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Monetary Policy and Real Estate Investment

I. Introduction

A. Real estate industry facing a number of challenges right now:

1. Slowdown in real estate markets in many parts of country, even in once heady California market;
2. Scarcity of construction financing as result of thrift restructuring; and even
3. Cautious stance of monetary policy.

B. None of these concerns is likely to disappear anytime soon, but they do mask some favorable longer-term developments.

C. So, today I'd like to address three topics:

1. Current approach of monetary policy;
2. What this means for the real estate industry's outlook;
3. And finally, my observations on some key structural changes that have taken place within the real estate industry in recent years.

II. Turning first to monetary policy, let me say emphatically that Fed is committed to controlling inflation and bringing it down.

A. We continue to see troubling signs of inflationary pressures:

1. Recent surge in producer and consumer price indexes.
2. Admittedly, a lot of this is due to recent spikes in price of energy and food.
3. But what worries me is that economy continues to operate at very high level; this puts upward pressure on prices.
 - a. For example, unemployment rate still is well below level economists consider consistent with stable prices.
4. Our forecast suggests that even though economy is slowing, inflation won't begin to moderate until well into 1991.

B. To reduce inflationary pressures, economy needs to back away from levels of activity that strain capacity.

C. Put bluntly, this means extended period of relatively slow growth.

1. Project real GNP growth of about two percent in 1990, somewhat below the economy's potential rate.
 - a. Not stellar, but not a recession, either.
 2. Key contributor to growth will be consumer spending.
- III. These policy concerns imply several things for real estate.
- A. First, because economy continues to operate at relatively high level, real interest rates remain high by historical standards. Clearly, this is a deterrent to real estate investment.
 - B. Second, the sluggish growth in income that I anticipate will have dampening effect on real estate investment.
 - C. Finally, declining inflation in medium- to longer-term may tend to slow rate of appreciation in real estate values.
 - D. Obviously, not a rosy picture.
 1. Residential investment:
 - a. I'm expecting some bounceback in residential investment after weak performance in 1989.
 - b. But recent uptick in mortgage rates will limit extent of bounceback.
 2. For commercial and industrial real estate investment, I expect almost no growth for the year.
 - a. Overbuilding has been a significant problem in certain areas.
 - b. And problems with the availability of construction financing may have an impact.
- IV. Having suggested a less-than-rosy outlook, I want to call your attention to some recent developments, particularly in residential investment, that are more encouraging.
- A. First, housing investment now more resilient to interest rate shocks than in the past.
 - B. Second, housing finance and, I would argue, real estate finance generally is now less subject to credit crunches and other dislocations.
 - C. Third, interest rates themselves have been less volatile in recent years.

- D. Let's look at these developments in more detail.
- V. Historically, housing investment has had close relationship with cycles in interest rates.
 - A. When interest rates rose, housing investment took a nosedive.
 - 1. Rising interest rates raised cost of investing in housing.
 - 2. Also tended to restrict supply of mortgage credit, making financing not only more expensive, but just plain harder to obtain.
 - B. So, when Fed tightened monetary policy, real estate tended to be the first sector affected.
 - C. In recent years, however, the link between real estate activity and interest rates has become weaker, particularly in the housing sector.
 - D. What accounts for this change?
 - E. In a nutshell, financial deregulation and innovations in housing finance.
 - 1. Prior to deregulation, supply of housing credit suffered from bouts of disintermediation whenever interest rates rose.
 - a. Disintermediation occurred in short run because traditional mortgage lenders (banks and S&Ls) weren't allowed to raise deposit rates to keep up with rising market rates.
 - b. Below-market returns prompted depositors to seek higher yields elsewhere -- typically in T bills.
 - c. This, in turn, left lenders temporarily without the funds to make mortgage loans, and prompted periodic credit crunches.
 - 2. Beginning in the early 1980s, deposit rates were deregulated.
 - a. As a result, disintermediation and mortgage credit crunches have become a much smaller issue.
 - b. Funds flows now appear to be relatively uncorrelated with interest rates, whereas in 1960s and 1970s, there was strong negative correlation.
 - 3. Another factor that has led to weaker link between housing and interest rates is deepening of secondary markets and relaxation of regulatory restrictions on mortgage instruments.

- a. Secondary mortgage markets have been a boon because
 - (1) they have tied housing finance into national credit markets, and
 - (2) have made supply of credit less dependent on deposit flows.
- b. ARMs also were a watershed for housing finance.
 - (1) ARMs offer interest rate-risk management tool that enables lenders to increase supply of mortgage credit.
 - (2) From borrowers' perspective, ARMs also improved affordability picture.
 - (a) Prior to authorization of ARMs, spikes in interest rates created problems for affordability.
 - (b) ARMs reduced these problems by giving lenders more flexibility to change loan features to accommodate borrowers' changing needs over rate cycle.
 - (c) The fact that ARM issuance (as a share of new mortgages) moves in lockstep with interest rate fluctuations shows how ARMs are helping alleviate cyclical affordability problems.
- F. For all these reasons, then, housing finance has become less prone to credit crunches, and housing investment, in turn, has become less sensitive to interest rate cycles.
- G. In addition, interest rate cycles themselves have become less pronounced.
 - 1. In recent years, the level of interest rate volatility has declined and is now on a par with the best periods of the 1960s and 1970s.
- H. As a result of both a weaker interest rate/housing link, and less volatile interest rates, cycles in investment have been dampened.
 - 1. Peak-to-trough swings in housing starts are in the half-million unit range today, versus the giant, 1.5 million unit swings we saw in the 60s and 70s.
- I. Bottom line is that monetary policy is not having the same impact

on residential investment that it has had in the past.

- VI. These developments have implications for the way the current restructuring in the thrift industry will affect housing and real estate investment.
 - A. To be sure, the thrift crisis is restricting the supply of credit.
 - 1. However, banks are picking up some of the slack.
 - 2. But even banks apparently are being more selective these days.
 - a. A recent survey of bank lending by the Federal Reserve suggests that construction and development financing, in particular, has been hurt.
 - 3. Such limitations on the availability of credit no doubt are having an impact on the level of activity in the real estate industry.
 - a. This is good to extent it is helping to promote more rational and prudent investment.
 - b. But credit restrictions may be having an impact on financing for sound projects, as well.
 - 4. Fortunately, these adverse influences are only temporary.
 - a. The deregulation of deposit rates, the deepening of secondary markets for mortgage instruments, and the introduction of new mortgage instruments will help to minimize dislocations caused by thrift restructuring.
 - b. Because financial markets are now more resilient, the loss of even a sizable number of lenders should not create long-term problems for the supply of credit.
 - 5. And with the demise of "go-go" lending by weak thrifts, I think we can look forward to a stronger real estate industry in the long run.
- VII. In conclusion, 1990 isn't going to be a banner year for the real estate industry.
 - A. Fed's commitment to eliminating inflation means a slow-growth environment for some time to come.
 - B. Fortunately, real estate industry no longer quite so tied to interest rate cycles and changes in Fed policy.
 - C. Consequently, if you compare the industry's outlook for 1990 with its performance in prior economic slowdowns, the outlook isn't too bad.