Research Department
Federal Reserve
Bank of
San Francisco

May 21, 1976

Home Sweet Home

The perverse American consumer has crossed up the experts once again. In the midst of the energy crisis two years ago, everyone took it for granted that Americans henceforth would drive only small cars and would live only in cramped (but energy saving) apartments and townhouses. Now, in 1976, the consumer has turned his back on compact cars in favor of much larger autos, and has continued to reject rental accommodations in favor of the traditional single-family home. Still, the shape of the 1976 housing market can be better understood in terms of the traditional factors governing family shelter decisions than in terms of the now half-forgotten energy crisis.

Despite some understandable belt-tightening, househunters have tenaciously held to their preference for single-family housing. New starts in this category exceeded 1.1 million (annual rate) in the first four months of 1976—more than 70 percent higher than the recession low and not far below the 1972-73 peak. Moreover, the recent strong rise in housing-permit activity suggests a strong level of single-family building for the rest of the year. In sharp contrast, multi-family building is still severely depressed. Starts in this category fell below 300,000 (annual rate) in January-April—about 20 percent above the trough but only a fraction of the level reached during the 1972-73 boom.

Money and prices

Why have we witnessed such strength in single-family construction, compared to the lagging performance of other segments of the market? One reason is inflation, which leads people to lock themselves into high fixed-payment mortgage contracts because of the expectation that today's sky-high housing prices will be even higher tomorrow. Another important reason is the blooming health of financial institutions that provide funds for single-family housing. Thrift institutions recorded a very strong buildup of liquidity in 1975 and early 1976. Since one quarter's savings flows normally become the next quarter's mortgage commitments, funds are now available for financing a very high level of new housing.

With record amounts of money still searching for outlets, mortgage interest rates remain well below earlier peaks. Last year's market recovered even in the face of mortgage rates of 9 percent or more, and the market strengthened further this year as rates on prime loans fell to 8½ percent or less in many localities, before firming again in recent weeks. The decline in rates from the 1974 peak meant a substantial cut in the size of the average monthly payment, and thus a major broadening of the market.

Of course, financing of single-family housing remains narrowly based, being dependent predominantly on thrift institutions (especially savings-and-loan associations) and on federal agencies. Over the past several decades, most private financial institutions except S&Ls

(continued on page 2)

Research Department
Federal Reserve
Bank of
San Francisco

Opinions expressed in this newsletter do not necessarily reflect the views of the management of the Federal Reserve Bank of San Francisco, nor of the Board of Governors of the Federal Reserve System.

have reduced their share of the total mortgage market, and all have reduced the single-family portion of their mortgage portfolios. In view of the interest-rate ceilings on thrift deposits, rising market interest rates always create a slowdown in savings flows and thus reduce the availability of mortgages for single-family housing. This threat will continue to overhang the housing industry—although it is not a significant problem in the spring of 1976 despite the recent rate upturn.

People and landlords

Demographic as well as financial considerations now support a high level of single-family construction. The children of the post-World War II baby boom have grown, and have begun to marry and have children of their own. Thus, according to Census data, the total number of households could increase almost one third by 1990. Although large numbers of these people will be searching for apartments rather than detached units, a considerable portion will become prime candidates for single-family housing.

Actually, the demographics today would suggest a stronger boom in the apartment sector than in the single-family sector. Adults in the apartment-hunting age category—20-34 years or over 65—should account for the entire 19.3 million increase of population in the 1970s, while the number of children is expected to decline by 5.1 million. But while the demographics are right for such high density housing, the economic factors are all wrong, since the present level of rents apparently is not high enough to offset the cost of building and operating rental units. Financing (except for REIT's) probably would be no problem at this stage were it not for this underlying economic difficulty.

The unprecedented slump in multi-family housing is partly a reaction to the preceding boom, which reached its peak in the 1971-73 period. Because of a prolonged period of heavy building, the percentage of the multi-unit housing stock below 10 years of age jumped from 21 to 55 percent of the total between 1960 and 1973. Now, in the wake of the boom, many communities still have abnormally high vacancy rates, although the national rate dropped to 5.5 percent in the last two quarters after averaging over 6.0 percent for several years.

In this situation, gross rental rates have had trouble keeping pace with sharp increases in operating costs for utilities, maintenance, taxes and management. Rents have increased at a 6-percent annual rate since last fall, but builders estimate that it would take a 15 to 20-percent rise in rent levels to offset increasing construction and operating costs. They may not get it, especially in view of growing pressures for rent control—all begun when New York City adopted its Temporary Rent Control Act in 1943.

While construction of rental housing lags, single-family construction continues to expand, despite the common argument that only a small minority of the population can afford the average home. Indeed, the median selling price of new homes jumped 42 percent (to $39,200) over the 1972-75 period, while the median family income rose at only half that rate in the same period. (Home prices apparently have accelerated even more to date in 1976.) Moreover, the home-ownership component of the consumer price index now is 35 percent above the 1972 level, compared with a 20-percent rise in rents over that period.

Misleading indexes

Those figures would suggest the presence of strong economic incentives to rent rather than buy, except that the CPI data tend to be misleading because of downward biases in the rent index and upward biases in the home-owner index. The rent index is biased downward because no adjustment is made for each year's depreciation although the apartments included in the index sample are one year older each year. (Depreciation is shown as a decline in price rather than a decline in quality.) In contrast, the home-purchase component of the home-ownership index compares houses of the same age in order to avoid the depreciation problem. In addition, the rent index is biased downward because of the increasing prevalence of rent-control ordinances, which mask a decline in the quality of the housing stock under a facade of stable prices.

The home-ownership cost index, in contrast, tends to be biased upward. The index consists of a number of disparate costs: several costs which homeowners must pay each year, such as property taxes, insurance, and maintenance; one cost (mortgage interest) affecting the index only when a house is purchased; and one cost (home-purchase price) affecting the index only when a house is purchased for the first time. The overall CPI cost item thus does not apply to all or even to most homeowners. Moreover, the importance of mortgage-interest payments and property taxes is overstated in the CPI because those items are deducted from income-tax liability by the two-thirds of all homeowners who itemize deductions.

Perhaps the greatest source of upward bias is found in the home-purchase price component, which accounts for 41 percent of the home-ownership index. The purchase price of a house reflects the expectation that house prices will rise in the future, as well as the value of housing services provided currently. Rents of course, reflect only the latter factor.

Fast-rising cost data might indicate that house hunters are choosing the most expensive form of shelter. However, the considerations noted here, as well as the psychological pressures to lock in fixed-payment terms sooner rather than later, would suggest that house hunters in an inflationary era are acting quite rationally.

William Burke

Research Department
Federal Reserve
Bank of
San Francisco
Alaska • Arizona • California • Hawaii
Idaho • Nevada • Oregon • Utah • Washington

FIRST CLASS MAIL
U.S. POSTAGE
PAID
PERMIT NO. 752
San Francisco, Calif.

BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 5/05/76	Change from 4/28/76	Change from year ago Dollar	Change from year ago Percent
Loans (gross, adjusted) and investments*	87,607	+ 534	+ 1,805	+ 2.10
Loans (gross, adjusted)—total	65,753	+ 522	+ 381	+ 0.58
Security loans	1,229	+ 143	– 30	– 2.38
Commercial and industrial	22,267	+ 290	– 1,675	– 7.00
Real estate	19,797	– 22	+ 153	– 0.78
Consumer instalment	10,970	+ 8	+ 1,080	+ 10.92
U.S. Treasury securities	9,638	+ 208	+ 1,713	+ 21.62
Other securities	12,216	– 196	– 289	– 2.31
Deposits (less cash items)—total*	88,032	+ 1,229	+ 3,391	+ 4.01
Demand deposits (adjusted)	24,375	+ 1,012	+ 1,232	+ 5.32
U.S. Government deposits	621	+ 8	+ 184	+ 42.11
Time deposits—total*	61,325	+ 19	+ 1,590	+ 2.66
States and political subdivisions	6,786	– 101	– 855	– 11.19
Savings deposits	26,048	+ 199	+ 6,414	+ 32.67
Other time deposits‡	26,331	+ 50	– 2,628	– 9.07
Large negotiable CD's	11,291	– 44	– 4,236	– 27.28

Weekly Averages of Daily Figures	Week ended 5/05/76	Week ended 4/28/76	Comparable year-ago period
Member Bank Reserve Position			
Excess Reserves	197	– 31	14
Borrowings	2	7	0
Net free(+)/Net borrowed (–)	195	– 38	+ 14
Federal Funds—Seven Large Banks			
Interbank Federal fund transactions			
Net purchases (+)/Net sales (–)	– 353	+ 352	+ 1,626
Transactions of U.S. security dealers			
Net loans (+)/Net borrowings (–)	– 196	+ 136	+ 641

*Includes items not shown separately. ‡Individuals, partnerships and corporations.

Editorial comments may be addressed to the editor (William Burke) or to the author. . . .
Information on this and other publications can be obtained by calling or writing the Public Information Section, Federal Reserve Bank of San Francisco, P.O. Box 7702, San Francisco 94120. Phone (415) 544-2184.