

**Policy Advisory Board Meeting
Joint Center for Housing Studies, Harvard University**

**Cathy E. Minehan
President and Chief Executive Officer
Federal Reserve Bank of Boston**

**February 5, 1996
Four Seasons Hotel
Washington, D.C.**

Last summer, many economic forecasters were expecting the weakness in residential investment from the first half of the year to continue through the second half of 1995. Fortunately, to paraphrase Mark Twain, rumors of the death of residential investment appear to have been greatly exaggerated. The third-quarter GDP report showed that real residential investment grew by 8.4 percent, and November housing starts of 1.42 million units and building permits of 1.43 million units are consistent with reasonable growth in the fourth quarter-- probably slower than the growth in the third quarter but certainly a better performance than in the first two quarters of 1995.

Why did many forecasters miss the strength in the housing sector in the second half of last year? I think many forecasters doubted the Federal Reserve's ability to successfully engineer a soft landing, with its very substantial benefits for the housing sector. We have, at least before blizzards, floods, and Government shutdowns muddied the waters, achieved a sort of economic nirvana: labor markets nearly fully employed, inflation at a level that does not influence business decisions, and long-term interest rates that have continued to decline. While many forecasts contained elements of these three characteristics, few expected the central bank to achieve all three.

Some forecasts had declining interest rates and unchanged inflation rates, but in the context of a weak economy--with sharply rising unemployment and sectors such as housing weakening substantially. Other forecasters expected a stronger economy and relatively strong housing, but with increased inflationary pressures and higher interest rates that--were they to persist--would eventually cause a substantial decline in housing as the Federal Reserve tried to contain an overheating economy.

Instead, with people fully employed in a noninflationary economy, and with housing affordability enhanced by lower interest rates, the housing sector performed well in the second half of 1995. It is just this type of outcome that we are striving for in 1996. A stable non-inflationary economy is exactly the environment that can promote a stable housing sector, avoiding the booms or busts that play havoc with the plans of potential home buyers, builders, and lenders.

Some of the benefits of stable inflation rates are evident in the movements in long-term interest rates over the past year and in the optimism reflected in our buoyant stock and bond markets. While the unemployment rate has remained basically unchanged for the past year

at a level that most economists consider to represent full employment, 30-year fixed-rate mortgage rates have fallen from almost 9 percent in the first quarter of 1995 to roughly 7 percent today. Other forces undoubtedly contributed to this decline, but it would not have happened if financial markets did not have confidence that inflation would remain well contained.

How do things look going forward? Despite recent rather gloomy rhetoric, most forecasters expect that unemployment will remain roughly the same in 1996, with the economy growing at or slightly below its potential and no significant inflationary pressures. While the uncertainties looking forward are great and perhaps downside risks have increased, the prospect of a stable unemployment rate, inflation rate, and solid growth in real GDP is both my expectation and my hope.

Such an environment should be quite benign for the housing sector, but it certainly does not imply a boom. So my expectation for housing is modest growth. (Although I recognize that whatever the trend, housing is always prone to sharp month-to-month and quarter-to-quarter swings.)

I want to focus the remainder of my remarks on three areas that

are important to the housing sector, both in 1996 and beyond.

The first is one that I am sure to be asked about if I don't address it now. If growth in the housing sector will be unspectacular and downside risks have increased, could interest rates be lowered, preferably by a lot? In the short run, the housing industry undoubtedly would grow more rapidly with a more accommodative monetary policy. In the short run, most--if not everyone--in this room would benefit from significantly lower interest rates.

Others would also like to see faster growth. At the modest rate of expansion we experienced in 1995 and that I expect to continue in 1996, not all sectors of the economy are growing and even within growing sectors, some firms are experiencing flat or declining demand.

So why not take interest rates lower, faster? In the short run, growth could be spurred by increasingly accommodative monetary policy, but this faster growth would risk an acceleration of inflation. According to traditional measures, the economy has little slack at the present time. Historically, whenever unemployment rates have been below 5.5-6.0 percent, we have seen inflationary pressures build. Labor costs start to rise, as turnover increases and wage demands pick

up. Tight labor markets also tend to coincide with tight markets for other products. Bottlenecks appear and prices rise.

Now some analysts claim that times have changed. They argue that global competition, the restructuring of industry, and the impact of technological change have made firms much more cautious about raising prices, and workers more wary about switching jobs or demanding higher wages. Thus, the unemployment rate that is compatible with stable inflation may be lower than in the past. Some have also suggested that productivity growth is greater than the measured figures show, which means that the economy could grow faster without generating inflationary pressures.

I am a little more sympathetic to these arguments than I used to be. At an average of 5.7 percent or so over the last several months, the unemployment rate has been at the low end of the range that most economists thought compatible with stable inflation. Yet even with such a low unemployment rate, inflation has been well-behaved, and expectations of inflation seem to have drifted lower. But we must be cautious.

While the growth in labor compensation has been very moderate,

some of this reflects smaller increases in health benefit costs. It is open to question whether this moderating influence will persist or whether it is just a temporary development due to a one-time restructuring in the health care industry. We should also recognize that we have had several consecutive years in which energy prices have been very well-behaved and have pulled down the rate of inflation. Obviously, this could change.

Finally, and to me most significantly, we saw the consequences of rapid growth in an economy operating with little slack, as recently as the late 1980s. It seemed, we had achieved a soft landing, with unemployment around 5.5 percent and inflation stable at around 4 percent. The Federal Reserve was cautiously raising short-term interest rates, to keep the economy on a course of noninflationary growth, when the stock market crash of 1987 raised concerns about a possible recession. We held back a bit, the economy rebounded, the unemployment rate fell still lower and inflation took off, setting the stage for the 1990-91 recession.

And it is inflation itself that will be most destructive to economic growth over the longer term. In the past 30 years, every recession

has been preceded by a run-up of inflation. Moreover, whenever unemployment and inflation rates have both been low at the same time, what brought this situation to an end was not the economy running out of steam and sliding into recession. Rather, the problem was that growth accelerated, straining labor and other resources and creating inflationary pressures that ultimately led to recession.

Inflation has a great deal of persistence, and it creates uncertainties and distortions that impede decision-making and divert investment into less productive uses. Through the miracle of compounding, even small increases can mount up, creating inequities that are intolerable. Thus, while it is easy to argue that monetary policy should be more supportive of growth, if we're not very careful, actions in this direction can have exactly the opposite consequences. More accommodative policy than necessary might stimulate the housing sector in the short run, but the consequences could very well be a boom followed by a bust. Such cycles can result in substantial hardships following the bust, an example all too vivid for anyone engaged in real estate in New England.

The second area that I am going to raise involves the numerous

questions related to fiscal policy. Fortunately you have Henry Aaron and William Niskanen on the program tomorrow to forecast the probability of a deficit reduction agreement, and to discuss tax policy alternatives and their ramifications for the housing industry. I will not attempt to steal their thunder--and it's rather doubtful that I could. However, I am very much in favor of deficit reduction, and the related reduction in dependence on foreign savings and redeployment of domestic savings to private investment that such a move might encourage. But the devil is in the details. If credible deficit reduction reduces long-term interest rates the housing sector and the economy in general should benefit on net; but overly tricky schemes that could increase deficit levels before they are reduced strike me as counterproductive. Similarly, there's probably a lot to be said for some form of tax simplification, but both the wide variety of plans in this area, and their wide-ranging implications, particularly whether they will end up being revenue neutral, leave me concerned about unintended consequences and what might be involved in the transition to these new tax schemes. So I am looking forward to hearing the panel tomorrow discuss how likely and how substantial these effects may be.

The third area I'd like to touch on involves what for me has been a real conundrum. Why in the face of relatively benign economic data--at least until the blizzard confused the employment situation--is the rhetoric about the economy so gloomy? I was in France during the height of the strikes, and most of the people I met were more upbeat about their own economic situation than those I see in the U.S., even after recognizing the economic challenges of the Maastricht Treaty. Maybe it's the weather, maybe it's the budget and debt ceiling confusion, but it could also be the almost palpable sense of job insecurity that has characterized this recovery. People believe the implicit labor contracts of the past have been broken, and if they are not candidates for layoff themselves, their neighbor is. And adding to this issue is the presence of income inequality in the United States--the rich are getting richer and the poor, poorer in every developed country, but the gap is wider in the U.S.

The big losers are men with only a high school education. Technological change, the shift from manufacturing to services, and increased competition from low-wage parts of the world have all contributed to a decline in real wages for unskilled and semi-skilled

men, even as the wages of women and those who are better educated have stabilized or risen.

Why is this an issue for you or me? It is an issue for all of us, because rising inequality, in my judgement, contributes to the pessimism with which so many seem to view our country's future. It fosters social divisiveness and encourages those who perceive themselves as losing ground to look for scapegoats. It is an issue for you in the housing industry in particular, because fulfillment of the American dream has always included home-ownership. To the extent that many high school graduates do not go on to college--and only about 30 percent of our nation's work force right now has a college education or better--the market for the homes you build can only shrink as relative incomes for many workers decline.

Changes in the competitive environment for unskilled and semi-skilled workers cannot be directly altered by the housing industry or by business generally or even by monetary policy; and engaging in uneconomic practices out of a desire to do good is counterproductive. But at the margin, there are things your businesses and others can do. Banks, I know, have begun to find nontraditional mortgage borrowers a

good source of business if they can adapt their practices to the realities of the low- and moderate-income borrower.

Through hiring, training, and procurement policies, businesses also can help open doors for those who are falling behind. In that regard I'd like to highlight a program we participate in at the Boston Reserve Bank called "Youthbuild-Boston." This program seeks to link classroom instruction and on-site construction and building maintenance experiences for young people who would otherwise have dropped out of school. Our experience has been quite favorable; trainees come to us after an initial period of instruction that orients them to the world of work. They work part-time, and go to school part-time. I'm told that the on-the-job exposure to aspects of geometry, for example, has taken that subject out of the dusty realms of irrelevance and made it live for these trainees. Not surprisingly, many of them go on to higher education, or at least complete their high school education, something that was highly unlikely before "Youthbuild-Boston" got involved.

There is no easy solution to rising income inequality, and I certainly do not think that massive public programs are the answer.

The day of such programs has long passed. However, small actions on many fronts, and especially those involving local private/public partnerships like "Youthbuild-Boston," may help chip away at this very serious problem.

The primary responsibility of monetary policy in this time of fiscal uncertainty and uneven economic progress is to create an environment that is conducive to growth over the long term. This means adjusting monetary policy so as to prevent major booms and busts and keeping economic growth high, without igniting inflation. In such an environment, balancing the budget is easier; and training and other policies to help those falling behind are more likely to succeed.

In conclusion, while we achieved a soft landing in 1995, maintaining the economy on a stable course is critical to consolidating those gains. Such an environment substantially increases the chances that home buyers, home builders, and home lenders can transact business with reduced uncertainty about the macroeconomy, reducing risk premiums, and thus the overall cost of making real estate transactions. A stable course should be good for the health of the overall economy and the long-run health of the housing industry.