REFLECTIONS ON MONEY AND HOUSING

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by

Monroe Kimbrel, President
Federal Reserve Bank of Atlanta

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There are some combinations that seem to lead to specific, foreordained results. Put a lion into a flock of sheep and you will very likely get a feast; put a Federal Reserve Bank President before the Economic Society of South Florida and you will probably hear a speech about housing. The Federal Reserve and housing are very closely linked. And housing (and the Federal Reserve) has taken its licks of late.

Housing has led the economy into a slump and has slumped much more than the rest of the economy. In the past year, housing starts have fallen more than 30 percent from levels that were already considered depressed. Construction employment in December 1974 was 302,000 under its December 1973 level, though total employment remained nearly unchanged over this period. Florida, as you must be aware, has had it worse. Florida accounted for one-sixth of the loss in construction jobs in this country last year. Let me give you another comparison. Whereas the number of housing units contracted nationally were down 35 percent during 1974, they were down 48 percent in Florida. In the West Palm Beach-Boca Raton area, they were down 51 percent; in Fort Lauderdale-Hollywood, 52 percent; and in the Miami area, 35 percent. You right here in South Florida have seen the worst of this country's current housing problems.

Why does housing so often lead the economy into a slump, and why does housing slump more than most other industries? I think the answer to these two questions lies in the product of the housing industry itself, in the way housing is financed, and in the way our economic stabilization policy is carried out.

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First, the product. Single-family or multifamily housing is durable and its purchase is postponable. People, after all, can make do with older houses for a while longer or stay in the same old apartment when homes, condominiums, and apartments go up in price. There are, on the other hand, many things the average person cannot postpone buying. Food and gasoline are good examples; so when inflation hits or things get bleak, consumers are more apt to put off buying a new home or renting a new apartment than they put off most everything else.

Homes, condominiums, and apartment buildings, of course, do, as we all know, involve a big outlay that must be financed. Consequently, interest rates influence home buying much more than most other consumer buying. The home or condominium buyer or apartment developer must borrow much of what he pays for a new home or building. In borrowing, each must compete, either directly or indirectly, with other borrowers who have a lot more staying power when interest rates are bid up to higher and higher levels.

The changing role of life insurance companies in home financing underlines this. Until the mid-1960's, life insurance companies financed a large portion of single-family home mortgages. But as corporations came to raise less money for capital programs from earnings and more and more in the capital markets, they bid the return on corporate bonds up in relation to the rate for residential mortgages. When it looked as if the relatively high corporate bond rates had become permanent, life insurance companies withdrew almost completely from single-family residential financing. They are still out.

Meanwhile, public utilities, industrial corporations, and other borrowers have continued borrowing money from banks and from the public through bond offerings in heavy volume, despite almost steadily rising interest rates. And as if there were not enough competition for funds, the Federal Government

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competed with private sources for credit during these prolonged periods of inflation and high interest rates.

What hurts housing is that corporations and state and local governments can be confident of passing on at least some of the additional credit costs, while the home buyer is usually less confident his income will rise. The Federal Government, with its nearly unlimited borrowing powers, has yet other advantages in competing for funds over home buyers and the institutions that finance housing.

A major part of the housing industry gets hurt more than most other sectors for yet another reason. That is our system for financing home buying. Since the life insurance companies departed, savings and loan associations and mutual savings banks are the main sources of permanent single-family financing. These institutions rely for their money on fairly short-term deposits to put into mortgages. They must raise the rates they pay on deposits when interest rates go up if they want to keep their old deposits and attract new ones. But most of the mortgages that make up the bulk of their assets have long maturities and fixed interest rates. Therefore, it is tough for thrift institutions to earn enough to pay more for their deposits and maintain their reserves at the same time. Now compare this to the situation of other investors. They have other opportunities for investing their money at high rates--into bonds and other types of debt instruments. As a result, thrift institutions get squeezed and lose deposits by a process called "disintermediation."

As recently as last fall, these institutions paid anywhere from 5 1/4 to 7 1/2 percent on various types of savings accounts, while returns of better than 8 percent were available on Federal obligations and better than 10 percent on corporate bonds. Is it any wonder savings banks and savings and loan

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associations lost about $3 billion of deposits in July and August 1974 and recovered little in September and October.

Financing of multifamily buildings has fewer problems than that of single-family housing. But even this activity has had its share of problems in recent months. Here I am thinking chiefly of the REIT's. As institutions typically with short liabilities, they discovered many of their assets had longer-than-expected terms. In a nutshell, they have felt many of the same forces the thrift institutions experienced.

The upshot of all this for housing is that money for construction and permanent financing is hard to come by when interest rates go up. Contrast this with General Motors, the Federal Government, and most other users of credit who do not face the same institutional setup. Rising interest rates affect them less severely.

Let me call your attention to still other elements particularly adverse to housing. These include usury laws on conventional mortgages and ceiling rates on FHA and VA mortgages. Most nonhousing borrowers do not come under the same sort of restriction. Free to pay higher interest charges, they get the credit. But housing, with its usury laws and other impediments, feels a shortage.

I am aware that I have not yet said a word about the Federal Reserve and what part it has played in this housing slump. I am coming to that subject now. Candidly, I don't think there is any question that the Federal Reserve bears some responsibility for the current dismal housing picture. It does because housing has felt the impact of the Federal Reserve's restrictive money policy. However, the officials of the Federal Reserve did not meet in secret and decide for some sinister reason to pick on housing. What we have tried to do is to moderate inflation, as the Congress long ago instructed us to do,

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with the limited powers Congress has given us over the years. These tools allow the Federal Reserve to restrict credit growth, thereby reducing the demand for goods in need of financing.

In the past two years, rapid inflation has by itself generated colossal demands for credit. Some businesses borrowed heavily to pay for stockpiled materials and equipment. Expecting prices to go up has been a motivating force for some of this buying and borrowing. Another was the simple fact that the higher cost of everything means it takes more money and credit for the same unit sales volume. Consequently, for these and other reasons extremely heavy credit demands have outrun savings. Whenever you have this situation, when credit demands exceed supply, some who want and need credit are refused, or get less than they need, and all pay more for credit.

The Federal Reserve could have made up this shortfall in the supply of credit by pumping enormous amounts of reserves into the banking system. But we did not do this for one simple reason. We were certain that more reserves would add fuel to the inflationary fire. Until quite recently, we chose to limit our contribution to bank reserves to levels below those of the preceding few years; this contributed to the shortage of credit and to the rise in interest rates.

In other words, we did not decide to pick on housing. But the effect of our decision to fight inflation, with the tools given to us, made the effect the same. Of course, other industries, consumers, and governments have felt the impact of tight money, too. But because residential construction, home buying, and our financial system have the peculiarities that I have mentioned, housing has felt the pains of fighting inflation with monetary policy earlier and more intensely than most other segments of the economy.

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Why should housing have to pay the price? And is there any good, in the greater sense, in bearing so much of the brunt? Here, the answers that I can give do not completely satisfy me nor will they satisfy you. First, if inflation is to be slowed, demand in the economy must be reduced. This has occurred, as we all know, in housing and, more recently, in practically every other part of the economy. By the same token, the inflationary spiral has been broken at long last. The inflation rate has slowed. That is in part because of less demand.

There are still other fallouts from the housing slump that again are little comfort to those concerned with housing but can possibly be assigned to good and welfare. When housing is cut back, scarce labor and materials become available for other industries. This is all to the good. The other fallout is that when spending on housing gets cut back, total spending in the economy is curbed too, and this, in itself, acts to restrain inflationary pressures.

But seeing housing fall into the valley of the shadow during the fight against inflation, does the Federal Reserve see any hope now? There are two kinds of hope that I look for, personally. One is the hope that housing will emerge from the valley soon. The other, and much more important, is the hope that when housing emerges from this valley it will not be taken back down so far in the future. I am a little more optimistic about the short run than I am about the long run, but my optimism is tempered in either case.

Just as a combination of factors causes greater problems for housing when inflation and tight money come together, the same factors give housing a lift when money eases. Financing costs fall as competition for funds eases and postponed demand for housing becomes active demand again. Of late, the Federal Reserve has taken some definite movements toward easing credit. One of the most publicized is a gradual reduction in the discount rate, from

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8 percent in early December to 6 3/4 percent more recently. More important, though, is that we took steps to allow money market rates to fall sharply and that long-term interest rates have moved down rather significantly.

Looking ahead, these Federal Reserve moves are supposed to be accompanied by a mildly expansionary fiscal policy. Housing can expect some positive impact from both. However, the positive impact of monetary and fiscal policy may be slow to feed another housing boom this time around. Real personal income has been down for several quarters and may recover slowly. Unemployment is very high and may be slow to fall. Inventories of houses, condominiums, and apartments still overhang, shadowing new production. All of these problems have more of an impact in Florida than in most other parts of the country, so you may have to wait a little longer for your housing recovery than some of the rest of us.

While I talk about current economic problems in the housing sector, let me say a few words about problems in the rest of the economy. The problems are there in force. For example, our country's financial system is coming through a very trying time. Banks and thrift institutions have had their troubles, and their troubles have been big in some cases. Yet, so far, they, with the help of some government-related organizations, have kept their troubles from disrupting the economy. Banks have charged off rather heavily. Some of their losses have already appeared, but I think it would be well to anticipate that many banks have identified additional possible losses and are zeroing in on them; all of these may not show up on the books until later this year or even later than that. I say this not to suggest general weakness in the banking system but to let you know that one should expect there will be other losses reported by banks this year. I am confident, however, that most banks can continue to deal with their problems in an orderly manner and that

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their managements will learn some lessons which will make banks less likely to get into this kind of trouble again.

Strength of financial institutions is important because even after we pull out of this recession, we cannot expect there will never be another recession again. We will get out of our present recession if we have patience, but a miracle cure for the problems that have brought us six recessions in the postwar period is quite unlikely. This means that the housing industry and its customers will be tested again. Unless some of the characteristics of housing, its finance system, and stabilization policies are changed, housing will again suffer badly.

The burden of seeing that these things will change falls partly on us. We must do all we can to see that stable prices return to this economy. If we do our job well, housing will be helped immeasurably, but we lack direct powers to see that housing gets more credit when other borrowers are bidding strongly. Realizing this, the Federal Reserve has proposed several reforms that would enable housing to get more credit. Many of you may not be aware of this. But in a 1972 study made at the request of the U. S. Congress, the Federal Reserve endorsed some fundamental reforms in housing finance. If the Congress ever adopts all of these reforms, it will help housing in the long run. These recommendations include: (1) removing usury ceilings and FHA-VA ceiling rates, (2) allowing the principal home financing institutions to lengthen their liabilities and shorten their assets, (3) moving toward greater uniformity of mortgage instruments and variable rate mortgages, and (4) imposing a flexible tax on business investment during periods of credit tightness. This last proposal was intended to leave more funds for housing and redistribute the burden from the housing sector. Congress, unfortunately, has not seen fit to act on most of this program. Nor has it acted on similar

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proposals made by the so-called Hunt Commission. These would, in addition, broaden the borrowing and lending powers of banks and thrift institutions in order to allow them to meet competition for housing funds with a greater and more flexible arsenal of competitive weapons. These programs are not total solutions, but they would spread some of the burdens of fighting inflation.

For the future, then, I am mildly optimistic about housing. It is true that there are a lot of unsold houses and that some builders are in difficulties; but interest rates are falling. Mortgage credit is easier to get and swelled by a long interval of postponements, housing demand should increase. Therefore, looking ahead, future years of 2 million plus starts may once again become a reality; builders will get well; lenders will have plenty of business; more of the nation's housing needs will be met; and pressure to change institutions will abate. But look for some more lean years to follow if we do not change our system of housing finance and the capacity of housing consumers to buy. Only if institutions are improved, sources of financing broadened, and prices stabilized, can the swings in housing demand and production be reduced and some of the burden of fighting inflation shifted away from housing.

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