Research Department
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May 11, 1979

FRBSF Weekly Letter

Break-the-lease Party

Howard Jarvis, the landlord, surely must be surprised by the damage done to his interests by Howard Jarvis, the tax reformer. In the aftermath of last year's stunning victory for California's Proposition 13, with its $7-billion tax windfall for property owners, Jarvis and other leaders called on landlords to pass on part of the tax savings to their tenants. Many complied, but many others did not, and this led to a tenants' revolt that has caused local governments to impose rent ceilings in many California localities.

More than 230 communities nationwide have operated with rent controls in recent years — Boston and some of its suburbs, Washington and some of its suburbs, a number of towns in New Jersey, and of course New York City. But the post-Proposition 13 upsurge of controls throughout California is something new. Governing bodies in Los Angeles, San Francisco, Berkeley and others have all imposed controls — and Santa Monica voters last month overwhelmingly endorsed rent ceilings, capping off the occasion with a Jane Fonda appearance at the victory rally. Admittedly, some of the new ordinances are labelled as temporary measures, but so too was New York's Temporary Rent Control Act of 1943.

Search for shelter

Yet no matter how much tenants strive to revenge themselves against the depredations of landlords and the ravages of inflation, demographic and economic factors will continue to exert strong pressures on the rental market. Adults in the apartment-hunting age category — 20-34 years or over 65 — have accounted for practically the entire 19-million population gain of this decade. The housing industry acted to meet that potential demand in the early 1970's with a massive boom in multi-family building; thus, the newer component of the multi-unit housing stock (i.e., units less than 10 years of age) jumped from 21 to 55 percent of the total between 1960 and 1973. But with overbuilding and financial difficulties, the market collapsed during the 1974-75 recession, and multi-family construction by 1978 still lagged 46 percent below the earlier boom level.

With the supply of new multi-unit housing still relatively sluggish, vacancy rates nationwide declined from 6.2 percent in 1974 to 5.0 percent in late 1978, and the pressure on rents increased accordingly. Rents increased about 5.0 percent annually throughout the middle years of the decade, but rose by 7.1 percent over the past year. Still, those increases lagged behind the general rate of inflation.

On the other hand, actual increases were greater than indicated by published figures, because of downward biases in the rent component of the consumer price index. In the index, no adjustment is made for each year's depreciation although the apartments included in the sample are one year older each year. (Depreciation is shown as a decline in price rather than a

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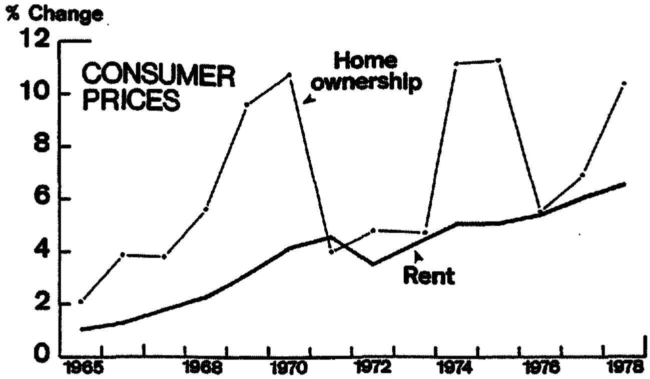
decline in quality.) Even more relevant today, the rent index is biased downward because of the increasing prevalence of rent controls, which mask a decline in the quality of the housing stock under a facade of stable prices.

Rents too low?
Conditions vary in different markets, of course, but the evidence from many of the stronger housing markets, such as California, indicates that further rent increases are in store. (Thus, rent-control pressures probably would have arisen in the near future anyway, even in the absence of the Proposition 13 tenant-landlord conflict.) Rents and home prices tend to move in tandem, since the forces which make living space more valuable act in that fashion regardless of whether the living space is owned or rented. But in California's major metropolitan centers, home prices have risen several times as fast as rents in the past half-decade, which suggests that rents should accelerate to close the gap.

Consider the fairly typical example of a close-in San Francisco suburb, where a two-bedroom townhouse in a large development costs $316 a month. Presumably, with a relatively old mortgage, that amount is enough to cover the landlord's costs. But that rent would cover only a fraction of costs if the apartment were sold at its present market value, which would be about $90,000. With an 80-percent mortgage and a 10¾-percent mortgage rate, the new landlord's monthly mortgage payment alone would come to $672 per month — or $782 per month with taxes and insurance added. (Maintenance and other costs would boost the total even more.) Thus, the new landlord's costs would amount to more than twice his normal monthly flow of rental income.

Why haven't landlords moved more rapidly to push rents higher, to levels commensurate with home prices? One reason has to do with the sociology of the rental market. In San Francisco, for instance, roughly half of the rental stock consists of owner-occupied buildings with 2-to-4 units. Because close personal ties frequently develop in such cases, landlords may not charge as much as the market will bear, especially when they are anxious to keep good tenants. Again, many landlords have been cautious about raising rents because of their fear that such increases would generate cries for rent control. Most importantly, many landlords invest in rental property primarily in expectation of substantial price appreciation, and are satisfied to charge relatively low rents for long periods of time. But whatever the reason, rents may still have some distance to go before they reach a true economic level.

Shift to condos
Tenants have been marching to the polls in increasing numbers to argue their point that rents are too high. Landlords also have been voting with their feet to make the opposite case — specifically, by leaving the rental field completely. The individuals concerned, although dealing with the same units, are operating in the sales rather than the rental end of the business — by placing a "For Sale" rather than a "For Rent" sign on the new buildings they



bring to market or, increasingly, by converting their present rental units to condominiums. Philip Kozloff, writing in *U.S. Housing Markets*, terms this development "the hottest sector in last year's housing boom — and the most likely to thrive in this year's more difficult climate."

According to Kozloff's estimates, the number of conversions doubled last year to 100,000 units, and could increase perhaps 30 percent more this year. New York and Chicago dominate the market, but activity is also strong in Denver, Houston, Washington, and the major California metropolitan areas. The action is as frantic today in some conversion markets as it was in single-family tract housing several years ago. In some cases, a conversion sells out when the offering is filed, or even before the printer delivers the advertising brochures. This activity is sparked by the high rate of first-year price appreciation on most converted units, which amounts in some cases to 50 percent or more.

Conversion has flourished because of the increasing demand for ownership, with its attendant tax benefits and inflation hedge, by those population groups that used to be considered the natural rental market — singles and childless couples. But landlords' disenchantment with renting, as noted earlier, has also contributed to the boom. Rent increases have not been able to keep pace with costs of operation, with the situation being worst in rent-controlled markets. Kozloff claims that in Washington and New York, apartment buildings sometimes are worth twice as much as conversion material than as rentals.

Restrictions

Many local governments are now fighting the conversion trend as a threat to their rental stock and as a displacer of low- and moderate-income households, especially the elderly. The tactics include requirements for engineering and environmental-impact reports, extra parking and recreational space, and lengthy notice periods and first-refusal rights to tenants. "Conversion" remains a politically loaded word, as was demonstrated recently in Chicago, where the upset winner in the mayoralty election rode to victory on the strength of the anti-conversion vote, and not simply the anti-snowstorm vote.

Altogether, the landlord's lot today is not a happy one. What to him represents a below-market rate of return, to many of his tenants represents a rip-off. In many communities, with the passage of rent-control legislation, the tenants' view of the situation is the prevailing one. Consequently, many landlords are tempted to take advantage of the rising equity in their properties and sell out to converters — but sometimes find that even that option is closed to them by restrictions on conversions. In their frustration, landlords complain that the nation is on its way to becoming a collection of burnt-out rent-controlled communities like Bedford-Stuyvesant and the South Bronx. It probably won't come to that, but the danger remains that the quality of the nation's rental-housing stock will decline perceptibly if its price becomes increasingly restricted.

William Burke

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BANKING DATA—TWELFTH FEDERAL RESERVE DISTRICT

(Dollar amounts in millions)

Selected Assets and Liabilities Large Commercial Banks	Amount Outstanding 4/25/79	Change from 4/18/79	Change from year ago @ Dollar	Percent
Loans (gross, adjusted) and investments*	124,426	− 86	+ 17,646	+ 16.53
Loans (gross, adjusted) — total#	101,407	− 80	+ 16,471	+ 19.39
Commercial and industrial	29,980	35	+ 3,643	+ 13.83
Real estate	36,290	131	+ 7,855	+ 27.62
Loans to individuals	21,133	108	NA	NA
Securities loans	1,490	− 103	NA	NA
U.S. Treasury securities*	7,924	− 100	+ 169	+ 2.18
Other securities*	15,095	94	+ 1,006	+ 7.14
Demand deposits — total#	42,571	− 1,294	+ 3,946	+ 10.22
Demand deposits — adjusted	31,391	− 636	+ 2,749	+ 9.60
Savings deposits — total	29,663	− 148	− 570	− 1.89
Time deposits — total#	49,744	351	+ 7,631	+ 18.12
Individuals, part. & corp.	40,392	287	+ 7,881	+ 24.24
(Large negotiable CD's)	17,167	103	+ 2,310	+ 15.55

Weekly Averages of Daily Figures	Week ended 4/25/79	Week ended 4/18/79	Comparable year-ago period
Member Bank Reserve Position			
Excess Reserves (+)/Deficiency (−)	81	− 11	− 55
Borrowings	122	46	51
Net free reserves (+)/Net borrowed(−)	− 41	− 57	− 106
Federal Funds — Seven Large Banks			
Net interbank transactions [Purchases (+)/Sales (−)]	+ 1,365	+ 2,441	+ 1,532
Net, U.S. Securities dealer transactions [Loans (+)/Borrowings (−)]	+ 84	+ 819	+ 76

* Excludes trading account securities.
# Includes items not shown separately.
@ Historical data are not strictly comparable due to changes in the reporting panel; however, adjustments have been applied to 1978 data to remove as much as possible the effects of the changes in coverage. In addition, for some items, historical data are not available due to definitional changes.

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