For release on delivery
10 30 a m CST (11 30 a m EST)
Saturday, January 28, 1995

Remarks by

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Board of Governors of the Federal Reserve System

before the

Board of Directors

of the

National Association of Home Builders

Houston, Texas

January 28, 1995

I am pleased to have this opportunity to speak to you today Although I meet frequently in Washington with your officers, it has been six years since I addressed the full Board of Directors It has been an eventful six years for our nation and your industry I would like to begin my remarks this morning by reviewing some of those events and then relate them to the outlook for homebuilding

When last I was here, we were in the early days of the credit crunch, though few, if any, of us realized how severe the cutbacks would be I do not have to tell you that it was a wrenching experience, especially for small and medium sized builders dependent on banks and savings institutions for construction credit The crunch was not first and foremost about interest rates, indeed, short- and long-term interest rates were coming down throughout the period But interest rates were not the issue for those of you who had trouble finding credit, at any price, from your traditional sources

As painful as it was the credit crunch could have been worse In contrast to some previous episodes of credit tightening, your customers--the homebuyers--were generally able to obtain credit on very favorable terms throughout the credit crunch Mortgage interest rates fell to ten-year lows, and qualification standards tightened little, if at all Owing in part to the development of securitization homebuyers were not so dependent on strapped depository institutions for their mortgages

The credit crunch was a particularly vivid example of a general principle, namely that excesses lead to problems The credit crunch was in large measure a reaction to the financial excesses of the previous several years Many of the mistakes were in real estate lending, especially acquisition, development, and construction financing of income properties The credit crunch demonstrated once again that a boom-and-bust cycle is no friend of the homebuilding industry More generally, boom-and-bust economic cycles are inimical to business and household planning, to saving and investment, and to the longer-term growth of the U S economy

The experience of the past several years also serves as a reminder that, although interest rates are important for homebuilding, they are only one influence, and often not the dominant influence, on your business From early 1989 to early 1991, total housing starts fell 40 percent despite declines of more than a percentage point in interest rates for both fixed- and adjustable-rate mortgages More recently, starts last year held up better than most analysts had expected, in light of increases in mortgage interest rates of more than 2 full percentage points Although it may be premature to conclude that adjustments to recent mortgage rate increases are complete, "resilient" is the word most often used to describe the housing sector's performance in 1994

Clearly other factors have been at work over the past year, offsetting the restricting effects of higher interest rates One of these offsets has come from some easing in credit availability to you and your customers Even as interest rates have been rising, non-rate terms on credit have been easing Low downpayment loans have become increasingly available to homebuyers, last year, the average downpayment on conventionally financed new homes was the lowest in at least thirty years And builders' access to construction credit from both traditional and non-traditional sources has improved, as a variety of lenders have sensed an improved potential for profit

Another important offset to higher interest rates has been income growth Business investment and export industries in particular have generated jobs and labor income over the past year that have exceeded the expectations of most analysts, including those at the Federal Reserve

A third factor supporting housing demand is consumer confidence, which surveys show to have risen markedly since late 1993 Confident consumers at 9 percent mortgage rates are better customers than nervous consumers at 7 percent rates To make a major purchase, most consumers need to feel that the future will be at least as favorable as the present They need to feel comfortable that they will have the income to service their mortgage And they must feel secure that their investment is safe, that is that house prices won't collapse

Neither of these requirements for confidence was present at the beginning of the 1990s Sluggish income growth was compounded in many local markets by worries about house price declines and, nationwide, by uncertainty surrounding the Persian Gulf war Weak demand, much more than the credit crunch, was responsible for the slow pace of construction during 1990 and early 1991

Since then, job growth and firmer house prices have contributed to a resurgence in confidence and demand Indeed, during the past two years a very favorable balance was struck People in most local markets have had the confidence to move forward At the same time, houses have remained quite affordable by historical standards Thanks to growing incomes and still moderate house price increases, typical homebuyers today have to devote less of their incomes to mortgage payments than at practically any time during the past twenty years, despite the mortgage rate increases of the past twelve months

It is hard to overestimate the importance of house price trends on consumer psyches and behavior Even with all the financial innovations and new forms of investment open to individuals houses remain the single most important store of wealth for much of the population To put the estimated $4 trillion in home equity in perspective, it averages out to about $65,000 per homeowner

Consumers view their home equity as a cushion or security blanket against the possibility of future hard times But many consumers also tap their home equity directly, for a variety of purposes, including home improvements, auto purchases, college tuition, and debt consolidation Home equity lines of credit, rare just ten years ago, are now held by roughly 5 million homeowners Of particular interest to homebuilders, trade-up homebuyers report that the proceeds from the sale of their previous home is the single most important source of the downpayment on their new residence In a way, new homes both begin and complete the circle of wealth accumulation through homeownership

A central message of the last several years is that, if your industry is to prosper, you need stability, be it in the availability and price of credit, materials costs, or consumer confidence and demand Instability, leading to large swings in the level of construction, increases your costs and, ultimately, the prices paid by homebuyers

A stable business environment will allow you to confront the challenges your industry faces over the remainder of this decade A central challenge for your industry and for the nation overall is to boost the number of homeowners After rising steadily for nearly a half-century, the homeownership rate among all households has been stuck since the early 1980s at about 64 percent Disturbingly, homeownership among young adults has fallen significantly during that same period

Young adults today have much lower ownership rates than did their parents, when *they* were young adults For example, currently one-third of all adults age 25 to 29 are homeowners But in the early 1970s, the ownership rate for this age group was 44 percent Homeownership among today's young adults can be expected to increase as they age, nonetheless, today's young are on lower ownership trajectories than were their parents

As Secretary Cisneros described earlier this morning, President Clinton has announced an initiative, a partnership of industry leaders, community lenders, and government, to bring more Americans into homeownership than ever before One tool for achieving this goal is to cut the costs of new construction Members of the NAHB have been leaders in developing low-cost designs and materials, and in working with government on regulatory and land use reform I encourage you to bring your expertise to the table in striving toward this important goal of increased homeownership

Housing finance is another area where gains can be made in promoting homeownership Working with lenders, you can increase the efficiency of loan originations and underwriting The objective here is to allow more people to qualify for home purchase During the 1980s, many of the innovations in housing finance were new mortgage products--adjustable rate mortgages and other loan designs that better matched the loan's terms to the borrowers' financial circumstances Also important was development of new mortgage securities that tailored cash flows to investors' needs Now, during the 1990s, more of the innovations in housing finance are coming as improvements in the way mortgages are underwritten, originated, and serviced streamlining the loan application and origination process, and ensuring that the downpayment and income requirements, and interest rates charged, accurately reflect the credit and prepayment risks involved in making those loans

More generally, lenders must further improve their ability to assess risk for all types of real estate lending The housing industry would be ill-served by lenders unwilling to take any risks, but you are equally ill-served by a financial community that takes excessive, avoidable risks Some of the overlending that led to the credit crunch was in multifamily housing This sector subsequently paid the price, as multifamily starts fell in the early 1990s to the lowest level of the past thirty-five years The multifamily rental sector is important to our economy and society It is appropriate to promote homeownership for all for whom it makes sense, but we must strive to provide a steady supply of multifamily housing for those who need or prefer it With many commercial banks and other credit suppliers now vigorously increasing their mortgage lending for multifamily and commercial mortgages, the challenge to these lenders is to avoid the excesses of the past, both the excessive risk taking of the mid-1980s, and the indiscriminate cutoffs of creditworthy borrowers seen during the crunch Lenders need to take a longer-term view of the prospects for projects, in both good times and bad

As you plan for the years ahead, one key determinant of your business that has clearly improved since last we spoke is the demographic outlook For a long time, the consensus forecast was that population trends would be less favorable for homebuilders in the 1990s than they had been in the 1980s, because the maturation of the baby bust generation was expected to substantially reduce the number of newly formed households Because most of your business comes directly or indirectly from population growth, reduced household formations were expected to significantly reduce the demand for new homes

The good news for homebuilding is that new Census Bureau projections point to a much more vigorous demographic underpinning for your industry over the balance of this decade More immigration and longer life-spans have substantially increased forecasts of adult population growth, and the likelihood is that housing demand in the 1990s will be as good as in the 1980s

Certainly work remains in matching your product to changing types and locations of households, but concerns about overall shrinkage of the market have ebbed In addition, the ever-growing stock of housing brings with it increased demand for remodeling, additions, and other improvements Last year, expenditures on residential improvements were nearly half as great as the total value of all new homes built, and this market is certain to remain a big part of your business

Your industry epitomizes the flexibility and resourcefulness required to adjust to, and exploit, demographic changes, technological breakthroughs and new forms of mortgage finance But you face enough challenges without having to confront a volatile macroeconomic environment In this regard, the responsibilities of the Federal government are several

In the realm of fiscal policy, the simple fact remains that deficits are damaging because they pull resources away from private investment, reducing the rate of growth of the nation's capital stock Less capital--that is, less plant and equipment--means less productive workers, which means lower incomes and less housing demand And the deficit drives up long-term interest rates in the private credit markets Over the past two years, the Congress and the Administration have taken important steps to put the federal deficit on a more favorable trend The new Congress brings new ideas about how to proceed from here There are various ways to reduce the deficit Some are, in my opinion, preferable to others But whatever path is chosen it is important that the momentum toward reducing the deficit be maintained

In addition to moving on the deficit, the federal government is poised to modify various housing programs, including the FHA, which last year was the funding source for about 10 percent of your customers I know you are participating in those discussions and urge you to continue to do so, because your input is important if these programs are to be run more efficiently and to be better targeted to achieve their intended purposes

As for the Federal Reserve, we are striving to provide a stable platform for business generally, and for homebuilding, in particular While it is certainly the case that part of short-term interest rate increases eventually become embodied in longer-term rates, the major part of long term rates is driven by expectations of future credit demands and inflation

A failure of monetary policy to contain inflation has brought great hardship on the mortgage market and homebuilding industry in the past, by engendering wide fluctuations Over a ten-year time frame, the cumulative number of homes built is little affected by interest rates The average number of homes built from one decade to the next is driven largely by population change What interest rates do affect is the severity of shorter-term homebuilding cycles, that is, how the decade's total is distributed by years

The most recent tightening of monetary policy began almost a year ago Some have criticized these rate hikes But I am convinced that if we had not acted, your business would have suffered Mortgage rates actually began to rise in late 1993, three months before the first tightening move by the Fed Absent the tightening, mortgage rates today may well have been much higher than they actually are

Monetary policy acts with a lag If we had waited until inflation had become evident, it would have been too late The oft-cited analogy to a barge travelling on a river is apt To successfully navigate a bend in the river, the barge must begin the turn well before the bend is reached Even so, currents are always changing, and even an experienced crew cannot foresee all the events that might occur as the river is being navigated A year ago the Fed began its turn, and we do not yet know if it has been successful All I can tell you is that our objective is to navigate the bend and keep our economy strong

In setting monetary policy, the Federal Reserve is looking to encourage the highest level of activity that the economy can sustain, not to hold it back Confidence is important for housing demand, and the best way to promote confidence is to establish sustained growth For growth to be sustained, it must be non-inflationary

Your industry has shown its ability to deal with adversity But it is a lot more fun to deal with prosperity For a strong economy, our country needs a healthy homebuilding industry And a strong economy is our shared objective