has occurred in those areas.

In marked contrast, real estate markets of the Southwest have been weak since 1985, reflecting the combined effects of depressed oil prices and previous overbuilding. Although house prices in that area remain well-aligned with household incomes, the investment motive for homeownership likely has been damped owing to the deflation in quality-adjusted house prices that has been ongoing since 1986. Reports also indicate an overhang of properties for sale in selected Southwest metropolitan areas.

IV. Looking Ahead

Looking ahead, a number of issues bear importantly on aggregate housing market activity. First of all, the demographic picture looks rather mixed. While the "baby boom" generation--often likened to an elephant moving through a boa constrictor--spurred housing demand in recent decades, the impending arrival of the "baby bust" generation [those currently aged 14-25] is expected to put housing demand on a slow downtrend into the next century. For the industry as a whole, this means, simply put, that fewer units will need to be built to keep the population housed. The easing of housing demand is expected to be gradual, however, in that the "baby-boom" generation [currently aged 26-44] is not yet out of the first-time home purchase market. In fact, little more than half of those households headed by persons aged 30-34 owned a home in 1988, and if the trend toward rising homeownership rates among older age groups holds, a substantial number of "baby boomers" will buy homes in the 1990s. Further, income growth among older "baby boom" households should help stimulate the markets for residential remodeling and vacation homes.

An immediate concern to all of us involves the effects of the thrift bail-out on the housing sector. Some analysts have voiced concerns of upward pressures on mortgage interest rates as the thrift industry scrambles to meet new rules that require those institutions to increase their capital base. It's certainly the case that thrift sell-offs of mortgage-backed securities have been considerable in recent months; further, the combined mortgage-backed security holdings of insolvent and thinly capitalized thrifts account for a full 10 percent of the total outstanding. However, I think it's fair to characterize the market for mortgage-backed securities as "thick", and in that regard, it appears that the sizable influx of securities to this point has been absorbed without a significant affect on mortgage interest rates and thus final housing demand.

We also are hearing some limited reports of cut-backs in construction lending to some builders as a consequence of the new regulatory standards for savings and loan associations. Thrifts apparently account for about 40 percent of such loans, and new restrictions placed on that industry limit the size of loans that these institutions can make to a single borrower. Further, since construction and land development loans are classified as unsecured loans, lenders are required to maintain a higher ratio of capital than for less risky credits. Such constraints may make lenders more reluctant to book acquisition and development loans. For better or for worse, the evidence to date concerning these effects is quite limited, and I'd be interested in hearing about any of your own experiences in this matter.

Perhaps the most important housing problem confronting the nation is that of housing affordability. The development of mortgage and financial markets reflects the importance that the U.S. historically has attached to promoting adequate housing for its population. Today, we see troubling indications that we are falling short of this objective. Of particular concern is the high proportion of income that low-income renters must spend to house themselves, the increasingly visible plight of the homeless, and the declining homeownership rate among young adults.

While homeownership remains a goal to which most young adults aspire, the ownership rate among households headed by someone between the ages of 25 and 34 declined from 52 percent to about 45 percent between 1980 and 1988. In part, the decline reflects the increased costs of owning relative to renting, with a larger share of households viewing renting as the lower-cost alternative. Young adults are more mobile than older households, and hence would be expected to more quickly adjust their housing to changing market conditions. But other factors are pertinent here as well; for instance, the incomes of young adults have not kept pace with the rest of the population. In that regard, minimum wage earners, and single parents, with their special problems in competing in the labor force, are more prevalent among young adult households.

Also, we appear to be turning into a country where income separates owner from renter. Indeed, the average income of renters today is about half that of owners, and the gap has been growing for some time. Although the problem facing low-income renters may be their low income rather than housing per se, the supply of modest rental apartments is dwindling in many areas, which tends to bid up rents on the units that remain.

Creative solutions to the affordability problem are required, in which a number of parties have critical roles to play. Expensive federal solutions are not in the offing, given the reality of budgetary restrictions; however, recent policy initiatives do seek to promote homeownership. The thrift bail-out legislation requires each of the Federal Home Loan Banks to set aside a portion of their annual earnings to subsidize mortgages for low-income households. Also, Congress recently raised the FHA loan ceiling in high-priced metropolitan areas and has solicited reaction to a variety of other proposals, including reductions in FHA downpayment requirements, and allowing the use of IRA or other tax-deferred savings for the home purchase downpayment.

State and local governments must play a role here as well, in the design of regulatory and development policies which enhance the availability of affordable housing. In that regard, local policymakers should be encouraged to explicitly include affordable housing units in comprehensive plans for community development. Builders may find it in their best interest to construct affordable housing, in that it remains a sector of the housing market characterized by robust demand.

Monetary policy also plays a key role in the outlook for the housing sector and, specifically, in promoting housing affordability. The Fed's task is to provide enough money and credit to support economic growth as we continue to move toward price stability. Throughout the years of the current expansion, the Fed has adjusted policy from time to time in attempting to keep the economy on a sustainable growth path. Over about the last half year, those actions have contributed to some easing in short-term interest rates. Long-term rates, including those on home mortgages, have moved down as well, which should work to support activity in the housing sector. We recognize that over the long haul, the vitality of the housing industry depends on sustainable economic growth and progress toward price stability, and we will continue to pursue policies that meet these goals.