HOUSING AND THE NATIONAL ECONOMY

Remarks of
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Housing and the National Economy

I'm delighted to have the chance to discuss business and financial trends with a group which plays such an important role in the state's economy. In glancing over your association's brochure, I was impressed with the description of the role of mortgage bankers, "as catalysts between the sources of funds and the developers who translate drawings into buildings." I was even more impressed with the figures which show how well the industry has prospered in the difficult years of the past decade, with servicing volume in the state rising from $14 billion to $27 billion between 1967 and 1974 alone. With the housing market now improving, I would expect this strong uptrend to continue.

My assignment today is to analyze the factors that will affect the national economy—especially housing—during 1976. Right at the outset, let me say that the recovery from the "worst postwar recession" is proceeding on schedule. Yet, as always seems inevitable in such situations, we will be faced for some time to come with the wreckage created by the recession and the preceding inflationary excesses. It's been a field day for financial-page headline writers. You know the list: W. T. Grant down to its last five-and-dime; the airlines fast losing altitude; the tanker industry on the rocks; the jerry-built REIT's being foreclosed; and New York City desperately trying to sell Brooklyn Bridge.

But the dominant fact, to repeat, is that the recovery is in place, with production, profits and employment rising substantially in recent months. As we move into 1976, consumer spending, inventory stockpiling and foreign purchases should help support the recovery, providing the
basis for a relatively strong increase of 5½ percent in real GNP. But what of the other sectors of the economy—especially the long-depressed housing industry? Consider first where the industry stands today. During the third quarter, residential construction outlays posted a healthy advance in real terms, following a modest turnaround in the previous quarter and the precipitous two-year slide before that. This increase in outlays reflected a significant improvement in housing starts, which averaged 1.25 million units (annual rate) in the third quarter—and even higher in October—in contrast to the average of 1 million units or less in the first half of the year. According to my staff's economic forecast, the average level of starts next year might be one-third higher than the 1975 average—about 1.57 million starts, as compared to this year's estimated 1.18 million units. But these figures indicate that further increases may be rather modest after the recent rise. This is understandable, in view of the rather mixed nature of the statistics indicating the health of the industry.

The Housing Outlook

To begin with, the inventory of unsold and uncompleted units remains rather high. Despite the obvious improvement in home sales since last spring, the inventory of unsold single-family housing has declined only moderately to about 375,000 units, which represents an 8½-month supply at recent sales rates. As for multiples, we lack precise information on the unsold inventory—but we do know that starts of multi-family housing, despite the recent upturn, are still only about one-third of the level reached during the 1970-73 boom. And there are signs that the recovery
in this sector may be rather slow, considering the reluctance of lenders to finance the construction of condos, as well as the continued high level of vacancies in the rental market.

Another important housing factor, the cost factor, has been improving recently. Average construction prices stabilized during the third quarter, reflecting some improvement in materials costs and (apparently) some reduction in the size and furnishings of new units. Sales prices of new homes also have levelled off, at about a $38,900 median, although the 9-percent rise over the past year has outpaced the rise in household income. The market in 1976 of course would benefit from a stabilization of home prices and a continued rise in incomes, but some of this impact could be offset by a continued rise in the overall costs of home ownership.

A more important question concerns the cost and availability of credit--the lifeblood of housing. As you know, money has generally been available this year, but at very high costs by historical standards. The same may well be true in 1976. Although rates on FNMA commitments fell by about 20 basis points in October, that decline offset only a part of the 80-basis point increase that occurred during the third quarter, leaving yields in this market at 9.32 percent in early November. And no matter how attractive such high rates may be to investors, they cut severely into the potential market for housing. For example, with the last decade's increase in mortgage rates from roughly 5½ percent to 9½ percent, the monthly payment on a typical 30-year, $30,000 mortgage has jumped by half, because of that factor alone.

The continuation of very high mortgage rates reflects the heavy competition for funds in long-term markets and, above all, the lender's
demand for a substantial premium to offset the effects of inflation. I'll say more about that subject in a minute. Now, it's true that the mortgage industry has been well able to compete for funds in the present environment. Thrift institutions will probably garner a record inflow of savings in 1975—probably more than $40 billion—and they could approach that figure again in 1976. Even so, the competition for funds will probably become stiffer over time, with corporations, state and local governments and (above all) the Federal government all entering the market with very heavy borrowing demands.

**Government and Housing**

Of course, support to the market will be available from various Federal programs. Should the housing market falter during 1976, strong pressures would arise in Congress to beef up such programs, adding to the already massive Federal presence in the market. But there's a self-defeating element in this approach. Federal programs can help housing in the short-run, but in the long run they only exacerbate the industry's basic problems. Housing activity always falters in periods of high and rising interest rates, but rates are pushed up by the need to finance soaring Federal deficits—which in turn are caused by increased government spending for housing and other purposes.

Federal government support has been a mainstay of the market for over a generation; for instance, with FHA-insured and VA-guaranteed mortgages accounting last year for 28 percent of total mortgage debt on one-to-four family properties. But government support has burgeoned during the past decade—a period which included the credit crunches of 1966, 1969 and 1973-74—with mortgage-loan holdings supported by various govern-
ment agencies and programs increasing about 25 percent annually over this period. Government and related agencies held 13 percent of the nation's outstanding residential-mortgage debt at the end of 1974, but in that one year alone, they supported 54 percent of the entire loan increase.

The pressure for an increased government role is evident in the House Banking Committee's recent report on Financial Institutions and the Nation's Economy--the FINE study. Like the Hunt Commission of several years ago, this study group is in favor of giving thrift institutions broader lending powers and removing ceilings from their deposit rates, provided that the assumption of such new powers is accompanied by acceptance of a common set of rules and restrictions. For example, all Federally-insured depository institutions would have to meet reserve requirements on their deposit liabilities, with all such reserves being held at the Federal Reserve. As for housing, the FINE study's authors go beyond the Hunt Commission and argue that broadened powers would not be sufficient to produce more money for the housing market--especially low-cost housing--and that further incentives are needed.

One such incentive would be a mortgage-interest tax credit, available to any financial institution, but restricted to mortgages on properties designed for low- and moderate-income owners and renters. A second incentive would be the broadening of Home Loan Bank lending at subsidized rates for low-cost housing, again available to any financial institution. Furthermore, the Federal Reserve would be authorized to provide reserve credits to all depository institutions involved in financing low- and moderate-income housing. For each dollar of reserves held at the Fed, each institution would receive a reserve credit equal to a
fixed percentage of its dollar volume of mortgage and residential-construction loans. Under this credit-allocation scheme, low-cost housing would have a preferred status over all other seekers of bank credit.

All of these Federal programs--present and proposed--only tend to get the Federal government more deeply enmeshed in the operations of the housing market. I would prefer to see a more direct attack on the basic cause of housing's woes--the prolonged inflation of the past decade, which has pushed market interest rates to unprecedented highs. Housing is always the most sensitive sector in the economy to tight money and high interest rates, since the level of the mortgage rate is much more critical in limiting the ability of the home buyer to carry such debt than is the interest rate on any other type of borrowing. The problem is compounded by the fact that mortgage funds become not only expensive but practically nonexistent during credit crunches, since the principal sources of mortgage money find their own money flows drying up or turning negative whenever short-term money rates rise above the ceiling rates that they can pay investors. Part of the problem thus is the long-run ineffectiveness of Reg Q ceilings, but the basic problem of course is inflation.

Government and Inflation

Our severe inflation problem has been attributed to many factors, such as oil embargoes, food shortages, dollar devaluation, and price and wage rigidities in concentrated industries. But the basic cause is the long series of soaring Federal deficits and its impact on financial markets. It's no accident that housing's problems, and the intensified Federal efforts to support housing, have gone hand in hand with the intensified deficit spending of the past decade. The basic difficulty has
been the failure of Federal budget-makers to find the funds to pay for the growing responsibilities they have taken on, and it has been aggravated by the impact of inflation on many spending programs. The problem threatens to swamp the new Congressional budget committees at the very inception of their activities, but it is one which they must grasp and bring under control.

More Federal spending would aggravate the pressures already evident in financial markets, with unparalleled Federal demands piled on top of gradually reviving private credit demands. This is the well-publicized and all-too-real problem of "crowding out." It's true that financial conditions normally ease substantially during a recession and remain easy even in the initial recovery period. But with the Federal deficit reaching $75 billion or more, total credit demands could outrun the available supply of funds, forcing interest rates higher and crowding many non-Federal borrowers out of the market. We've already had a sample of what could happen with the third-quarter bulge in rates. Even with the recent easing, Treasury bill rates still hover near 5 1/2 percent--unusually high levels for this stage of the business cycle, and a portent of disintermediation if credit demands quicken.

One way that mounting credit demands can be satisfied without an increase in interest rates is for the Federal Reserve to accelerate the growth of money and credit. But if done for too long, or to an excessive degree, such an action could generate inflationary pressures which would soon become imbedded in the nation's price structure. Still, many people reply, with so many idle resources in the economy, how could inflationary pressures arise from easy money at this stage?
The answer, at least in part, involves the lags in the effects of monetary policy. Generally speaking, whenever an excessively easy-money policy is adopted, the "good news" appears first, with production, employment and profits expanding within six to twelve months or so—but then the "bad news" arrives, in the form of increased inflation with a lag of one to three years. Conversely, if a tight-money policy is adopted, the bad news of a dampening of economic activity comes first, whereas the good news of a diminished rate of inflation is delayed.

For this reason, the Federal Reserve at this stage of the business cycle is strongly alert to price considerations. At the same time, it is also strongly alert to the need to provide the financial basis for continued recovery. In a word, we are determined to maintain a prudent but not parsimonious monetary policy. This stance is seen in the monetary growth path that the Fed is attempting to follow between the third quarter of 1975 and the third quarter of 1976—that is, a 5-to-7½ percent growth rate for the M₁ measure of the money supply (currency plus demand deposits).

This range is quite appropriate in the present environment of high unemployment and unused industrial capacity. On the other hand, it is on the generous side by long-term historical standards. Thus, we could endanger the fight against inflation if we continued expanding the money supply indefinitely at today's specified pace. I might add that the directors of the Federal Reserve Bank of San Francisco are fully alert to this situation, since they view inflation as the nation's No. 1 problem. As the economy returns to higher rates of resource utilization, we'll have to reduce the rate of monetary and credit expansion, in order to lay the foundation for a prolonged era of prosperity without inflation.
Concluding Remarks

To sum up, it appears likely that the economy will strengthen further in 1976, on the basis of the improvement already evident in the consumer and inventory sectors--and in residential construction as well. But as I've indicated, housing may not be as strong a support as it has been in earlier recovery periods. The housing boom of the early 1970's has left, as its legacy, both an overly high level of costs and an overly large inventory of unsold units. The severe inflation of the past decade meanwhile has left, as its legacy, a mortgage-financing mechanism that is both overly subject to disintermediation and overly dependent on government support.

In 1976, we're likely to see a gradual increase in the credit demands of mortgage borrowers and other private borrowers. How the market handles these demands depends critically on the size of the Federal deficit. Even with the deficit held under Congressional target levels, there could be periods of market congestion as the year goes on. The first task of policymakers thus is to bring Federal credit demands under control. Otherwise, "crowding out" could become a painful reality--and we all know which industry would be the first casualty in that situation.

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