Remarks by

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Board of Governors of the Federal Reserve System

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of the

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I am pleased to have this opportunity to speak to you today. Realtors and their colleagues in the real estate industry are among the most interested observers of the Federal Reserve, and—judging from the mail, calls, and visits—hold some fairly strong views about our policy actions. We, in turn, recognize that movements of interest rates can have major effects on your business. And, as you know, market interest rates have moved a lot over the past year or so. This has owed in part to monetary policy, but also has reflected changing market perceptions about strength in the economy and pressures on prices, and about the odds on further Federal Reserve actions.

I can assure you that it is not a goal of monetary policy to encourage fluctuations in interest rates, even if it does make your lives more interesting. In fact, I thought it might be useful to take a few minutes today to spell out what our goals are as we conduct monetary policy and how this interacts with the environment for your business over time. I'd also like to touch on some other government policies important to you, as well as some non-governmental influences on long-term trends in your business.

In setting monetary policy, we at the Federal Reserve are striving to provide a stable platform for businesses generally, and we believe this is in the best interests of the real estate industry. That is, the Federal Reserve looks to encourage the greatest possible sustained advance in economic activity over time. This requires that growth be noninflationary. Price stability is a key ingredient in maintaining the highest possible levels of productivity, real incomes, and living standards. It enables households and firms to concentrate on what they do best—produce, invest, and consume efficiently.
Our efforts to promote sustained expansion obviously entail changes in short-term interest rates. These changes, in turn, reflect a lot of forces acting on the US economy: ebbs and flows in household and business confidence, shifting fiscal policies, and developments in export markets. Federal Reserve policy and financial market conditions more generally need to adapt to these rapidly evolving factors if our economy is to avoid the unstable cycles inimical to a prosperous business environment. It is important to recognize that while short-term interest rate movements have an influence on longer-term rates, much of the variation in 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 to the mortgage market and real estate industry in the past, by engendering wide fluctuations. The tightening in monetary policy that began last year was intended to forestall an intensification of inflation pressures that ultimately would threaten the expansion.

The experience of the past several years serves as a reminder that, although interest rates are important for the real estate sector, they are only one influence, and often not the dominant influence, on your business. From early 1989 to early 1991, sales of both new and existing homes fell sharply, despite declines of more than a percentage point in interest rates for both fixed-rate and adjustable-rate mortgages. And sales last year held up better than most analysts had expected, in light of increases in mortgage interest rates of more than two full percentage points. It was a very good year for single-family construction, and, with nearly 4 million transactions, 1994 was the second best year on record for existing
home sales. Other factors clearly can offset the restricting effects of higher interest rates, including an easing in credit availability. Last year, for example, even as interest rates were rising, non-rate terms on credit were being eased. Low downpayment loans have become increasingly available to homebuyers.

Interest rates clearly do affect the severity of shorter-term housing cycles, but there is little evidence that they have any significant effect on the volume of activity over a longer period, say, a decade. Demographic change and income growth pretty much determine decade-long totals of construction and sales, while fluctuations in mortgage rates are more important for determining how housing activity is allocated year by year within the period. And, of course, local market conditions can dominate national trends. Last year, for example, even as existing home sales nationwide posted a gain of roughly 4 percent, 17 states registered declines.

A central message of the past couple of decades is that, if the real estate industry is to prosper consistently, you need stability, be it in the availability and cost of credit or in consumer confidence and demand. History is replete with examples of a general principle, namely that excesses lead to problems. Boom-and-bust cycles are no friend of real estate professionals or your customers. For one thing, these cycles have often involved sharply rising house prices followed by plummeting values. Home price volatility leads to unrealistic price expectations, which can play havoc with your business and make it more difficult for your customers to adjust their housing as their personal circumstances change. 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 make their monthly mortgage payments. And they must feel secure that their investment is safe—that is, that house prices won’t collapse.

It is hard to overestimate the importance of house price trends for 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. Changes in house prices affect the level of this wealth, as current homeowners accrue capital gains or losses. To put the current 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. Still, for many owners, home sales convert accumulated home equity into more liquid forms. Owners whose homes have appreciated realize capital gains at the time of sale, but even those owners whose properties have not accrued gains convert their housing wealth into cash at the time of sale. Of particular interest to realtors, trade-up homebuyers report that the proceeds from the sale of their previous home is one of the more important sources of the downpayment on their new residence. In a way, home sales both begin and complete the circle of wealth accumulation through homeownership.

Of course, monetary policy is not the only government policy that can contribute to the long-run stability and prosperity of
your industry. In the realm of fiscal policy, the simple fact remains that budget deficits are damaging because they drain our pool of savings, raising real interest rates, damping investment in housing and in business capital, and inhibiting the growth of labor productivity. I am encouraged with the increased attention the persistent federal budget imbalance and its consequences have been receiving in the past few years. Important steps have been taken, but it is essential that the momentum toward reducing, and eventually eliminating, the deficit be accelerated.

Moreover, the shortfall of domestic saving relative to investment has a mirror image in our external accounts. In the past few years, we as a nation have been able to finance much of our investment by tapping saving from abroad. But the United States has been running persistent and growing deficits in its current account position vis-à-vis the rest of the world. Our past ability to finance our domestic investment with savings from abroad highlights the openness of world capital markets. But, to repeat what I have stated many times in the past, it is unlikely that we can rely on foreign sources of capital indefinitely. Looking back at the history of the past century or more, the record would suggest that nations ultimately must rely on their domestic savings to support domestic investment. Given the weakness in the foreign exchange value of the dollar earlier this year, world capital markets may have been sending us just that message.

In addition to moving on the deficit, the federal government is poised to modify various housing programs, including programs funded under the FHA, which last year was the funding source for at least 15 percent of all homebuyers. 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 achieve their intended purposes.

Regulatory reform is another important federal initiative. Too often regulations stay on the books long past their useful lives, or have unforeseen and unintended consequences, or their costs unexpectedly outweigh their benefits. We need periodically to reassess our laws and regulations in light of our experience with them. As you are well aware, housing and housing finance are among our most regulated industries. The Federal Reserve would become directly involved with regulatory reform of your industry through legislation recently introduced in the Congress that attempts in a very limited way to improve the administration of the Real Estate Settlement Procedures Act, or RESPA. The Growth and Regulatory Paperwork Reduction Act would transfer regulatory authority for RESPA from the Department of Housing and Urban Development to the Federal Reserve Board. Although such a transfer may have some intuitive appeal, given the Board's Truth in Lending responsibilities, there are important reasons why the Board is opposed to this provision. First and foremost, unlike Truth in Lending, certain portions of RESPA are in essence a price-regulation scheme, this is foreign to the Board's central bank responsibilities. The Federal Reserve Board lacks expertise to administer such a program, but even if the Board were more suited to the task, simply transferring responsibility for RESPA from one agency to another would not necessarily achieve the intended purpose of lessening the regulatory burden.
Instead, the Federal Reserve Board has offered in recent testimony an alternative solution for RESPA. We believe that an in-depth reassessment by the Congress of RESPA's fundamental requirements is more to the point. There are very complex issues raised by RESPA that need to be addressed separately, rather than as part of general efforts to improve government efficiency and reduce the costs of governmental regulation. The Board believes that the Congress should consider the questions raised by RESPA in separate hearings that could focus on the substance of RESPA rather than on administrative jurisdiction.

Of course, government policies are far from the only influences on your business. One important factor that remains favorable is the demographic outlook for existing home sales. The stock of existing homes is almost sure to increase, given the certainty of continued growth in the adult population. Although the number of households added to the population will likely vary from year to year, this volatility is of less concern to your business than to the home building industry, where the level of demand is determined in large measure by the growth in the population rather than by the size of the population.

Demographic trends also have some bearing on another key variable for your business—the homeownership rate, that is, the proportion of all households that own their home. After rising steadily for nearly a half-century, the homeownership rate has held since the early 1980s at about 64 percent. Homeownership has been flat despite some aging of the population, which normally would be expected to increase homeownership. But changes in marital status and household composition have offset this aging. And for some groups of
the population, income growth has not kept pace with the costs of homeownership. Notably, the homeownership rate among young adults has fallen significantly since 1980. Currently about 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. Much of this decline can be linked to changes in marital status and family composition among young adults. But, in addition, young families with children have experienced significant declines and now have much lower ownership rates than did their parents, when they were young families. 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.

But you are not entirely at the mercy of demographics. Housing finance is one area where gains can be made in broadening homeownership opportunities. Working with lenders, you can continue to 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 the development of new mortgage securities that tailored cash flows to investors' needs. Now, during the 1990s, more of the innovations in housing finance take the form of improvements in the way mortgages are underwritten, originated, and serviced. Streamlining and automating 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.
In closing, let me return to the theme of stability. The Federal Reserve has no magical power to eliminate economic fluctuations. But we endeavor to minimize them, and in doing so, seek to improve the environment for long-term growth. Toward that end, we closely monitor developments in the real estate industry, including the statistics and analysis provided by your association. We are doing our best to provide a financial and economic environment in which you, your customers, and our nation can prosper.