Remarks by
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Chairman, Board of Governors of the Federal Reserve System
before the
Board of Directors
of the
National Association of Home Builders

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I am pleased to have this opportunity to speak to you today. I meet in Washington with your officers from time to time, but this is my first session with the full Board of Directors. It's good that we are meeting here at the Omni, because I don't think this Board would fit in our Board room.

The economic circumstances today certainly are more comfortable than they were seven years ago when my predecessor, Paul Volcker, appeared before this group. At that time, mortgage interest rates were peaking at 18 percent, and housing construction was bottoming out at its lowest level since World War II. Since then, of course, the housing industry and the economy generally have enjoyed good times by practically any measure of aggregate performance.

In my remarks today I want to concentrate on an important, but often overlooked, aspect of your business in recent years—its stability. Single-family housing starts have topped 1 million units in each of the past six years. While earlier periods saw single-family construction jump temporarily to levels far above those of recent years, not since the 1950s has there been such a sustained record of good performance. The falloff in total housing starts since 1986 has resulted mainly from a decline in apartment construction and tends to mask what has been a major achievement in single-family homebuilding.
I want to comment on the significance of that stability in homebuilding, the reasons for it, and the challenges to maintaining it in the future.

Large swings in the level of construction benefit neither you nor your customers. Such volatility increases costs. It is more burdensome to build in slack times because fixed costs are incurred, but with a smaller volume of construction there is less chance of recovering them. In peak periods it is, of course, expensive to build because all variable inputs—labor, materials, and, especially, land—cost more. Volatility makes long-range planning and business development difficult, if not impossible. One legacy of the collapse in homebuilding at the beginning of this decade is that speculative construction—breaking ground without a sales contract in hand—has been less common in recent years than in the go-go 1970s. I venture to say that most of you would gladly trade the boom-bust cycle of the late 1970s and early 1980s for something more resembling the relatively steady, sustained pace of the current expansion.

Consumers share the burden of any ups and downs in homebuilding. They bear some of these extra costs you encounter because of the uneven pace of construction. In addition, consumers' preferred timing of purchases can be disrupted by temporary changes in market conditions, adding
to the amplitude of construction cycles as pent-up demand boosts activity once conditions become more favorable.

The stability in housing construction of the past six years thus has been a blessing for both you and your customers. This stability has come about through the combined effects of several positive influences. Because of their relevance for the future, let me take a few minutes to review them.

First is the demographic underpinning to the market. After a sharp drop early in the decade—attributable in part to the recession—household formation returned to a level not much below the average pace of the 1970s, which was near the all-time high. The so-called baby boomers have continued to fuel household formation, and changes in marriage and divorce patterns have contributed to a spreading out of the population over a larger number of housing units, thereby increasing total housing demand. Historically, a large majority of all housing units added to the stock have gone to accommodate growth in the number of households. In the past ten years, for example, household formation has averaged, in round numbers, about a million and a half annually. In contrast, fewer than a half million units annually have been required to satisfy the demand for vacation properties and replacement of existing housing. Most of the demand for additional housing has been met, as always, through new construction of houses and apartments;
mobile homes and net conversions from nonresidential use have accounted for less than one-quarter of all additions to the stock. In light of these statistics, the importance of population trends for your industry is hard to overstate.

The current economic expansion also has been marked by strong and sustained growth in household income. Since the back-to-back recessions of the early 1980s, personal income adjusted for inflation has grown steadily, averaging a bit over 3 percent annually. The stability of the growth has been important to housing demand because people typically don't jump into the market the first week their paycheck increases. As a long-term commitment, consumers' purchases of housing are affected primarily by their long-run income expectations. Consumer confidence is therefore a key determinant of housing demand. The sustained income growth has given consumers that confidence, as indicated by several years now of positive consumer attitudes toward the purchase of a home. These consumer attitudes have in fact never been higher for such an extended period of time.

The consumers have been there, and they've had the income and confidence to act. The houses they have been buying each year have been bigger and better. Indeed, much of the increase in new home prices reported in recent years has reflected these quality improvements rather than price inflation per se.
Also supporting the steady pace of construction has been a much improved financial environment and important innovations in housing finance. During the 1980s, the share of home mortgage credit held in securitized form has increased from less than 10 percent to more than one-third. It is uncertain how much securitization has influenced mortgage interest rates, but the direction is clear; moreover, it is certain that securitization has broadened the base for housing finance, making provision of mortgage credit far less dependent on the fortunes of any one type of financial institution. The demonstrated ability of the mortgage market to flourish throughout the recent years of turmoil in the thrift industry attests to the broadening of the sources of credit supply. Securities have also broadened the geographic base of mortgage lending, by facilitating the interregional flow of credit to areas where demand is strongest.

Securitization has brought added efficiency to mortgage finance by prompting specialization. Individual institutions may have comparative advantages in different aspects of mortgage lending, and securitization promotes an efficient division of labor. For instance, it enables institutions and individuals who have expertise or interest only in the investment function to commit funds without originating or servicing mortgages.
Another contribution of securitization has been to enable custom tailoring of the cash flows from mortgages to meet the investment requirements of a wider range of individuals and institutions. Derivative mortgage securities—the alphabet soup of CMOs, IO/POs, and the like—offer something for nearly every investor: short-term paper, long-term securities, fixed-rate and floating-rate instruments, and securities with prepayment risk either much lower or much higher than on the underlying mortgages. Among other uses, when employed knowledgeably, these derivative securities can be helpful tools for managing the interest rate risk on portfolios of mortgage loans.

Adjustable-rate contracts are the other major innovation influencing mortgage finance and housing markets during this decade. Adjustable-rate mortgages as we know them today did not exist at the beginning of the decade. Their prevalence of late points to their increased acceptance among consumers and lenders alike; in the past five years about half of all conventional home loans originated have carried adjustable rates, and today perhaps one-quarter of the entire stock of home mortgage debt is in adjustable form. We do not yet know how much these new instruments have boosted total housing demand in the long run or how much they have altered the cyclical sensitivity of homebuilding to interest rate changes. Some influence, however, is certain.
On more traditional mortgage instruments, interest rates on fixed-rate loans dropped several percentage points from the 1982 peaks and, especially during the past three years, have been at levels that, while high by broad historical standards, have been low enough to support considerable demand. During much of this period, long-term interest rates have been relatively stable, and this stability has contributed to a spread of mortgage rates over other long-term instruments that is lower than typical; lenders have required less of a return to compensate them for the uncertainty of prepayment speed.

Another factor that has promoted the stability in home building has been the lower rate of inflation of the past several years. If there had ever been any doubts, everyone should by now be convinced that inflation is no boon to housing. The rise in inflation in the 1970s temporarily boosted your business as consumers bought housing as an inflation hedge. But the adverse consequences were severe and not long in coming. House prices shot up to levels that took many potential buyers out of the market as carrying costs became prohibitive regardless of the perceived investment value of home purchase. Housing finance institutions, burned by borrowing short to lend long during a period of rising interest rates, boosted their offering rates on new mortgages to cover their now higher
expectations of inflation and the increased risk stemming from the general economic uncertainty.

Challenges of the Future

A number of hurdles must be overcome to maintain the stability your market has enjoyed in recent years. First, the demographic picture is mixed. On the positive side, demographic trends are, of all the determinants of housing demand, the most stable and the easiest to predict and therefore to plan for. The bad news is that the outlook for household formation—the critical demographic variable for aggregate housing demand—is not a cheery one for builders. Most forecasters put household formation on a slow downtrend continuing through the end of this century. For individual builders, this fact may be less important than the outlook for migration and economic growth in the local market areas in which you operate. But, for the industry as a whole, this means, quite simply, that fewer units will need to be built to keep the population housed. Remodeling and the building of trade-up homes will almost certainly grow relative to construction of starter homes as a market for your skills and services. Income growth, if continued, will help stimulate the market for vacation homes, which may well grow beyond the market share of 5 percent they already command of all newly built units.
Demographic change also has a bearing on a more immediate concern and challenge to you and to the nation—housing affordability. This is certainly not a new issue, but attention has focused once again in recent years in response to several highly visible and troubling indicators—the high proportion of their income that many renters must spend to secure even modest accommodations, the increasingly apparent problem of homelessness, and the declining homeownership rate among young adults.

Consider first the decline in homeownership. For the population as a whole, lower inflation has meant less need for an inflation hedge and has reduced this component of demand for owner-occupied housing. In this sense, then, a decline in the ownership rate is not an unambiguously negative development. Nor is it surprising that when adjustments in homeownership occur, they are most apparent among young adults. This group is the most mobile and therefore the quickest to adjust their housing to changing market conditions. However, the falloff in ownership among young adults reflects more than just the changing relative cost of owning and renting. Incomes of young adults—those under age 35—have not been keeping pace with the rest of the population. Both demographic and labor market factors have induced this shortfall. Single parents, with their special problems in competing in the labor market, have been increasingly prevalent among young adult households. And
more generally, the sheer number of baby boomers flooding the ranks of entry-level job seekers has held down their wages relative to those earned by more experienced workers.

So lagging income growth and the shifting relative cost of owning and renting both contribute to the decline in ownership that is most apparent among young adults. This decline is troubling, however, because ownership is an aspiration of most young adults and achievement of this goal provides benefits to individuals, families, and their neighborhoods beyond those captured by simple dollars-and-cents calculations.

The problem of low-income renters, a group that might be broadly defined to include the homeless, is of a different sort. We are becoming more and more a country in which income separates owner from renter. The average income of renter households today is less than 60 percent the average income of owners. The gap has been growing for some time. The larger problem facing low-income renters is their low income rather than housing per se, although the supply of modest rental apartments is dwindling in many areas, which tends to bid up prices on the units that remain.

In attacking the problem of housing affordability, a number of parties have critical roles to play. First, builders must continue to seek out cost-minimizing methods of construction, using new technology and efficient project
management to increase productivity. State and local governments have the difficult task of designing and enforcing building regulations with multiple objectives. But building codes, zoning ordinances, impact fees, and other state and local government regulation of residential construction must be monitored and adjusted when possible to enhance housing availability.

Creative solutions to the affordability problem will be required, because expensive federal solutions are not in the offing, given the reality of budget restrictions. The work last year of the National Housing Task Force, under the bipartisan sponsorship of the Congress and with the active participation of many groups, including your own, has been a font of ideas for low-cost measures.

In tackling the challenge of affordability, we now have a housing finance system that is more flexible and more broadly based than the system of old. The integration of the mortgage market with capital markets at large does, however, bring with it a quicker response of mortgage rates to rates in other sectors, as home mortgage lenders now compete more directly with corporate borrowers and the government for investors' favor. We have seen this clearly during the past couple of years. Some uncertainty in interest rates is the price that needs to be paid for a more certain supply of credit.
The challenge in this new world of housing finance is to manage these risks well. Consumers need to be mindful of the risks of higher future payments and negative amortization on alternative mortgage instruments and be able to absorb these if they should occur. Lenders need self-discipline and prudence in the pricing and underwriting of these loans and not go for the quick up-front fees at the expense of long-run profitability and the quality of their loan portfolios.

Monetary policy of course plays a key role in the outlook for the building industry and, specifically, in promoting housing affordability. The Fed’s task is to provide enough money and credit to support economic growth at a pace that can be sustained as we continue to move toward price stability. Inflationary pressures must be contained if we are to avoid the wrenching volatility of the past.

Throughout these years of economic expansion, the Fed has adjusted policy from time to time in attempting to keep the economy on a sustainable trajectory. During the past year, these actions contributed to upward movement in short-term interest rates. Long-term rates, however, including those on home mortgages, have held fairly steady, which may to some extent be an expression of confidence on the part of financial market participants that actions taken now will preclude a more severe tightening later. This gets
us back to the notion of stability and its importance for your industry and the economy at large.

To recapitulate, stability in the economic environment in which you do business allows you to produce at an even and sustainable pace, with benefits for both you and your customers. This is an important lesson of recent years. The challenges faced by your industry are ample without your being forced to cope with a volatile market setting. At the Fed we hope to contribute to the conditions of stability in the homebuilding industry. But, needless to say, we can't do it alone. Actions on the budget deficit and by industry itself will be major factors.