STABILIZATION POLICIES AND THE HOUSING INDUSTRY

Speech
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I am pleased to have this opportunity to discuss with you the impact of monetary actions on the home building industry. Construction and real estate lending, as you are all aware, have been subject to much wider fluctuations than business generally, and the timing of housing fluctuations has been somewhat different than for most other activities.

Some observers claim that monetary policy actions designed to resist inflation have discriminated excessively against the housing industry. For this reason, pressures develop to moderate anti-inflationary actions because of their possible adverse effects on the large and important housing sector.

My view is that much of this criticism has been misdirected. Our studies indicate that inflation and excessive total demand for goods and services, fostered by overly expansionary monetary and fiscal actions, have been the real villains to the housing industry. In fact, it is likely that the industry has an even greater interest in stable economic growth without inflation than most others. A favorable economic climate is important for several reasons: because outlays for a home are so large relative to most other expenditures, because financing plays a major role in sales, because of competition from existing homes which last a relatively long period, and because costs of building are very responsive to inflationary pressures.

First, I will review the impact of monetary actions on spending, production, prices, and interest rates. These, then, will be related to developments in the housing industry in the postwar period.

Monetary Actions and Overall Economic Activity

Considerable evidence indicates that changes in the money stock are a primary determinant of changes in total spending for goods and services. Changes in total spending, in turn, have been associated, first, with changes in output, and later, with changes in prices. Consequently, the trend rate of growth of the money stock is viewed as having a major influence in the determination of the trend rate of growth of prices, whereas accelerations and decelerations in the growth rate of money around the trend lead mainly to short-run fluctuations in output and employment.

These short- and long-run effects of the money stock on prices, output, and employment are demonstrated in Chart I in your packet. This chart presents the course of these variables since early 1952. The trend growth of the money stock, as shown in the top tier, remained at a 1.7 percent annual rate from early 1952 to the fall of 1962, accelerated to a 3.7 percent rate until the end of 1966, and then to a 5.8 percent rate through last year. The trend rate of growth of prices, as shown by the "General Price Index" panel, has risen in a similar pattern since the early 1950's, reflecting, after about a three year lag, changes in the trend growth of the money stock.

Relationships between movements in output and employment and changes in the growth rates of the money stock relative to its underlying trend rates can be observed by comparing the top tier with the bottom two tiers of Chart I. During the two decades covered, money stock growth occurred at rates significantly greater than the underlying trend on a number of occasions, for example, in 1952, in late 1954 and early 1955, and in 1958 and early 1959. Each of these periods was accompanied (with a lag of one or two quarters) by an upward movement in real output toward or above potential output. Also, unemployment declined as a percent of the labor force.

During this same twenty-year interval, the economy experienced four recessions (indicated by the shaded vertical bars on your chart) and two periods of brief economic slowdown (in late 1962 and late 1966-early 1967). Each of the recessions and slowdowns was preceded by a marked reduction in the growth rate of the money stock relative to the trend.

Next, let me comment briefly on the effect of monetary actions on interest rates. An acceleration in monetary expansion adds to the supply of loanable funds, placing an immediate downward pressure on interest rates. However, after a period, the tendency to reduce interest rates is often overwhelmed by other effects. As I have just discussed, an acceleration of the money stock has expansionary effects on total spending and places upward pressures on prices. Greater spending and inflationary expectations cause greater demands for credit. The increased demand for credit which results from a large prolonged monetary expansion is usually much greater than the supply of credit created. Thus, net upward pressure on interest rates results after a short lag.

In short, interest rates are a misleading indicator of monetary actions. A rapid and sustained increase in the rate of money growth by the Federal Reserve System has nearly always had opposite short- and long-run effects on interest rates. More rapid increases of the money supply have usually caused interest rates to be lower for several weeks than they might otherwise have been. However, when the more rapid rate of money growth has been sustained over several months, interest rates have usually risen to levels higher than they were originally. Historically, the highest levels of interest rates have occurred after prolonged periods of excessive monetary expansion and intensification of inflationary forces (such as in the late sixties and early seventies). By contrast, lowest interest rates have usually existed following periods of extreme monetary restraint and recession.

Excessive Demand, Inflation and the Housing Industry

Let us now apply this monetary analysis to the housing sector. It has been demonstrated that rapid monetary expansion, such as occurred in 1967 and 1968, stimulates total spending for goods and services and intensifies inflation. These developments in turn, generate a rapidly growing demand for credit and rising interest rates.

Interest rates play an important role in the demand for housing. The evidence is overwhelming, and I need not belabor this point with you. Traditional housing analysts, as well as monetarists, agree that a rise in interest rates has adversely affected homebuilding more than most other activities. The responsiveness of housing demand to mortgage rates results, in large part, because the cost of financing normally represents a relatively large portion of total cost.

A crucial difference between monetarists and the traditional view is over what causes the high interest rates. The traditional view has held that high interest rates indicate monetary restraint. Monetarists have pointed out that high interest rates are a reflection of excessive demands for goods, services and credit and of inflationary expectations which have generally resulted from expansive monetary actions.

Comparison of expenditures on housing relative to total spending during past periods of severe monetary restraint indicates no strong tendency for housing to be more seriously affected than the rest of the economy. Chart II shows real outlays on residential construction as a portion of total real spending since 1951. The shaded areas in this chart are sustained periods of slowest (or negative) money growth.

The chart indicates several periods in which the housing sector has experienced a prolonged decline relative to other sectors in the economy, such as from early 1955 to mid-1957, from early 1959 to mid-1960, and from the end of 1963 to the end of 1966. An interesting aspect of the chart is that each of these periods began during a period of relatively rapid monetary expansion. During the first quarter or two of a period of slow monetary expansion, the housing sector has tended to continue its relative decline begun during a previous period of rapid monetary expansion. Then, as monetary restraint continued, housing outlays have tended to level off or start rising relative to other activities. The one exception was the 1959-60 period.

The number of new, private houses started each quarter has followed a pattern similar to the one for construction. Housing starts are shown in Chart III. All marked and sustained declines in housing starts began in periods of monetary expansion. In several cases the decline in starts was reversed after a quarter or two of monetary restraint.

The developments illustrated in charts II and III can be explained in terms of the framework presented at the beginning of my discussion. Since the housing industry is very interest sensitive, rising interest rates have acted as a major deterrent to housing activity. Most sustained interest rate rises, however, have occurred after a prolonged period of excessive monetary expansion, as measured by changes in Federal Reserve credit, the monetary base, and money stock. A restrictive policy might temporarily put upward pressure on interest rates and thus adversely affect housing. However, the long-run effect of monetary restraint has generally been lower interest rates which act as a powerful stimulus to the housing sector.

Housing activity probably responds more to changes in interest rates than it does to the absolute levels of rates. This partially explains how spurts in housing developed in early 1967 and 1970 when mortgage rates were at higher levels than in the housing recession of 1955 and 1956. Although mortgage rates were high by historical standards in 1967 and 1970, they were somewhat lower than those in the immediately preceding period, which probably weighs heaviest on expectations.

Inflation has not only hurt the housing industry by increasing the cost of financing, but it has raised the relative cost of building a house. Only part of this higher construction cost may be offset by a rise in the expected future resale value of the house. During periods of excessive total demand and inflation, construction costs have risen much more rapidly than other prices. Since 1965, when inflation has been most intense, overall consumer prices have risen at an average 4.4 percent annual rate while the cost of home ownership has risen at a 6.7 percent pace. Not only have construction costs been more sensitive to economic developments, but during the Vietnam build-up, some of the rise in construction costs may have reflected a bidding away of men and materials for the war effort.

The rising costs of construction have probably damaged the housing industry more permanently than the higher interest costs. Interest rates are in most cases responsive to changes in demand and supply, and hence after the excesses which caused the higher rates are eliminated, it is likely that interest rates will drift lower. However, once the costs of construction rise, there is strong resistence to any reductions, since market forces are prevented from becoming fully effective by monopolistic practices.

In passing, let me mention another adverse impact on housing which usually accompanies a period of excessive monetary expansion. That is, the effects of interest rate ceilings that are applied or become effective in periods of high and rising interest rates. Such interferences to the market process greatly distort the allocation of funds. One example is state usury laws which prohibit interest rates on mortgages from rising to the market-clearing rate. Other interferences include Regulation Q and similar regulations on rates of interest financial intermediaries are able to pay to attract savings.

Although one purpose of such regulation may be to hold down the cost of real estate financing, they have usually operated to the detriment of the potential home buyer. The rules make those institutions which finance housing less competitive in obtaining funds during periods of relatively high market rates, than big businesses and Government, which are not subject to interest rate ceilings. Elimination of such discriminatory restrictions would greatly aid the housing industry in obtaining financing and attracting resources during periods of overall high demand for them.

Conclusions and Outlook

The widespread belief that housing has been seriously hurt by monetary restraint probably has resulted from mistakenly identifying rising market interest rates with monetary restraint. Interest rates have usually been a poor guide to either the rate of monetary expansion or its impact on economic activity.

Conversely, the evidence is strong that housing has been seriously hampered by excessive total demands for goods and services and by inflation. Our studies indicate that the chief cause of such excesses is unduly expansionary monetary policies. Not only do such excesses drive up the cost of constructing houses, but the huge demands and the inflationary pressures push up market interest rates, which tend to bear most heavily on the housing industry.

Because the nation has suffered from continuous rapid inflation and high interest rates since the mid-1960s, the housing industry has been in a depressed state for an extended period. More and more the industry is being supported by Government aid, but this is a relatively poor solution to the problem. Government programs are costly, reduce freedom, and tend to misallocate resources since they are not subject to the discipline of the market.

Studies at the St. Louis Federal Reserve Bank indicate that the most appropriate course would be to pursue a steady and moderate rate of monetary expansion. Steadiness is required to avoid destabilizing effects on production, employment and incomes. Moderation is essential to avoid excessive total demands, and thereby maintain a low level of inflation and interest rates. The evidence indicates that the benefits flowing to the housing industry from such a policy course would be greater than for any other major industry, although virtually all of society would benefit. The housing industry has probably suffered most from the instability generated by past stop-and-go stabilization policies.

Finally, a word about the outlook. Because of past policy excesses, particularly from 1965 through 1968, the housing industry has been in a depressed state for a prolonged period. Since early 1969 overall monetary actions have been somewhat more moderate on balance, and the housing market has shown improvement. However, monetary actions in 1971 were more erratic than I would have desired, which has probably had a slight dampening effect on the recovery in housing.

Assuming that monetary growth now proceeds at a relatively steady and moderate pace (say, at a 4 to 6 percent annual rate), the demand forhomes should be very strong for several years, adequate financing should be available on reasonable terms, and the housing sector would likely be one of the most vigorous in the economy.

On the other hand, if policy is made much more stimulative, as advocated by many, in order to quickly attain capacity levels of production and employment, housing is likely to suffer again. I say this realizing that sales may be stimulated for about six months. By 1973, however, residential construction would again probably suffer cutbacks resulting from a revival of excessive total demands, accelerating inflation, and higher interest rates.