Research Department
Federal Reserve
Bank of
San Francisco

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FRBSF Weekly Letter

Money and Housing

The lumberjacks of the Northwest, the condo developers of Miami, and everybody in between are now feeling the effects of another housing crunch—one of the industry's steepest declines of the past generation. The homebuilding sector, which had held up relatively well throughout most of sluggish 1979, has now experienced a one-third decline in housing starts since last fall, and further decline seems to be in store. Many analysts expect starts to fall soon below a 1.0-million annual rate—only one-half the average of the peak 1977-78 period. The impact, according to the president of the National Association of Home Builders, will be "the equivalent of letting four Chrysler Corps. go bankrupt."

In recent years, many industry leaders had argued that housing, with its growing financial flexibility, would be able to withstand tight credit better than in the past. They were wrong, and it may be wise to see where they went wrong. It may also be useful to consider what steps policymakers have in mind to rescue the industry from its present problems. But first, we should consider how well the industry has done recently in housing the American people.

Production record

The nation produced 17.8 million housing units during the 1970's, for a substantial 24-percent increase over the previous decade's production. But the volatility of the industry increased along with its size. During the 1960's, the lowest annual level of starts was 17 percent below the annual average; during the 1970's, the lowest annual starts figure was 34 percent below the decade average, and in one major industry downturn (fourth quarter '72-first quarter '75), starts declined 60 percent between peak and trough.

Over time, this growing yet volatile industry has been well supplied with funds. During the 1960's, almost $80 billion flowed into home financing, and in the 1970's more than $284 billion became available for this purpose. Consequently, the home-mortgage share of total credit flows grew from an average of 19 percent in the 1960's to a 20½-percent share in the 1970's. However, home financing has come to depend heavily upon government-sponsored institutions, which financed almost one-fourth of all home mortgages in the 1970's—and more than one-third of the total in tight-money periods (see chart).

Over-production?

With all those funds available, the question naturally arises: has more money meant more and better housing for the nation's people? According to Census data, average family size decreased during the 1970's, while the average housing unit expanded in size over that period. The number of households increased more than 20 percent over the decade, or twice as fast as the growth in total population. In 1978, more than half of all households consisted of only one or two individuals, and the average household contained less than three people. Yet the average size of homes increased, and the number of homes with five or more rooms jumped 22 percent between 1970 and 1976 alone.

These figures might suggest that more resources have gone into housing than necessary, as a consequence of inflation and growing Federal subsidies for the industry. One such subsidy is the allowable tax deduction for mortgage-interest payments—a feature which tax reformers constantly attack, but which home buyers defend as their constitutional right. According to Harvard economist Martin Feldstein, mortgage borrowing in recent years has become very cheap because of the combined effects of inflation and mortgage-interest deductibility. In his example, a couple with a $30,000 income at the beginning of 1979 incurred actual interest costs of only 6.3 percent on a 10.0-percent mortgage, because the deduction reduced

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taxes considerably at the family's marginal tax rate of 37 percent. In addition, inflation has tended to boost housing demand artificially, by creating large capital gains for families who have occupied their homes for any period of time.

The question of overbuilding is somewhat academic in 1980, however, because building activity has slowed substantially in the circumstances created by the stratospheric cost and limited availability of mortgage money. (Home purchases depend heavily on credit, because only a relatively few households can afford to pay cash for a home.) The scenario has begun, as it usually does, with a slowdown in the market for existing homes, which generally account for about two-thirds of all home sales. Many people are postponing plans for buying new houses until they can find buyers for their present homes in a tightening mortgage market. Mortgage lenders, worried about the quality of credit in an incipient recession, are disqualifying more and more borrowers. Many thrift institutions, experiencing large-scale deposit outflows and mounting pressure on their liquidity and earnings, are tightening their lending or have dropped completely out of the mortgage market.

Soaring rates

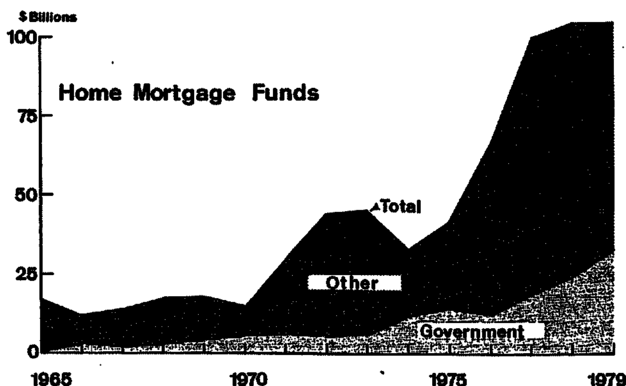
Soaring interest rates are a major factor in this scenario. For most people, home buying is now an impossibility because of the impact of current mortgage rates on the size of monthly payments. For example, a "modest" Southern California home with a $100,000 mortgage would have required $878 in monthly principal-and-interest payments last year with a 10-percent mortgage rate, but now requires $1,507 in monthly payments with an 18-percent mortgage rate. Only a relative handful of home buyers would have the income necessary to qualify for such loans—and the household cited in Feldstein's example would find that its mortgage was no longer costless at current mortgage rates.

Soaring interest rates are also a factor in the present plight of mortgage-lending institutions, which again are suffering from disintermediation—the outflow of deposit funds into market instruments—because rate ceilings on a large portion of their deposits are encouraging savers to place their funds elsewhere. When thrift institutions lose funds in this fashion, they cannot finance more mortgages, and housing-market activity declines sharply as a consequence.

Many thrift institutions have been under earnings pressure because of the mismatch between the rates they currently pay on short-term sources of funds, and the rates they earn on long-term mortgages. In the second half of 1979, the average cost of money for federally-insured savings-and-loan associations reached 7.7 percent; this represented what they paid on passbook accounts, money-market certificates, other certificates, and outside borrowings. But their cost of funds was only about one percentage point below the average yield on their overall loan portfolio, which is too narrow a spread to cover the cost of doing business for many (or most) institutions. The situation has deteriorated even further in 1980. Apparently, only about one-fifteenth of S&L mortgage loans now carry yields approximating those on the money-market certificates which account for more than one-third of all S&L deposits.

More funds for S&L's?

Disintermediation may be less of a problem in future years, because of Congress' decision to phase-out interest-rate ceilings under the "Depository Institutions Deregulation and Monetary Control Act of 1980," which was signed by the President on March 31. The entire process may take six years to complete, because Congress believed that a slow phase-out would be needed to ease transition problems for depository institutions. In the transition period, as a further means of protecting S&L deposit flows, thrift institutions may retain the ¼-percentage-point differential on many time and savings deposits, in relation to commercial-bank rates. Also, to encourage the same end, Congress legalized certain deposit innovations which had been developed by the industry in recent



years, but which had been ruled illegal by a federal court last year. For example, thrift institutions may offer NOW accounts (negotiable orders of withdrawal) for individuals and nonprofit institutions nationwide, effective next December 31.

Some Congressional moves to help the *thrift* industry seem likely to improve their overall health, but at the cost of reducing the flow of funds into the *housing* industry. The new legislation authorized S&L's to issue and extend credit on credit cards, to exercise trust powers, and to invest up to 20 percent of their assets in consumer loans and in various types of corporate debt. Also, it authorized mutual savings banks to offer checking accounts to business customers, and to place as much as 5 percent of their assets in commercial loans to institutions located in the same market area.

More funds for housing?

All of these moves should help improve the future health of the mortgage-finance industry, but they don't represent a direct response to the pleas to "help housing" in its present crisis. Still, in the new law, Congress pre-empted state usury ceilings on most residential mortgage loans, except where state legislatures override such actions within three years. And in a separate action, the Federal Home Loan Bank Board this month approved a new kind of home-mortgage loan for Federal S&L's with an interest rate subject to change every three to five years (with no more than a 5-percentage point increase over the life of the mortgage). The lender would be obliged to renew this 30-year contract—which means that the borrower would receive greater protection than under Canada's "rollover" mortgage, which can be cancelled after five years. Federally insured S&L's may still offer traditional fixed-rate loans, but they are not compelled to do so by the Bank Board's new regulation. Over time, these steps should ensure a closer match between market interest rates and those earned by mortgage-lending institutions, just as the dismantling of deposit-rate ceilings brings about a closer match between market rates and those paid by such institutions.

Adaptation to the market is a long-term solution to the industry's problems, but it can't offer much solace during the present crisis. Up to now, the industry has coped reasonably well in its search for funds, what with the introduction of money-market certificates and a number of other innovations, including improved secondary markets and the increased size of mortgage-backed securities. These innovations have failed to sustain a high level of housing activity in 1980, so that industry leaders have argued for stronger measures, such as the revival of the Brooke-Cranston program which helped produce an extra 190,000 homes in the 1974-75 recession. That program would provide subsidized mortgages at 2 percentage points below market rates for single-family homes, and at 3½ percentage points below market rates for multi-family units. But the substantial costs involved have led the Senate Budget Committee to ignore the proposal in its first budget resolution for fiscal 1981.

A final resolution of the industry's problems awaits a favorable resolution of the nation's fight against inflation, because high and rising mortgage rates basically reflect high and rising inflation rates. The problem is fundamental, because as Federal Reserve Governor Henry Wallich recently told the National Association of Mutual Savings Banks, "Inflation is dragging this country into a kind of economic civil war." In the last analysis, we must resolve a conflict between, on the one hand, home-owners who are obtaining large capital gains on their homes as a result of inflation, and on the other hand, savers who are being expropriated by that same inflation as well as potential home-buyers who are forced out of the market by inflationary home prices and interest rates.

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 4/2/80	Change from 3/26/80	Change from year ago Dollar	Change from year ago Percent
Loans (gross, adjusted) and investments*	139,142	+ 425	+ 15,010	+ 12.1
Loans (gross, adjusted) — total#	117,411	+ 824	+ 15,767	+ 15.5
Commercial and industrial	34,032	+ 130	+ 4,052	+ 13.5
Real estate	45,543	+ 150	+ 9,094	+ 24.9
Loans to individuals	24,487	+ 10	+ 3,246	+ 15.3
Securities loans	1,223	− 58	− 566	− 31.6
U.S. Treasury securities*	6,507	− 235	− 1,379	− 17.5
Other securities*	15,224	− 164	+ 622	+ 4.3
Demand deposits — total#	46,830	+5,116	+ 3,182	+ 7.3
Demand deposits — adjusted	32,274	+1,898	+ 1,168	+ 3.8
Savings deposits — total	27,224	− 56	− 3,105	− 10.2
Time deposits — total#	62,027	+ 555	+ 12,003	+ 24.0
Individuals, part. & corp.	53,583	+ 838	+ 12,901	+ 31.7
(Large negotiable CD's)	21,902	+ 37	+ 4,238	+ 24.0

Weekly Averages of Daily Figures	Week ended 4/2/80	Week ended 3/26/80	Comparable year-ago period
Member Bank Reserve Position			
Excess Reserves (+)/Deficiency (−)	107	− 6	48
Borrowings	42	198	65
Net free reserves (+)/Net borrowed(−)	66	− 204	− 17

* Excludes trading account securities.
# Includes items not shown separately.

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