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HOUSING AND MONETARY POLICY

Remarks by

Henry C. Wallich
Member, Board of Governors of the Federal Reserve System

to the

Pacific Coast Builders Conference

San Francisco, California

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It is a pleasure, and an honor, to be on this panel together with Jay Janis and Herman Smith, under the guidance of Marvin Gilman, to talk about federal economic policy in today's housing picture.

As we move into the second half of 1980, we are looking at the beginning of a new housing cycle. Housing starts are likely to bottom out soon. Permits have already turned up, although I would not give too much attention to data for a single month.

Today, housing construction is severely depressed in most parts of the nation. Housing has been the victim of the surge of inflation, as has happened several times before. As we look to the future and formulate our policies, we must be guided by the need both to restore the immediate health of the housing industry and to forestall continuation of this typical cyclical pattern.

How We Got Here

Let me review how we got to where we are. In recent years, the role of housing and its finance in the American economy has become more important than ever. Home ownership now represents the single most important asset of American families, totaling $2.2 trillion. The dollar value of new housing units constructed in 1979, close to $100 billion, was nearly three times its level 10 years ago and two times its level five years ago. The volume of home mortgages issued last year was of the order of $110 billion. This accounts for 28 percent of all the credit raised by nonfinancial borrowers in the economy. The total stock of 1 to 4 family home mortgages outstanding amounts to $872 billion, equal to 23 percent of the total debt of nonfinancial borrowers outstanding, or about equal to the debt of the federal government. The wealth of the American people increasingly has come to consist of their homes, their saving has increasingly been done for them by the rise in the price of their homes, and they have increased their mortgage indebtedness in order to liquify accumulated housing equity.

The evidence shows that people today are willing to devote a much higher fraction of their income to homeownership than in the past. For nearly 46 percent of home buyers in 1979, housing expense exceeded 25 percent of household income, against 38 percent in 1977. The pressure to acquire an inflation hedge seems to be as strong among the unmarried as the married. In Washington, D.C., the percentage of home buyers who were single rose from 20 percent in 1977 to 40 percent in 1979.

Housing Aids

Behind this love affair of the American people with their homes are forces that have been constructive and others that have been distinctly not so. Housing in the United States is supported by a variety of incentives and subsidies, many of which are not available in other countries. Full tax deductibility of mortgage interest, without imputation of implicit rent to the owner's income, seems to be an almost unique feature of the housing scene in the United States. Deductibility of interest is far more limited, where it exists at all, in Canada, Germany, the United Kingdom, France, and Italy. The government for many years has offered to insure and guarantee homeowner mortgages, and in recent years, we have created a pipeline from the bond market into the housing finance market, through a variety of mortgage-backed passthrough securities. An effort has been made, ill advised in my view, to hold down mortgage interest rates by not allowing thrift institutions and banks to pay a market-oriented interest rate to small savers. The flow of small savings has been diverted to mortgage-oriented thrift institutions by allowing them to pay a slightly higher deposit rate than their commercial bank competitors. This is only a partial list of the public policies we have employed to help channel resources into housing.

Price vs. Volume

Aided by strong demographics, measures like those I mentioned have strengthened the demand for owner-occupied housing. Rental construction has fared far less well, again largely because of public action such as rent controls. But the supply of new housing has shown itself to be not very elastic in response to mounting demand. Construction capacity is limited, and high activity has led to higher production costs. Limitations on the supply of land mandated by nature have been aggravated by man through regulation of all sorts. Much of the demand, therefore, has gone into higher prices rather than increased volume. Over the last 5 years, the price of owner-occupied homes has risen by 69 percent for new and 64 percent for old homes, contrasted with a rise in the consumer price index of 47 percent. Thus, housing prices have contributed to general inflation. They have also made homeowners affluent while inflation was destroying the value of savings in thrift institutions, in bonds, and in common stocks. And meanwhile potential new home buyers, who had no existing home to sell at a profit, were increasingly driven out of the market. Recent survey data indicate that from 1977 to 1979 the share of first-time buyers among all home buyers dropped from over one-third to about one-sixth.

Inflation and Interest Rates

Meanwhile inflation was relentlessly driving up interest rates. Both borrowers and lenders, except for small savers and stockholders, have increasingly learned to defend themselves against inflation. Lenders know that they must get an interest rate at least equal to the rate of inflation, and more if they are taxable. Borrowers have learned that rising property values and rising incomes will compensate them for higher interest rates, and if they are taxable, they will still be ahead of the game. Until late last year monetary policy, in its effort to moderate the rise of interest rates, only made them higher in the end by tolerating more inflation. The government's huge deficits added to demand in capital markets and to rising interest rates. Following the policy changes instituted last October, which were designed to give the Fed better control over aggregate flows of money and credit, market interest rates rose further and many mortgage lenders temporarily withdrew from the market.

Efforts to Avoid Disintermediation

Thus, it was not a lack of demand that struck housing, but principally the unavailability of financing, or availability only at very high interest rates. This has been the experience also of the earlier business and housing cycles experienced by our economy. In the expansion that came to an end early this year, special efforts were made by the Federal Reserve, the Federal Home Loan Bank Board, and other agencies, to shield housing against a recurrence. The six-month money market certificate was introduced, perhaps the most "successful" financial instrument of all time. I put the word "successful" in quotation marks advisedly, because in the end it only helped to postpone the day of disintermediation for the thrift institutions to a time of still higher interest rates and so helped to substitute a serious earnings problem for what might have been mainly a liquidity problem. Regulation Q ceilings were shifted around and the monetary aggregates allowed to expand excessively to avoid what were considered premature increases in interest rates. All this represented well-intentioned efforts to shield the thrift institutions and their principal customer, the housing industry, against disintermediation. But all that was achieved was to postpone a little the day of reckoning and to make it more severe when it came.

The measures of March 14 that had to be instituted late in the day, in order to keep accelerating inflation from exploding, also took special account of the needs of the housing industry. The credit controls imposed at that time sought to avoid the need to slow the inflation mainly by high interest rates. Given the tax shelters enjoyed by most borrowers, even the very high nominal rates reached in the mortgage market were still severely negative in real terms for many borrowers. Moreover, the controls and restraints imposed by the Federal Reserve specifically exempted small business and especially home builders from limitations on bank credit expansion. Also, small banks with high loan ratios were given special rediscount privileges, a measure addressed primarily toward the needs of agriculture but also helpful to housing. Reserve requirements were imposed on money market mutual funds to slow the drain of money from local banks and thrift institutions into money market centers. All this, together with a series of actions taken by the Federal Home Loan Bank Board, has helped to ease the situation of financial institutions.

Interest rates have come down dramatically since March under the new procedures instituted by the Federal Reserve which focus on a rigorous pursuit of a money supply target. Treasury bill rates are down about 8 percentage points from their peak, and so is the prime rate. Mortgage rates have come down about 4 points, and the supply of funds is building up. The condition of thrift institutions has improved, and if there were concerns earlier they have been removed. The financial system has weathered the strain of the last few months in good condition.

We must now look toward the future. As I said before, this means two things: to resume moderate speed in housing and in the economy generally, and, second, to work toward avoiding a repetition in future years of the boom-and-bust cycle.

The forces that will turn housing and the economy around are already at work. Lower interest rates, greater availability of money, and an improvement in the balance sheets of households and business are underway. These developments do not need any special stimulation from a tax cut or an acceleration of monetary growth. Such measures would have their effects too late to affect the present situation and would only guarantee us a resumption of accelerating inflation a few quarters down the road.

It is precisely toward the control of inflation that future measures need to be geared at the Federal Reserve. If inflation were to keep rising, I would see little hope for the future of our economy or of the housing industry. Inflation has ravaged our savings, our productivity, the value of our dollar at home and abroad, and will continue its grisly work if we do not fight it resolutely even at some cost. The costs of letting inflation run are vastly greater than the costs of fighting it. That is true even if housing could to some extent be shielded by imaginative new devices such as variable-rate and rollover mortgages. The Federal Reserve supports these techniques, as it also has supported Federal preemption of state ceilings on home mortgage rates, the broadening of the asset and liability powers of thrift institutions and the gradual phasing out of Regulation Q which have now been mandated by Congress. But without an end to inflation, these measures cannot restore the lasting health of the housing sector or of our economy.

Nor should we deceive ourselves by prematurely declaring victory in this struggle and going home. The consumer price index has exaggerated the rate of inflation on the upside, owing to the heavy weight given to home prices and mortgage interest rates. It will soon begin to exaggerate success in bringing inflation down, as housing prices slow and lower mortgage rates are incorporated in the index. It will take much longer than a few months to wring out an inflation that has taken 15 years to build up. We should not delude ourselves as to the difficulties of the struggle. But neither should we entertain illusions about the fate that awaits this economy if it yields to the temptation of trying to live with inflation. To avoid that outcome, all our efforts must be united.