HOUSING, INTEREST RATES AND GOVERNMENT POLICY

REMARKS OF

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FEDERAL RESERVE BANK OF SAN FRANCISCO

MEETING WITH PORTLAND COMMUNITY LEADERS

AND DIRECTORS, PORTLAND BRANCH

FEDERAL RESERVE BANK OF SAN FRANCISCO

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Housing, Interest Rates and Government Policy

I appreciate this opportunity to discuss with you the problems of the national and regional economies, and to indicate the steps I think we should take to recover from our present difficulties. In a few short years, the economic mood has swung from euphoric optimism to abject pessimism -- and the swing has been most evident in the housing industry, which is so crucial to the health of the Pacific Northwest. The optimism was clearly undeserved, especially since it went hand in hand with a serious inflation that led directly to our current plight -- and the pessimism will be equally undeserved if we follow correct economic policies. Let me suggest, therefore, how we might bring the overall economy (and the housing industry) back to the safe path of noninflationary growth. But first, let me pause to pay tribute to those strong individuals who have helped immeasurably with their advice on our policies and operations, the directors of the Federal Reserve Bank of San Francisco.

Role of Directors

The directors at our five offices are involved with each of the major tasks delegated by Congress to the Federal Reserve. That encompasses the provision of "wholesale" banking services such as coin, currency and check processing; supervision and regulation of a large share of the nation's banking system; administration of consumer-protection laws; and in particular,

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THE DEVELOPMENT OF MONETARY POLICY. WE ARE FORTUNATE IN THE ADVICE WE GET FROM THEM IN EACH OF THESE AREAS.

OUR DIRECTORS CONSTANTLY HELP US IMPROVE THE LEVEL OF CENTRAL-BANKING SERVICES, IN THE MOST COST-EFFECTIVE MANNER. THIS IS A CRUCIAL ROLE AT THE PRESENT TIME, BECAUSE UNDER THE TERMS OF THE MONETARY CONTROL ACT OF 1980, THE FEDERAL RESERVE IS MOVING INTO A NEW OPERATING ENVIRONMENT. OVER THE PAST YEAR, THE FED HAS BEEN MAKING ITS SERVICES AVAILABLE TO ALL DEPOSITORY INSTITUTIONS OFFERING TRANSACTION (CHECK-TYPE) ACCOUNTS AND NONPERSONAL TIME DEPOSITS, AND THOSE SERVICES ARE BEING PRICED EXPLICITLY FOR THE FIRST TIME.

YET ABOVE ALL, OUR DIRECTORS HELP US IMPROVE THE WORKINGS OF MONETARY POLICY. AS ONE MEANS OF DOING SO, THEY PROVIDE US WITH PRACTICAL FIRST-HAND INPUTS ON KEY DEVELOPMENTS IN VARIOUS REGIONS OF OUR NINE-STATE DISTRICT AND IN VARIOUS SECTORS OF THE WESTERN ECONOMY. OUR DIRECTORS THUS HELP US ANTICIPATE CHANGING TRENDS IN THE ECONOMY, BY PROVIDING INSIGHTS INTO CONSUMER AND BUSINESS BEHAVIOR WHICH SERVE AS CHECKS AGAINST OUR OWN ANALYSES OF STATISTICAL DATA. THEIR ADVICE HAS BEEN ESPECIALLY VALUABLE TO US THESE LAST SEVERAL YEARS, WHEN WE'VE HAD TO FACE PROBLEMS OF HIGH INFLATION, HIGH INTEREST RATES, AND SHARP FLUCTUATIONS IN BUSINESS ACTIVITY.

RECESSION PROBLEM

WE NEED ALL THE ADVICE WE CAN GET, BECAUSE WE ARE FACED TODAY WITH ONE OF THE WORST RECESSIONS OF THE PAST GENERATION

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-- OR PERHAPS I SHOULD SAY SERIES OF RECESSIONS, BECAUSE AFTER SEVERAL UPS AND DOWNS, THE NATION'S OUTPUT IS NO HIGHER NOW THAN IT WAS THREE YEARS AGO. PART OF THE PROBLEM LIES WITH THE 150-PERCENT OIL-PRICE SHOCK OF THE 1979-80 PERIOD, WHICH ACTED AS A GIANT SALES TAX, RAISING PRICES AND DRAINING OFF PURCHASING POWER THAT OTHERWISE WOULD HAVE BEEN AVAILABLE FOR BUYING OTHER GOODS AND SERVICES. BUT THE MAJOR CAUSE OF THE PROBLEM MUST BE INFLATION ITSELF, WHICH FOR A DECADE HAS UNDERMINED BUSINESS AND CONSUMER SPENDING PLANS, LEADING TO A DECLINE IN PRODUCTIVITY AND IN THE GENERAL HEALTH OF THE U.S. ECONOMY. IN ADDITION, THE SUCCESSFUL ANTI-INFLATION PROGRAM OF THE PAST SEVERAL YEARS, WITH ITS TIGHTENING OF MONETARY POLICY, HAS CLEARLY ACHIEVED ITS GOAL BUT AT THE TEMPORARY COST OF A REDUCTION IN BUSINESS ACTIVITY.

NONETHELESS, THE WORST MAY NOW BE BEHIND US. SEVERAL IMPORTANT STATISTICS, SUCH AS INDUSTRIAL PRODUCTION AND DURABLE-GOODS ORDERS, SHOWED STRONG IMPROVEMENT IN FEBRUARY, ALTHOUGH PART OF THE RISE SIMPLY REPRESENTED A REBOUND FROM JANUARY'S WEATHER-DEPRESSED FIGURES. IN ANY CASE, OPTIMISM SEEMS TO BE IN ORDER BECAUSE OF THE AUTOMATIC NATURE OF THE ECONOMIC PROCESSES NOW AT WORK. IN AN AUTOMATIC CYCLICAL FASHION, INCREASED EMPLOYMENT SHOULD RESULT AS BUSINESSES RUN OFF THEIR PRESENT EXCESS INVENTORIES AND ARE FORCED TO REORDER NEW MATERIALS AND EQUIPMENT. ALSO, IN AN AUTOMATIC STABILIZING FASHION, THE DOWNWARD SPIRAL SHOULD BE NEUTRALIZED BY THE FISCAL REFORMS OF THE PAST GENERATION -- THE AUTOMATIC

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REDUCTIONS IN INCOME-TAX RECEIPTS AND INCREASES IN UNEMPLOYMENT COMPENSATION AND SOCIAL-SECURITY BENEFITS THAT GO ALONG WITH ANY DOWNTURN IN PRODUCTION AND EMPLOYMENT. THESE AUTOMATIC PROCESSES, PLUS THE FISCAL STIMULUS DEVELOPING FROM THE 1981-82 TAX REDUCTIONS, SHOULD LEAD TO AN UPTURN IN THE ECONOMY AS WE MOVE FURTHER INTO THE YEAR.

OREGON'S SITUATION

OREGON'S ECONOMY NATURALLY WILL BENEFIT FROM ANY UPTURN IN THE NATIONAL ECONOMY. BUT THIS STATE, DESPITE ITS RECENT DIVERSIFICATION, SUFFERS HEAVILY FROM ITS DEPENDENCE ON A SINGLE BADLY-DEPRESSED INDUSTRY, THE NATIONAL HOUSING INDUSTRY. AS A RESULT, OREGON HAS LOST MORE THAN 85,000 JOBS IN THE PAST SEVERAL YEARS, AND SUFFERS DOUBLE-DIGIT UNEMPLOYMENT WHICH PLACES IT AMONG THE MOST BADLY-DEPRESSED STATES IN THE NATION. THIS IS IN SHARP CONTRAST TO THE BOOM YEARS OF THE 1970'S, WHEN PEOPLE POURED INTO THE STATE IN SEARCH OF JOBS AND THE GOOD LIFE -- PERHAPS IN RESPONSE TO ALL THAT ADVERTISING THAT TOLD THEM TO STAY AWAY.

CONSIDER THE SITUATION IN SOME OF THE STATE'S MAJOR INDUSTRIES. AGRICULTURE, FOR EXAMPLE, HAS SUFFERED TWO BACK-TO-BACK YEARS OF DECLINING INCOME, AND MORE OF THE SAME MAY BE IN STORE FOR 1982. FARM INCOMES ARE LIKELY TO SUFFER BECAUSE OF THE NATIONAL RECESSION, THE WEAKENING OF CONSUMER FOOD PURCHASES, THE ABUNDANT SUPPLY OF CROP AND LIVESTOCK PRODUCTS, AND THE CONTINUED RISE IN FARM COSTS. THE EXPORT TRADE,

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MEANWHILE, HAS BEEN HURT BY THE WORLDWIDE RECESSION, AND ALSO BY THE HIGH COST OF U.S. PRODUCTS RESULTING FROM THE BOOST IN THE VALUE OF THE DOLLAR. THE CURRENT WEAKNESS IN THESE AREAS -- AND ABOVE ALL, IN FOREST PRODUCTS -- LENDS GREATER EMPHASIS TO THE NEED FOR DIVERSIFICATION. THE PORTLAND METROPOLITAN AREA, WITH ITS BROAD RANGE OF INDUSTRIES, SHOWS WHAT CAN BE DONE TO HEDGE AGAINST THE SWINGS OF RESOURCE-ORIENTED INDUSTRIES. DIVERSIFICATION THUS SEEMS TO BE THE KEY TO STABLE LONG-RUN GROWTH.

IN THE SHORT RUN, HOWEVER, OREGON'S PROSPECTS DEPEND HEAVILY ON A RECOVERY IN THE NATIONAL HOUSING INDUSTRY. AS THE GOVERNOR RECENTLY SAID, "TIMBER IS OREGON'S ECONOMIC LIFEBLOOD". THUS, WHEN ALMOST ONE-THIRD OF THE JOBS IN THAT KEY INDUSTRY DISAPPEARED OVER THE PAST SEVERAL YEARS, THE STATE AS A WHOLE WAS BOUND TO SUFFER SEVERELY. FOR THAT REASON, WE MUST FIND A SOLUTION TO THE PROBLEMS OF THE HOUSING INDUSTRY IF WE ARE TO IMPROVE OREGON'S PROSPECTS FOR THE 1980S.

PROBLEMS AFFLICTING HOUSING

LET'S REVIEW THE DEVELOPMENTS OF THE PAST DECADE IN THAT CRUCIAL INDUSTRY. DEMOGRAPHIC FIGURES SHOW THAT HOUSEHOLD FORMATIONS HAVE REACHED ALMOST TWO MILLION UNITS PER YEAR, WHILE HOUSING STARTS HAVE BARELY SURPASSED HALF THAT AMOUNT. MOREOVER, THE INDUSTRY HAS ALSO BEEN PLAGUED BY SEVERE VOLATILITY; IN THE 1973-75 SLUMP, AND AGAIN IN THE 1978-81 DOWNTURN, HOUSING STARTS DECLINED BY HALF OR MORE. THUS,

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AFTER A THIRD STRAIGHT YEAR OF DECLINING STARTS, BUILDING ACTIVITY IN 1981 REACHED THE LOWEST LEVEL SINCE WORLD WAR II.

WE MUST NOT FORGET THAT THE PRESENT SLUMP FOLLOWED A TREMENDOUS UPSURGE IN HOUSING ACTIVITY. THE HOUSING STOCK INCREASED 28 PERCENT (TO 88.3 MILLION UNITS) DURING THE 1970'S, COMPARED WITH AN 11½-PERCENT RISE IN THE TOTAL POPULATION (TO 226.5 MILLION). BECAUSE OF THIS AND THE HOUSING BOOM OF EARLIER DECADES, THE NUMBER OF PERSONS PER HOUSEHOLD DROPPED SHARPLY OVER THIS PERIOD. THE QUALITY OF THE HOUSING STOCK ALSO IMPROVED CONSIDERABLY, MEASURED BY INCREASES IN FLOOR AREA PER OCCUPANT OR BY IMPROVEMENTS IN SUCH AMENITIES AS GARAGE SPACE OR CENTRAL AIR-CONDITIONING.

THOSE STATISTICS HOLD LITTLE CONSOLATION FOR THE AVERAGE FIRST-TIME HOMEBUYER, HOWEVER. A FAMILY EARNING THE MEDIAN INCOME TODAY MUST PAY ROUGHLY ONE-THIRD OF ITS INCOME TO BUY A MEDIAN-PRICED HOUSE -- TWICE THE SHARE IT HAD TO PAY IN 1965. THIS DRASTIC CHANGE PARTLY REFLECTS THE FACT THAT HOUSING PRICES HAVE RISEN FASTER THAN INFLATION, SPURRED ON BY DEMOGRAPHIC FACTORS AND THE PREFERENTIAL TAX TREATMENT OF HOUSING. A MORE IMPORTANT FACTOR, HOWEVER, IS THE COMBINED EFFECT OF INFLATION EXPECTATIONS AND THE CONVENTIONAL FIXED-RATE MORTGAGE, WHICH CAN CREATE A SIGNIFICANT CASH-FLOW PROBLEM FOR THE FIRST-TIME HOMEBUYER. ONE SYMPTOM OF THE PROBLEM IS HIGH MORTGAGE RATES, WHICH REMAIN SEVERAL PERCENTAGE POINTS ABOVE THE SUPPOSED THRESHOLD OF 13 TO 13½ PERCENT FOR POTENTIAL HOMEBUYERS. INFLATION EXPECTATIONS AND INSTITUTIONAL

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BARRIERS -- SUCH AS LOCAL BUILDING CODES AND LAND-USE REGULATIONS -- ALSO WORK TO PRICE FIRST-TIME HOMEBUYERS OUT OF THE MARKET. STILL, THE MORTGAGE-FINANCE PROBLEM IS CRITICAL.

PROBLEMS OF MORTGAGE FINANCING

THE HOUSING INDUSTRY -- AND THE FOREST-PRODUCTS INDUSTRY -- CLEARLY CANNOT RECOVER WITHOUT AN IMPROVEMENT IN THE FORTUNES OF THE MORTGAGE-FINANCE INDUSTRY. OVER THE YEARS, THAT INDUSTRY BUILT UP LARGE PORTFOLIOS OF LONG-TERM FIXED-RATE MORTGAGES, BUT FINANCED THOSE INVESTMENTS WITH SHORT-TERM DEPOSITS SUCH AS PASSBOOK ACCOUNTS AND SAVINGS CERTIFICATES. TODAY, THRIFT INSTITUTIONS ARE PAYING ROUGHLY 13 PERCENT ON SIX-MONTH MONEY-MARKET CERTIFICATES, ALTHOUGH 60 PERCENT OF THE MORTGAGES ON THEIR BOOKS CARRY YIELDS OF LESS THAN 10 PERCENT. THUS, AFTER LOSING ABOUT $5 BILLION LAST YEAR, THE INDUSTRY IS STILL FACING SEVERE EARNINGS PROBLEMS.

THE PRESIDENT'S COMMISSION ON HOUSING, IN ITS RECENTLY RELEASED PRELIMINARY REPORT, EMPHASIZED THAT THE CURRENT PROBLEMS IN THE HOUSING INDUSTRY AND THE HOUSING-FINANCE SYSTEM ARE CLOSELY RELATED. BOTH ARE STRONGLY AFFECTED BY EVENTS IN THE OVERALL ECONOMY, AND BY THE STRUCTURE AND BEHAVIOR OF INTEREST RATES. SINCE THE MID-1960'S, HIGH AND VARIABLE RATES OF INFLATION HAVE RAISED THE LEVEL AND INCREASED THE DEGREE OF FLUCTUATION IN MARKET INTEREST RATES, THEREBY INCREASING THE VOLATILITY OF HOUSING CONSTRUCTION AND HOME FINANCE. TO DEAL WITH THIS PROBLEM, WE MUST BRING DOWN THE

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RATE OF INFLATION THROUGH CONSISTENT MONETARY AND FISCAL RESTRAINT OVER A LONG PERIOD OF TIME, BECAUSE THAT IS THE ONLY WAY WE CAN BRING ABOUT LASTING REDUCTIONS IN MORTGAGE AND OTHER INTEREST RATES.

IN ADDITION, A BROADER-BASED AND MORE RESILIENT SYSTEM OF HOUSING CREDIT IS NEEDED TO FINANCE THE HOUSING NEEDS OF THE 1980'S. THRIFT INSTITUTIONS HAVE A LONG TRADITION OF MORTGAGE LENDING, AND THEY UNDOUBTEDLY WILL REMAIN AN ESSENTIAL COMPONENT OF THE SYSTEM. BUT DIVERSIFIED INVESTORS -- SUCH AS COMMERCIAL BANKS, INSURANCE COMPANIES, AND PENSION FUNDS -- WILL NEED TO PLAY AN INCREASING ROLE IN MEETING THE HOUSING-FINANCE REQUIREMENTS OF THE FUTURE.

MONETARY POLICY AND INFLATION

TO REPEAT, THE FEDERAL RESERVE HAS AN ESSENTIAL ANTI-INFLATION (AND PRO-HOUSING) ROLE TO PLAY BY REDUCING MONEY GROWTH GRADUALLY OVER TIME. THIS FOLLOWS BECAUSE INFLATION IS PRIMARILY, BUT NOT EXCLUSIVELY, A MONETARY PHENOMENON. THUS, IN OCTOBER 1979, THE FEDERAL RESERVE CHANGED ITS OPERATING PROCEDURES TO GAIN BETTER CONTROL OVER THE GROWTH OF THE MONEY SUPPLY. OUR OLD OPERATING PROCEDURES CERTAINLY HELPED TO STABILIZE INTEREST RATES IN THE SHORT RUN, BUT IN THE FACE OF HUGE FEDERAL BUDGET DEFICITS IN THE 1970S, THEY LED TO SYSTEMATIC OVER-SHOOTING OF OUR MONEY-SUPPLY TARGETS AND TO SUBSEQUENT DOUBLE-DIGIT INFLATION. IN TURN, THIS LED TO DOUBLE-DIGIT INTEREST RATES. THE NEW PROCEDURES, ALTHOUGH ALLOWING INTEREST RATES TO BE DETERMINED LARGELY BY MARKET

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FORCES, HAVE GIVEN US BETTER CONTROL OF THE MONEY SUPPLY -- AND HENCE INFLATION -- ON A YEAR-TO-YEAR BASIS.

THE NARROW M-1 MEASURE OF MONEY -- CURRENCY PLUS ALL TRANSACTION (CHECKABLE) DEPOSITS -- HAS DECELERATED SIGNIFICANTLY IN RECENT YEARS, TO FIVE-PERCENT GROWTH IN 1981 FROM 1978'S EIGHT-PERCENT GROWTH. FOR 1982, FEDERAL RESERVE CHAIRMAN VOLCKER RECENTLY ANNOUNCED AN M-1 GROWTH TARGET OF 2½ TO 5½ PERCENT. BUT AS HE TOLD CONGRESS, AN OUTCOME IN THE TOP HALF OF THAT RANGE WOULD BE ACCEPTABLE, IN VIEW OF LAST YEAR'S RELATIVELY SLOW GROWTH.

CONSEQUENTLY, WE SHOULD SEE FURTHER ENCOURAGING RESULTS FROM OUR ANTI-INFLATION PROGRAM. ALL PRICE INDEXES RECENTLY HAVE DECELERATED SIGNIFICANTLY. FOR EXAMPLE, CONSUMER PRICES ARE NOW ABOUT 7½ PERCENT ABOVE A YEAR AGO, COMPARED WITH A 10½-PERCENT RATE OF INCREASE AT THE EARLY 1980 PEAK. PRICES AT WHOLESALE HAVE DECELERATED EVEN MORE. INDEED, CRUDE-MATERIALS PRICES AT THE PRODUCER LEVEL HAVE ACTUALLY DECLINED BY SEVEN PERCENT OVER THE PAST YEAR -- AND THAT PORTENDS WELL FOR CONTINUED DECELERATION OF PRICES AT THE RETAIL LEVEL.

INTEREST RATES AND MONEY GROWTH

RECOVERY FROM RECESSION MEANWHILE HAS BEEN AGGRAVATED BY SEVERE INTEREST-RATE PROBLEMS -- ESPECIALLY BY THE UNEXPECTED UPTURN IN RATES THAT OCCURRED THIS WINTER. THIS RAISES SOME BASIC ANALYTICAL QUESTIONS. WE SHOULD REMEMBER THAT INTEREST RATES ARE DETERMINED BY MANY FACTORS -- INCLUDING, BUT NOT

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MAINLY, THE ACTIONS OF THE FEDERAL RESERVE, WHICH CAN CONTROL ONLY THE SUPPLY OF MONEY AND NOT THE DEMAND. BUT BUSINESS-CYCLE CONDITIONS ALSO INFLUENCE RATES, AS CREDIT DEMANDS RISE AND FALL WITH THE CYCLE. AND ABOVE ALL, PRICE EXPECTATIONS HEAVILY INFLUENCE RATES, AS LENDERS DEMAND AN INFLATION PREMIUM TO PROTECT THEMSELVES AGAINST AN EXPECTED LOSS IN THE PURCHASING POWER OF THEIR MONEY.

BUT AS THE PRESIDENT RECENTLY SAID TO THE SECRETARY OF THE TREASURY, "WHY ARE INTEREST RATES SO HIGH WHEN INFLATION IS COMING DOWN?" ONE POSSIBLE EXPLANATION HAS TO DO WITH THE WINTER PERIOD'S SHARP UPSURGE IN MONEY GROWTH, WHICH THE FED'S CRITICS COULD HAVE CONSTRUED AS A RESPONSE TO THEIR DEMANDS FOR EASING UP ON THE MONETARY BRAKES. NOW, MANY ECONOMISTS BELIEVE THAT SUCH ACTION NORMALLY WOULD INCREASE THE LIQUIDITY OF THE ECONOMY AND PUT DOWNWARD PRESSURE ON INTEREST RATES. BUT THIS RECENT EPISODE, AS WELL AS SEVERAL OTHER EPISODES OF THE PAST TWO YEARS, INDICATE THAT SHARP UPSURGES IN MONEY GROWTH MAY PERVERSELY LEAD TO INCREASES IN INTEREST RATES. INDEED, THIS IN FACT HAPPENED DURING THE WINTER MONTHS, FOLLOWING SEVERAL MONTHS OF DECLINING RATES LAST FALL, AS MARKET PARTICIPANTS PUSHED RATES UP (RATHER THAN DOWN) BECAUSE OF INCREASED FEARS OF FUTURE INFLATION.

INTEREST RATES AND DEFICITS

WE SHOULD NOT OVERLOOK, HOWEVER, A SECOND MAJOR REASON FOR LAST WINTER'S UPSURGE IN INTEREST RATES -- NAMELY, FEDERAL

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DEFICIT-FINANCING PRESSURES. YOU MAY REMEMBER THAT THE DECEMBER INCREASE IN INTEREST RATES OCCURRED ALMOST SIMULTANEOUSLY WITH THE LEAKING OF THE NEWS ABOUT A SHARP AND UNEXPECTED RISE IN FEDERAL-DEFICIT FORECASTS OVER THE NEXT SEVERAL YEARS. UNTIL EARLY DECEMBER, $43 BILLION WAS THE "OFFICIAL" FORECAST OF THE FISCAL 1982 DEFICIT. BUT THEN CAME RUMORS OF SHOCKING INCREASES IN DEFICIT FORECASTS, SINCE CONFIRMED BY THE OFFICIAL BUDGET DOCUMENT. THE ADMINISTRATION NOW FORECASTS AN AGGREGATE DEFICIT OF $273 BILLION OVER THE FISCAL 1982-84 PERIOD, WHILE THE CONGRESSIONAL BUDGET OFFICE CLAIMS THAT THE TOTAL COULD REACH $454 BILLION UNDER CURRENT TAX AND SPENDING LEGISLATION.

LARGE FEDERAL DEFICITS IN THE NEXT SEVERAL YEARS MAY NOT CREATE FINANCIAL CHAOS, BUT THEY CERTAINLY WOULD AGGRAVATE OUR PRESENT ECONOMIC PROBLEMS. SPECIFICALLY, THE FEDERAL RESERVE MAY BE ABLE TO PREVENT A SIGNIFICANT RISE IN INFLATION BY ALLOWING ONLY SLOW GROWTH IN THE MONEY SUPPLY -- BUT IN THE FACE OF A RELATIVELY LOW SAVINGS RATE AND HUGE FEDERAL BORROWING, INTEREST RATES WOULD TEND TO STAY HIGH AND "CROWD OUT" PRIVATE BORROWING. MOREOVER, SUCH A POLICY COULD SERIOUSLY STRAIN CONGRESS' TOLERANCE OF HIGH INTEREST RATES. AS A RESULT, CONGRESS COULD MAKE STRONG DEMANDS ON THE FED TO RESUME THE POLICY OF ACCOMMODATING FEDERAL DEFICITS THROUGH HIGHER MONETARY GROWTH -- EVEN THOUGH IT MIGHT EXACERBATE INFLATION IN THE LONGER RUN.

THE PHENOMENON OF "CROWDING OUT," WHICH HAD BEEN DISMISSED BY MANY ANALYSTS, HAS FINALLY ARRIVED -- AND WITH A VENGEANCE.

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ACCORDING TO ADMINISTRATION ESTIMATES, FEDERAL BORROWING FROM THE PUBLIC -- INCLUDING BOTH DEFICIT FINANCING AND "OFF BUDGET" FINANCING -- COULD RISE FROM $79 BILLION IN 1981 TO $115 BILLION IN 1982. THIS REPRESENTS THE CULMINATION OF AN IMPORTANT TREND IN THE NATION'S FINANCIAL MARKETS. TOTAL FEDERAL BORROWING AMOUNTED TO 16½ PERCENT OF TOTAL FUNDS RAISED IN CREDIT MARKETS DURING THE 1970'S, WITH THE SHARE INCREASING DURING RECESSION YEARS. BUT NOW, ACCORDING TO OUR STAFF ESTIMATES, THE SHARE COULD APPROACH 32 PERCENT IN THE 1982 RECESSION YEAR AND 26 PERCENT IN THE 1983 RECOVERY YEAR. CLEARLY, THIS OVERWHELMING FEDERAL PRESENCE IN CREDIT MARKETS HAS AFFECTED THE AMOUNTS AVAILABLE TO FINANCE STATE AND LOCAL GOVERNMENTS, BUSINESS NEEDS FOR PLANT-EQUIPMENT AND INVENTORY -- AND, NEEDLESS TO ADD, THE HOUSING MARKET. IN THAT EVENT, THE ESSENTIAL NEEDS OF THESE CRUCIAL SECTORS OF THE ECONOMY CAN BE MET ONLY AT VERY HIGH LEVELS OF REAL INTEREST RATES.

MANY BRIGHT MINDS IN CONGRESS AND IN THE ADMINISTRATION ARE NOW ADDRESSING THIS PROBLEM, ALBEIT SOMEWHAT RELUCTANTLY. THEY HAVE A WIDE MENU OF CHOICES, INCLUDING INCREASES IN TAXES -- OR REVENUE ENHANCEMENTS, IF YOU WILL -- AND REDUCTIONS IN VARIOUS SPENDING COMPONENTS. ON THE SPENDING SIDE, WE SHOULD REMEMBER THAT WHAT GOES UP CAN COME DOWN, AT LEAST IN RELATIVE TERMS. ONE PERCEPTIVE OBSERVER, MARTIN FELDSTEIN -- THE PRESIDENT OF THE NATIONAL BUREAU OF ECONOMIC RESEARCH -- RECENTLY NOTED THAT MOST OF THE MAJOR INCREASES IN GOVERNMENT SPENDING WERE OF FAIRLY RECENT VINTAGE. FEDERAL CIVILIAN

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SPENDING, AS A SHARE OF GNP, ROSE FROM NINE PERCENT IN 1960 TO 13 PERCENT IN 1970, AND FINALLY TO 17 PERCENT IN 1980. RETURNING SUCH SPENDING TO THE 1970 SHARE OF GNP, WHICH IS HARDLY A DRASTIC CUTBACK, WOULD REDUCE OUTLAYS BY FOUR PERCENT OF GNP, OR $160 BILLION AT THE 1984 LEVEL -- THAT IS, BY ENOUGH TO ELIMINATE THE ENTIRE DEFICIT. A CUTBACK OF THAT SIZE IS UNLIKELY, OF COURSE, BUT THE FIGURES INDICATE THAT THERE IS STILL SOME ROOM FOR A ROLLBACK OF FAST-EXPANDING CIVILIAN PROGRAMS. ALSO, SOME CONGRESSIONAL LEADERS ARE NOW PROPOSING SUBSTANTIAL CUTBACKS IN THE BUDGETED INCREASES IN DEFENSE SPENDING. MEANWHILE, ON THE REVENUE SIDE, CONGRESSIONAL LEADERS ARE NOW CONSIDERING A HOST OF CHANGES -- SUCH AS EXCISE-TAX BOOSTS, WINDFALL-PROFIT TAXES ON DECONTROLLED NATURAL-GAS PRICES, OR A POSTPONEMENT OR TERMINATION OF THE SCHEDULED MID-1983 INCOME-TAX REDUCTION.

THE APPEARANCE OF RUNAWAY BUDGET DEFICITS, PERHAPS PREDICTABLY, HAS LED TO A SEVERE REACTION AT THE STATE AND LOCAL LEVEL. AS OF NOW, 31 STATE LEGISLATURES HAVE PETITIONED CONGRESS TO CALL A CONVENTION TO CONSIDER A BALANCED-BUDGET AMENDMENT TO THE CONSTITUTION -- AND THE VOTES OF ONLY THREE MORE STATES WOULD BE NEEDED TO TRIGGER THE CONVENTION CALL. THE OPPONENTS OF THIS APPROACH ARGUE THAT IT WOULD STRAIGHT-JACKET THE FISCAL-POLICY PROCESS. BUT WHATEVER ITS MERIT, THE CONSTITUTIONAL-AMENDMENT APPROACH MAY PLAY A USEFUL ROLE IN GETTING BADLY-NEEDED FISCAL DISCIPLINE. INDEED, BOTH HOUSES OF CONGRESS ARE NOW CONSIDERING BALANCED-BUDGET AMENDMENTS WHICH PARALLEL THE LANGUAGE ADOPTED BY MANY STATE LEGISLATURES.

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STILL, THE BEST WAY FOR THE ADMINISTRATION AND THE CONGRESS TO COUNTER THIS SOMEWHAT RIGID APPROACH WOULD BE TO TAKE SPECIFIC ACTION, ON BOTH THE REVENUE AND EXPENDITURE SIDES, TO BRING THE BUDGET CLOSER INTO BALANCE TODAY. IN THIS CONNECTION, WE HOLD NO BRIEF FOR ANY SPECIFIC FISCAL-POLICY MEASURES, BUT AS CENTRAL BANKERS, WE HAVE A RESPONSIBILITY TO POINT OUT THE IMPLICATIONS FOR FINANCIAL MARKETS OF THE CROWDING-OUT PROCESS CREATED BY HEAVY DEFICIT-FINANCING PRESSURES.

IN BRIEF, THERE MUST BE A MAJOR REDUCTION IN THE SIZE OF PROSPECTIVE FEDERAL BUDGET DEFICITS IF THERE IS TO BE ANY HOPE OF A SIGNIFICANT DECLINE IN THE LEVEL OF INTEREST RATES. SUCH A DECLINE IS BADLY NEEDED TO SET THE STAGE FOR A HEALTHY RECOVERY IN THE NATIONAL ECONOMY, INCLUDING THE HOUSING INDUSTRY. THE COUNTRY THUS ANXIOUSLY AWAITS SIGNS OF A COMPROMISE ENDING THE PRESENT DEADLOCK BETWEEN THE CONGRESS AND THE ADMINISTRATION ON MEASURES TO REDUCE THE BUDGET DEFICITS.

CONCLUDING REMARKS

IN SUM, I BELIEVE THAT VARIOUS MONETARY, FISCAL, AND INSTITUTIONAL MEASURES ARE ESSENTIAL TO THE FUTURE HEALTH OF THE HOUSING INDUSTRY -- AND TO THE ECONOMY GENERALLY. A DISCIPLINED MONETARY POLICY OVER TIME MEANS A REDUCTION IN THE INFLATION RATE, AND IN TURN A REDUCTION IN THE LEVEL OF MORTGAGE AND OTHER INTEREST RATES. A DISCIPLINED FISCAL POLICY MEANS MUCH LESS CROWDING-OUT OF HOME PURCHASERS FROM CREDIT MARKETS. AND CERTAIN INSTITUTIONAL CHANGES TO REDUCE BUILDING RESTRICTIONS AND BROADEN ACCESS TO MORTGAGE-FINANCING SOURCES SHOULD HELP

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KEEP HOME PRICES FROM RISING AT A MUCH STEEPER RATE THAN THE GENERAL LEVEL OF PRICES. BY IMPLEMENTING SUCH PROPOSALS, WE SHOULD SEE MUCH MORE STABILITY IN CREDIT FLOWS AVAILABLE TO THE HOUSING MARKET, AND THUS THE END OF THE VAST SWINGS WHICH PUSH UP HOUSING COSTS SO SEVERELY. AND NEEDLESS TO SAY, IN ACCOMPLISHING THOSE GOALS, WE SHOULD BE ABLE TO DAMPEN THE VAST SWINGS IN NATIONAL BUILDING ACTIVITY WHICH HAVE SO BADLY UNDERMINED THE STRENGTH OF THE FOREST-PRODUCTS INDUSTRY AND OF THE STATE'S ECONOMY AS A WHOLE.

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