"HOUSING AT THE CROSSROADS"

Address by
Theodore H. Roberts
President
Federal Reserve Bank of St. Louis

Before the
Home Builders Association
St. Louis, Missouri
April 17, 1984
I am very pleased to have this opportunity to share my views on housing and monetary policy with members of the St. Louis Home Builders Association.

With the recent substantial rise in interest rates and this morning's report of a 27 percent decrease in housing starts last month, some of you hardy survivors must be wondering if we are about to replay the homebuilding devastation of 1981-82. I was in the banking business at that time and also a director of a Real Estate Investment Trust, and I saw what happened to even the best homebuilders. The sharp rise in inflation preceding that period encouraged speculation both in land acquisition and building. The mood of the times was "buy it or build it before the price goes up again." No one anticipated the level of interest rates which it eventually would take to control rapidly increasing prices throughout the economy. Builders found that interest reserves on development projects were grossly deficient as short-term interest rate levels soared, increasing the costs of their floating rate construction loans. Meanwhile substantially higher long-term interest rates priced buyers out of the market, lengthening the time required to dispose of completed properties, even at distressed prices.

None of us wants to experience such difficulties again. The question is how to avoid them. Sometimes in searching for a solution, it is useful to stand back and look at a problem in historical perspective. That seems particularly appropriate when you realize that the St. Louis Home Builders Association is celebrating its 50th anniversary this year, and the Fed has been around some 70 years. Both of us must have been doing something right just to have survived through all the tumultuous events of these years.
Let's first take a quick look at what has been happening to housing and its financing since 1934, the year your association started. Home ownership in this country has risen from less than one-half of households to almost two-thirds. By comparison, only half of British, French, and Italian, and just one-third of German families now own their own homes. Clearly, the homebuilders of America deserve great credit for producing affordable, quality residences for a broad segment of the population.

Of course, you have had a little help along the way. The universal dream of homeownership has fostered political pressures which have produced public policies designed to increase the allocation of resources to housing through massive direct and indirect subsidies. These include federally chartered and insured mutual savings and loan associations with special tax advantages, and access to the money and capital markets via credit from federally sponsored agencies. These institutions were literally designed to make low-rate, long-term, amortizing mortgages. One also thinks of federally insured and guaranteed mortgage loans, and tax free bond issues of states and cities to raise funds for relending in low rate mortgages. Beyond all those, we have the income tax deductibility of mortgage interest and property taxes with an estimated annual value to homeowners of some $37 billion.

Meanwhile, thrift institutions were not immune to the problems of inflation and tight money. Without substantial government assistance and considerable "creative accounting," most thrift institutions would not have survived until rates declined in 1982. Their problems were aggravated by deregulation of deposit interest rates which raised funding costs and reduced operating margins to negligible proportions. Determined
not to get caught in the same interest rate squeeze again, thrift institutions have begun to emphasize variable rate lending and are selling off fixed rate loans.

The past few years have produced more innovations in mortgage finance than we have seen since the early thirties. You recall the "creative financing" used by sellers of homes during the period of highest interest rates. These short-term, balloon loans, usually at below market interest rates kept properties moving and concealed a decline of about 10 percent in real market prices after 1979. More recently, builder "buy-downs," and graduated payment mortgages have joined the options available to home buyers. A common denominator of all these new mortgage forms is a shift of interest rate or payment risk to the borrower, certainly a matter of some concern since a rash of defaults and forced sales is not likely to be constructive for new homebuilding.

A more fundamental development in housing finance has been the pooling of mortgages into securities for sale either to institutions or individuals. Initially, these mortgage-backed participation certificates were guaranteed by Ginnie Mae, Fannie Mae, or Freddie Mac. Now, we are seeing some being sold with only conventional mortgage backing and carrying no government agency guarantee. Recently, such securities have converted underlying mortgage amortization payments into bond-like semi-annual payments of various short, medium, or long-term maturities, thereby substantially broadening the market. These mortgage backed securities now supply over half the funds for new mortgages. By removing much of the regional interest rate differential, they have helped create a truly national market for mortgages. In a way, we have gone full circle in mortgage finance and are now back to the practices of the
twenties except for retaining the pattern of long-term mortgage amortization. Once again, individuals are a major factor in the supply of mortgage credit either directly or through pension funds. Combine this development with modern computer technology and you have the possibility of instant credit approval and sale of mortgages via computer terminals to mortgage bankers, investment bankers, or brokers who package them into securities form and resell them. This is actually taking place today.

What brought about this virtual revolution in home financing? What are the likely longer-run consequences for the housing industry? The shock that initiated this scramble for different techniques to finance housing was the accelerating inflation that began in the 1960s. Along with greater inflation came a phenomenon of more variable inflation as well. Now, a more variable rate of inflation produces not only a varying price level but also sizable and unexpected changes in relative prices. As relative prices change, some activities will become relatively more profitable and other less so. Consequently, people's spending and investing patterns shift back and forth solely because of the inflationary impact. The mix of economic activities shifts back and forth in response to these spending patterns.

In the case of housing during the late 1960s and 1970s, the impact of higher and more variable inflation was amplified by the deposit interest rate ceilings; the end result was alternating booms and busts for home builders. Since 1960, the annual growth in output of all goods and services varied between minus 2 percent to plus 6 percent. Housing starts varied between minus 34 percent to plus 60 percent by the same measure. Housing construction experienced booms in 1968, 1972–73, and
1977-78; at the outset of each of these booms, the rate of inflation jumped by 3 or more percent relative to its average over the preceding two years. When this rapid runup in inflation combined with interest rate ceilings, housing production was recurrently pushed to unusual and unsustainable bursts of activity. This movement was fueled by the public's perception of negative real interest rates on mortgages. That is, the interest rates charged to borrowers turned out (after the fact) to be lower than the inflation rate. Lenders, it turned out, were giving away wealth to borrowers. Indeed, these three housing booms roughly coincided with the largest negative real interest rates during the past fifteen years.

If this were the full story of inflation's impact on housing, home builders might well ask "What's wrong with housing booms?" The problem was, however, that each boom was followed by a bust which required layoffs, costly inventory reductions, and high failure rates among construction firms. Following the 1972-73 boom, housing starts fell to less than half their 1972 peak; from the 1977-78 boom, they fell by about 50 percent over the next 4 years. In particular, as all of you know well, 1979-82 was an especially traumatic and protracted period of falling housing starts and failing home builders.

One result of recent financial innovations is that, ultimately, the housing industry will not be subjected to the sharply magnified impact of business cycles that affected it in the past. In particular, it will not be boosted by negative real interest rates, and it will not be depressed when those rates become sharply positive. The variable rate mortgage will insure that the flow of savings to the housing market does not disappear. The much broader base of savers provided by mortgage pool
instruments will assure that mortgage interest rates do not fluctuate more sharply than other long-term interest rates.

While these financial innovations will protect the housing industry from magnified fluctuations relative to the rest of the economy, they will clearly do nothing to minimize business cycles and interest rate fluctuations in general. To a large extent this is the province of monetary authorities and the policies that they pursue. Clearly, monetary policy is not a panacea to all economic ills: excessive government borrowing and spending will not necessarily disappear, Middle East crises will still cause energy prices to fluctuate, the vagaries of weather will cause the prices of food to change, and people's decisions whether to save more or to borrow will change interest rates. But, if monetary authorities provided stable and moderate monetary growth, this would go a long way towards reducing or minimizing the fluctuations that we have experienced in the past.

If we want to eliminate inflation, we must reduce monetary growth to reasonable levels which are compatible with output growth. But research also indicates that abrupt and large reductions in money growth cause sharp and costly economic contractions. Thus, the long-term solution must be a gradual and steady reduction in monetary expansion. If this is to be achieved, however, we must condone market-induced fluctuations in interest rates and in all other relative prices. Attempts to manipulate interest rates produced the chronic inflation and economic fluctuations of the seventies and early eighties. By focusing on interest rates instead of money growth, we managed to win some battles, but lose the war.
In the more immediate future, I can see the potential for the adoption of a desirable monetary policy. There is no doubt that the economy cannot continue to expand at 6 to 7 percent per year; real growth of this magnitude is not sustainable. Nor, unfortunately for you, are housing starts at an annual 2.2 million rate sustainable for any considerable length of time. A slowdown is inevitable. Moreover, monetary growth in the recent past indicates that inflation will accelerate for a time, and short-term interest rates will rise. But if monetary growth can be maintained at the middle of the current Federal Reserve range, at about 6 percent, and then slowly reduced over the years ahead, we could reduce inflation, we would see lower interest rates, and we would see a much more stable economy.

I think you would agree that such an environment would facilitate your planning, enhance your productivity, reduce your risks, and generally make your prospects for survival more favorable.