HOUSING AND MONETARY POLICY

Remarks of

John J. Balles

President
Federal Reserve Bank
of San Francisco

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Certain monetary, fiscal and institutional changes are essential to the future health of the housing industry, says Mr. Balles. 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 various institutional changes should help 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 in homebuilding activity which have driven up housing costs so severely."

In my conversations with business leaders throughout the West, I've frequently been told that the problems of your industry can be laid directly at the door of the Federal Reserve System. For that reason, I'm grateful for the opportunity to state the Federal Reserve's case — namely, that while the Fed may be part of the short-run problem, it is a major part of the long-term solution. The difficulties of the forest-products industry of course reflect the problems of the housing industry, and the latter in turn reflect a host of fiscal, monetary and institutional problems that have developed over the past 15 years or so. I'd like to review for you today the developments in each of those areas, and wind up with several proposals designed to ease the housing industry's problems. But first, let's consider the present state of the industry.

Problems Afflicting Housing

Demographic figures show that household formations have been running at almost two million units per year, while annual housing starts are running at around one million or less. On the surface, this indicates the existence of a severe shortage. However, the housing industry's problems are related to the volatility of housing activity; in the 1973-75 slump, and again in the 1978-81 downturn, housing starts declined by half or more. Indeed, we are now completing a third straight year of declining starts, so that 1981 may be the lowest housing year since World War II.

We must not forget, however, 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. In fact, the average new home today is twice as large as its counterpart of the early post-World War II era, and the typical mobile home today is as large as the typical single-family home of that earlier period.

Moreover, housing increased its share of credit flows during the past decade — accounting for 21 percent of the total in the 1970's, as compared with 19 percent of all credit flows in the 1960's. Also, mortgage-credit flows were several times greater in 1979 than they were a decade before. But by the middle of this year, less than 14 percent of total-credit flows was going into housing — in dollar terms, 36 percent less than housing claimed at the 1978 peak. This reflects once again the vast fluctuations in credit flows that have always afflicted this feast-or-famine industry.

This problem, in turn, reflects the severe structural problems now confronting the mortgage-lending industry. Over the years, thrift institutions 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 the thrifts are paying more than 15 percent on 6-month money-market certificates, although 60 percent of the mortgages on their books carry yields of less than 10 percent. Thus, as we've seen, the industry is having severe earnings problems.

Let's also consider the problem from the homebuyer's standpoint. A family earning the median income in 1980 had to pay over 33 percent of its income to buy the 1980 median-priced house. In contrast, the ratio was only 15 percent of income back 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.

Expected inflation requires that lenders be compensated for the expected deterioration in the purchasing power of money. Moreover, the conventional fixed-rate mortgage requires that payments be spread evenly over the duration of the mortgage, so that dollar payments remain constant. Today's conventional mortgage thus imposes a significant cash-flow problem for the homebuyer, especially the first-time homebuyer. In this context, then, reducing inflation is a crucial part of the fight to restore the health of the housing industry.

In 1981, of course, housing is severely depressed, at least partly because mortgage rates have been running 4 to 5 percentage points above the supposed threshold of 13 to 13½ percent for potential homebuyers. Interest rates of that magnitude mean impossibly high monthly payments for most people, especially when they are tied to fixed-rate mortgages many years into the future. But remember that interest rates are only one factor in the high price of housing. As I've just noted, the combination of inflation expectations and institutional barriers (especially the fixed-rate mortgage) makes it prohibitively expensive for first-time homebuyers to break into the market today.

The core of the problem is inflation, which means that we can only bring down interest rates if we are successful in our overall fight against inflation. This year, we have begun to see some progress in the form of declining inflation — *and* declining interest rates. Although that progress has been slow and halting, it does suggest that the worst may be about over.

Interest Rates and Policy

Interest rates are determined by many factors — including, but not mainly, the actions of the Federal Reserve, which can control only the supply of money and not the demand. Certainly the Fed has some effect on rates in the short run, because of its efforts to control the amount of reserves in the banking system and the amount of money in the hands of the public.

However, business-cycle conditions also influence rates, as credit demands rise and fall with the cycle. And above all, price expectations heavily influence rates, frequently offsetting other market influences. Today, for example, if people expect prices to rise by (say) 10 percent a year, lenders will demand that 10-percent inflation premium plus some "real" underlying interest rate of perhaps 3 to 4 percent to protect themselves against an expected loss in the purchasing power of their money.

In the realm of anti-inflationary monetary tactics, the Federal Reserve shifted its operating procedures two years ago to emphasize money-growth control rather than interest-rate control. Our experience has clearly demonstrated that during periods of heavy (private plus government) credit demands, attempts to dampen rising interest rates result in rapid money growth. And history has also shown that rapid money growth eventually leads to inflation — accompanied by high interest rates. By the same token, history shows that reductions in money-supply growth definitely reduce the inflation rate over time, usually with the lag of a year-and-a-half to two years. This suggests, then, that the Fed should continue to follow the path of gradual deceleration adopted in October 1979.

The evidence for 1981 indicates some progress against inflation, despite a third-quarter price upsurge created by an acceleration of food and (especially) housing prices. The consumer-price index, which increased by 12½ percent during 1980, has been rising on average at about a 10-percent rate to date in 1981. The broader GNP price index (deflator), following its 10-percent increase during 1980, has been rising at about a

9-percent rate over the first three quarters of 1981. The battle, of course, remains as tough as ever, as we can see from the past quarter's price upsurge. Yet, overall, I have no doubt that a policy of gradual deceleration in money growth will mean a further deceleration in inflation over the next several years.

Technical Problems

The Fed's policy task is complicated, however, by technical questions of measurement, as the newspapers have been pointing out in recent months. In an era of financial deregulation and innovation, different monetary measures have been giving off different signals. The narrow measure of the money supply — currency plus transaction (check-type) accounts, known as M1-B — decelerated slightly in each of the past two years, and sharply thus far in 1981. Recently it has been running considerably below the bottom of the 1981 target growth range, as set by the Fed, of 3½ to 6 percent, after adjustment for shifts of savings into check-like NOW accounts. To complicate matters, the actual M1-B measure — before adjustment for shifts of NOW-account funds — has been running roughly in the middle of that 3½-to-6 percent range. Moreover, a broader measure — primarily currency plus all depository institutions' deposits (except large CDs) and money-market fund shares, known as M-2 — has been running near or above the top of its 6-to-9 percent target range, although below last year's actual growth. Other broad measures of money and credit also have been expanding rapidly.

The difference in growth trends can be traced ultimately to the effect of high interest rates on household and business cash-management practices. High rates have minimized the use of traditional transaction balances included in the M1-B measure, and have stimulated the growth of money-market mutual funds and other components of the broader monetary aggregates such as M-2.

These technical questions, abstruse as they may seem, reflect some hard political and economic decisions. As the *Wall Street Journal* recently observed, with M-2 above its target and adjusted M1-B below its target, the Fed's critics have the option of blaming the Fed for creating money too rapidly and causing inflation, for creating money too slowly and causing recession, or perhaps for both at once. Some critics recently have argued for an anti-recession acceleration of adjusted M1-B growth, to bring it within its growth range. However, this would require accelerated money growth, at about a 12-percent annual rate, for the rest of this year.

A growing body of evidence now indicates that the unadjusted M1-B figure is a better measure than the adjusted figure. Briefly, it appears that the attraction of high interest rates has considerably reduced the demand for currency and check-type deposits in relation to income. If this is true, we would be mistaken in policy terms to accelerate money-supply growth in coming months, because that would only create more inflationary tinder at a time when we have made definite progress against inflation by getting money growth under control. In that case, we would only repeat our earlier experience, when we appeared to have licked inflation in the mid-1970's because of a moderate monetary and fiscal policy, but then threw away our hard-won gains in the overexuberant atmosphere of the late 1970's.

Fiscal Policy Problems

The disinflationary money path followed by the Federal Reserve in the 1980's is a necessary reversal of the inflationary money growth of the preceding decade-and-a-half. That policy can be successful, however, only if it is accompanied by an equal reversal in the field of fiscal policy. The Congress and the Administration have made some progress along this line this year. But without further progress, we would be faced with the prospect of large deficits in relation to the nation's savings potential, with its inevitable implications for financial markets and for housing and other sectors dependent on credit. The harsh fact is that the past track record has not been encouraging. The Federal budget has not recorded a surplus since 1969, and in fact, has been in deficit in all but one of the past 21 years. In most years also, deficit forecasts have become larger and larger with each new estimate, giving market participants grounds for increasing skepticism.

Budget deficits also have affected the markets more directly. After adjustment for capital-consumption allowances — that is, the amount necessary to maintain the present stock of business investment and housing — the nation generated about $185 billion of savings in fiscal 1981, largely in the form of business-retained corporate earnings, household savings, and state and local pension-fund contributions. That amount represented the funds available to add to our plant and equipment, to inventory, to housing — and to finance the Federal Government. But Federal deficit and off-budget financing, when combined, totalled over $80 billion — nearly one-half of the nation's total savings.

Now, you could argue that our budget deficits are relatively small by international standards, when measured in relation to total production. This is true, but unfortunately our savings are also small, and it is the relation between the two that is crucial. For example, in the last half-decade, U.S. net savings amounted to less than 5 percent of the nation's total output. In contrast, the savings ratio was more than twice that large in most major European nations, and almost four times that large in Japan.

Now, any economist will tell you that the effect of budget deficits on the economy and capital markets should be judged differently at different stages of the business cycle. There is little danger of "crowding-out" in a period when we have high actual savings, falling investment demands, and low interest rates. But surely, that is not the situation confronting us today, when competing demands clash so strenuously in the marketplace. Thus, we see the Federal Government crowding-out other borrowers — households, homebuilders, farmers, small businesses, and state and local governments — who cannot afford to pay the interest rates that the Federal Government is willing and able to pay. Surely, this massive Federal presence in credit markets must be considered a major cause, along with high inflation, of the high interest rates now undermining the housing market.

Policy Proposals

Let me summarize my argument, therefore, by making several policy proposals, beginning with the continued need for a disciplined monetary policy. The path of wisdom calls for a policy that will keep all of the major monetary aggregates from straying too far off course. For the remainder of 1981 — according to Chairman Volcker's latest Congressional testimony — the Federal Reserve thus is willing to hold adjusted M1-B growth near the bottom of its range, and M-2 growth near the top of its range. For 1982, the Fed tentatively has again reduced its projected growth range for M-1 (a single narrow aggregate) to between 2½ and 5½ percent, while maintaining a 6-to-9 percent range for M-2. Thus, by carrying out our "game plan" of reduced money growth in 1981, and projecting similar discipline next year, we should add credibility to the nation's anti-inflation program and help to reverse long-standing expectations of continued high inflation.

Next, we must make every effort to reduce Federal deficit-financing pressures on the markets, and thereby reduce the crowding-out of borrowers. I've been impressed this year by the joint Administration-Congressional efforts to reduce taxes and spending in tandem. However, we are still left with the prospect of substantial deficits in fiscal 1982 and subsequent years. In passing, I might note an estimate that if half the funds required for financing the fiscal '81 deficit had gone instead into housing, we would be back again at the 1978 peak level of homebuilding activity.

I believe, therefore, that a vital "phase 2" will be needed to ensure further reductions in Federal deficits. Washington policy makers are now actively discussing ways of accomplishing this goal, through both further expenditure cuts and tax measures. With regard to expenditures, many observers believe that Congress should take a hard look at various entitlement programs, since large budget deficits in recent years have mostly reflected the inflation-indexed upsurge in payments for Social Security and other such programs. With regard to tax measures, the Administration has proposed some increases in taxes other than on income, and in particular, some Congressmen have discussed deferring the income-tax cuts now scheduled for mid-1982 and mid-1983. It may be necessary to work on both expenditure reductions and added tax-revenue measures to head off a very unhealthy surge in the Federal deficit.

Third, we should support various mortgage-financing innovations which help first-time homebuyers leap the hurdle to homeownership. These innovations — such as the variable-rate mortgage, the graduated-payment mortgage and the shared-appreciation mortgage — mean that both borrowers and lenders share the risks and the benefits of inflation. But this approach also enables mortgage borrowers to obtain more housing services over time — especially because initial payments would be lower than they are under the terms of fixed-rate mortgages.

Finally, we should eliminate the various state and local restrictions which have made housing prices rise even faster than the general rate of inflation in recent years. These include local building codes, limitations on land use, and other restrictions which drive building costs up at a substantial rate year-in and year-out. Some observers believe that we also need a Federal override of state-court decisions which prohibit enforcement of due-on-sale clauses in mortgages and which thus permit homebuyers to assume low-rate mortgages on existing homes. Realtors and buyers of existing homes may welcome this assumability feature, but it has aggravated the thrift institutions' problem of making funds available for new housing construction, and also of improving the return on their mortgage portfolios. Too many pressures as it is are forcing thrift institutions away from their basic responsibility of financing housing. Thus, I would welcome any action which would ease the thrifts' task of carrying out their basic home-financing role.

In sum, I believe that these monetary, fiscal, and institutional proposals are essential to the future health of the housing industry. 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 the various institutional changes I have suggested should help 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 have driven up housing costs so severely. And needless to say, by accomplishing those goals, we should be able to reduce the vast swings in building activity which have driven up your industry's costs in turn.