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ECONOMIC REVIEW

The Southeast in 1978: Expansion for a Fourth Year

Inflation and Home Buying

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Good but uneven growth characterized the southeastern economy last year. Robust consumer demand for new homes and durable goods, stimulated by the onset of chronic inflation, provided much of the momentum. Both households and businesses borrowed avidly, boosting the earnings and straining the liquidity of lending institutions. Higher prices and expanded output of farm products brought welcome relief to the ailing agricultural sector. But the minimum wage hike put a damper on job gains, and by year-end, most sectors were signaling slower growth in the months ahead.

Inflation and Home Buying. 14

Long-term appreciation of house values has made home buying a truly profitable investment and one that is particularly attractive in periods of rapid inflation. Rising incomes and gradual changes in financing arrangements have kept homeownership within the means of more households but not without greater leveraging of their financial positions.

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THE SOUTHEAST IN 1978: EXPANSION FOR A FOURTH YEAR

This article was prepared by *Charles J. Haulk* based on material contributed by other Federal Reserve Bank of Atlanta economists Charlie Carter, John Godfrey, Frank King, and Gene Sullivan.

1978 OVERVIEW

The 1978 southeastern economy could be assessed as one of good but uneven growth. After suffering a poor January due to weather and the coal workers' strike, the economy bounced back briskly for several months and then entered into a period of sluggish growth in late summer. Although some strong activity reappeared in October, recent evidence points to a continuation of modest growth for late 1978. The unemployment rate, which had fallen steadily through 1977, seems to have stuck at just under 7 percent after reaching as low as 6 percent in June. Retail sales, which for most of the first half of 1978 grew at a blistering pace, seem to have cooled off during the latter half of 1978, although year-over-year gains of 15 to 20 percent were reported for many areas in the Southeast. Inflation continued to worsen throughout 1978 and has become a major source of concern.

Construction was the leading growth sector, with residential contracts and employment up substantially from 1977. Manufacturing production, especially durable goods, ran well ahead of the year-earlier rate. The combined growth of employment, higher wages, and longer workweek pushed factory payroll income 13 percent above the 1977 figure. As with retail sales, production and income growth rates were very strong in the first half and slowed to a less ebullient pace in the second half.

Farmers. Unlike the 1977 experience when farm cash receipts were falling through much of the year, farm receipts were up sharply in the first few months of 1978. Farmers were the beneficiaries of rapidly rising prices through midyear. Since July, District farmers have seen prices stabilize, but crop production has been so much greater than a year ago that receipts have continued to show strong growth and could exceed the 1977 level by $2 billion. Weather was conducive to good crops in most areas of the Southeast, although Georgia and parts of Alabama suffered some severe drought conditions. But, by and large, abundant crop yields were reported throughout the region. Record harvests nationally began to restrain prices of grains and soybeans by harvesttime. Cattle producers and, to a lesser degree, hog and poultry growers benefited from higher prices. Citrus production was depressed by a severe freeze in late 1977, but prices stood at record levels for most of the year and producer incomes were unusually good. All in all, 1978 was a much better year for agriculture than was 1977.

Banks. The banking industry was in high gear for most of 1978. Total bank credit in the Southeast was up nearly 14 percent. Deposit growth was at a much more moderate 8-percent rate, and, as a result, liquidity pressures began to develop.

Consumer credit continued to be a major source of loan growth, as auto sales posted a solid year. Home mortgage lending was very brisk in response to the surge in demand for homeownership. Interest rates rose rapidly but business borrowing grew with little letup. Although demand deposits grew at a 10-percent rate, time deposits and particularly passbook savings did not advance as they had for the previous three years.

Savings and loan associations experienced deteriorating savings inflows through May, but with the introduction of the money market certificates of deposit, savings inflows improved markedly in June and remained strong for several months.

Employment. Employment growth, which had surged during fourth-quarter 1977, continued to move ahead strongly in first-quarter 1978. Since late spring, employment growth has been sluggish, if not flat. Labor force growth in 1978 trailed the 30,000 new entrants per month pace of 1977. Even though the numbers unemployed increased, the unemployment rate held fairly steady at under 7 percent for most of the year because of the labor force growth that did occur. Overall, employment was up 3 percent from the previous year.

Florida led the region in job growth, both in actual numbers and in percentage terms. In every state, construction was the leading sector for employment growth. Job growth was also strong in wholesale and retail trade, finance, insurance and real estate, services, and durable goods manufacturing. Weak growth occurred in transportation, government, and nondurable manufacturing. Textile employment was actually down from 1977 levels.

Other. The tourist industry enjoyed one of the best years in history, if not the best. Florida and New Orleans were inundated with visitors. Hotel occupancy tax collections were up 22 percent in New Orleans. Nashville hotels had good occupancy rates, but visitors to Opryland were below anticipated numbers. Interest in the Mississippi Gulf Coast as a resort area continued to increase during 1978.

Reports from most of the major growth centers—Miami, New Orleans, Nashville, Atlanta, Birmingham, and Jacksonville, as well as smaller areas, such as Tallahassee, Knoxville, Huntsville, and Alexandria, Louisiana—indicate that 1978 was a virtual boom year despite fears of inflation and high and rising interest rates. Very few areas seem to have had any serious economic difficulty. However, at the close of the year, an air of pessimism had crept into many of the statements made by businessmen. Continuing high inflation, along with rising interest rates and a severely pummeled dollar for most of the year, began to raise questions about the true underlying strength of the economy. While businessmen from most areas believed the Christmas season would be good if not a record, the number of pre-Christmas sales being used to lure buyers was a worrisome development because of reduced profit margins and the possible negative effect on consumers' willingness to spend after Christmas.

INFLATION AND THE CONSUMERS' RESPONSE

In 1978, inflation became the nation's number one economic concern. With prices soaring and still higher prices anticipated, "inflation psychology" encouraged consumers to buy cars and houses before further price increases. Inflation has affected the vast majority of people and the way they live, causing more wives to enter the work force, young couples and singles to buy houses rather than rent apartments, and older people to delay retirement.

At the beginning of the year, the Administration forecasted a 6- to 6½-percent inflation rate. The record of 1978 turned out to be quite different. Through November, consumer prices had been rising at near a 9.0-percent rate, much higher than 1977's 6.5 percent and 1976's 5.8 percent. A major contributor to the price increases has been food. Food prices surged at an 11.3-percent annual rate last year, compared to 7.7 percent in 1977 and 4.0 percent in 1976. Within the food group, the combined category of meat, poultry, fish, and eggs showed the most dramatic increase. In 1978, prices of these items have grown at an 18.1-percent annual rate, more than double the 6.8-percent increase in 1977.

On the other hand, nonfood commodity prices rose at a 6.8-percent annual rate in 1978, while services increased 9.7 percent, largely due to housing's domination.

After raging at 15 percent in the first quarter and 19 percent in the second, food price inflation moderated in the third quarter to a 3-percent annual rate. During the first half of 1978, food prices were pushed up by beef shortages. Beef production in 1978 was down from the 1977 level as the liquidation phase of the cattle cycle continued to reduce herd sizes. Four years of heavy financial losses to cattle producers and area droughts combined to produce massive reductions in the cattle herd. The most drastic herd liquidation occurred in 1977, although a further drop in cattle numbers evidently occurred in 1978. The result has been less plentiful supplies at markets. Although the pork industry has had the economic incentive to expand output, the expected expansion did not occur in 1978. While total supplies of meat were smaller than anticipated, consumer demand was growing, pushing prices up sharply for all livestock products.

Food prices could flare up again. The outlook for 1979 is good for feed grains, but meat prices could accelerate when cattlemen begin to withhold animals to rebuild herds. Even if rebuilding starts in 1979, beef production may continue to decline for several years. The USDA forecast calls for a 1- to 1½-billion pound drop in beef production in 1979. Partially offsetting this is an expected 600- to 1,100-million pound increase in the production of poultry. The supply of pork and poultry provides the key to food prices in 1979. Unless there is rapid expansion, meat will cost more.

Within the Sixth Federal Reserve District, consumer prices are measured bimonthly in two SMSAs—Atlanta and Miami. Both of these cities closely followed the national pattern of overall price increases led by food prices, particularly meat. One difference, though, was that prices of services didn't rise as sharply in Atlanta and Miami as they did nationally. As a result, overall consumer prices of all items rose slightly less in these two cities.

As was true in the nation, southeastern consumers were responding to inflation by stepping up their purchases of durable goods, particularly automobiles. The continued strong growth of consumer debt in 1978 is fair testimony of the decreasing willingness of consumers to hold liquid assets in a period of rampant inflation. Home buyers largely ignored increases in interest rates and seemed to be only concerned with meeting their monthly payments, expecting that inflation will protect their investment. More liberal repayment terms for automobile loans have enabled many buyers to stay in the market. Forty-eight month car loans are now commonplace. In September, automobile credit outstanding at commercial banks was 26 percent ahead of the year before. Car loans outstanding have increased a phenomenal 63 percent in 24 months. Overall, instalment credit had grown 20 percent over 1977 levels.

CONSTRUCTION ACTIVITY ENJOYS STRONG GROWTH

The pace of construction activity in the Southeast continued to build on the growth of 1977. Construction was the leading growth sector, with employment up nearly 10 percent and the value of residential construction contracts running at least 20 percent ahead of the 1977 pace. Nonresidential contracts were down from the 1977 level, but 1977 was unusual in that several multibillion dollar power plants were announced. The 1978 figures for the more typical plant and commercial announcements have been quite strong. Building permits, which were at or near record levels during early 1978, had begun to taper off after the summer months but were still at the strong year-earlier level.

Florida exhibited the strongest gains, with permits running nearly 25 percent ahead of 1977. Permits in Alabama and Tennessee were lagging somewhat behind the year-ago pace. Strong rental markets and high occupancy rates contributed to a rebound in multifamily starts. Substantial purchases of luxury condominiums by South Americans were a significant factor in the boom-like sales of real estate in Dade and Broward Counties in Florida.

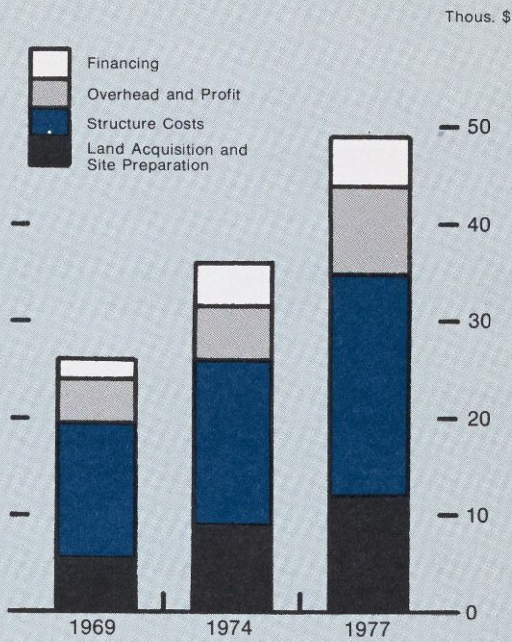
The Nashville and Knoxville areas of Tennessee experienced a booming real estate market for most of the year. Jackson, Mississippi, on the other hand, experienced some reduction in activity from the 1977 pace. Sluggishness seemed to develop in Jacksonville's and Huntsville's home building as the year progressed. The Tri-Cities area of Tennessee had housing demand grow in response to the inflows of people due to the industrial expansion in that area. The price of land for housing developments rose sharply in New Orleans despite rising interest rates. The Mississippi Gulf Coast reported an extremely busy year in home construction.

Nonresidential construction moved ahead in 1978, partially due to the large contract year of 1977. However, 1978 was a good year in its own right, and new plant announcements made in 1978 will help keep construction moving in 1979. Contracts for nonbuilding construction were well below the unusually strong 1977 levels, but contracts for commercial and industrial buildings were substantially ahead of 1977. This pattern was repeated throughout the United States and not confined to the Southeast.

Some of the highlights of plant announcements include: Miller Brewing Company, a $247-million facility in Albany, Georgia; Allis-Chalmers, a $150-million plant in Palmetto, Florida; Procter & Gamble, a $200-million pulp operation in Macon, Georgia; G. F. Business Furniture, a $300-million plant in Gallatin, Tennessee; a $400-million munitions facility at Picayune, Mississippi; and in Louisiana, a $150-million Georgia-Pacific project at Plaquemine and Union Carbide, a $181-million development at Taft. Through the first three quarters of the year, announcements of facilities of more than $10 million have been at about the 1977 pace.

Housing Costs. There has been a lot of concern recently about escalating home prices. Much of the concern over housing prices has focused on new one-family houses. The average sales price, for example, for new one-family houses in the South increased from $49,100 in September of 1977 to $56,400 in September of 1978, a rise of 15 percent. One basic reason is the

COMPONENT PROPORTIONS OF THE MEDIAN PRICE OF NEW ONE-FAMILY HOMES*



*Sources: National Association of Home Builders and U.S. Department of Commerce.

higher rate of household growth which spurs housing demand.[1]

However, greater demand is not the only trend causing home prices to rise. In the case of new homes, cost factors enter the picture. According to data provided by the National Association of Home Builders, land's portion of the total cost of a single-family home grew from 21 percent in 1969 to 25 percent in 1977 (see chart above). The increase reflects both higher costs of land acquisition and more regulations guiding land development projects. Financing costs have been growing as a percent of the total home price, but the cost of the structure, including labor and material costs as a percentage of total cost, has declined. Higher productivity through mechanization of building techniques, the standardization of construction through

[1] See "Inflation and Home Buying" in this issue for a long-term analysis of national housing inflation.

greater use of prefabrication methods, more efficient building tools, and general use of industry methods in the building trade can be cited as the major reasons causing the decrease in the percentage of structure costs. Rising interest rates, insurance costs, closing costs, and taxes have pushed financing costs upward at a rapid pace. In fact, since June of 1977, financing costs have grown 15 percent, more than twice the rate of growth from January of 1976 to June of 1977.

The degree that each cost component contributes to the overall cost of a house varies from place to place. For example, the land costs in a city generally are much higher than in rural areas, simply as a result of the greater concentration of population and demand. Also, wage rates for builders have been lower in the South than in the other regions of the country; however, the gap is closing fast. Generally, areas that have rapid growth, zoning restrictions, and many public services also tend to have a trend of rising housing costs.

Most of the trends concerning the costs and prices of new homes are also apparent for existing homes, although existing homes are generally lower in price than new homes. The cost factors that influence the price of existing homes are basically the same as for new homes. For instance, the costs of maintaining an existing home include the same materials and labor expenses that are required for a new home but on a much smaller scale.

CREDIT FLOWS TO THE HOUSING INDUSTRY

The growth in residential construction activity, alluded to earlier in this article, and in single-family housing prices indicates that credit flows for construction and purchase of housing held up very well. Mortgage lending by savings and loan associations exceeded lending in the previous year in each month from January through July. The gap narrowed continuously as funds became more costly to the associations and mortgage rates paid by ultimate borrowers rose by about three quarters of a percentage point. In August and September, net mortgage lending was below year-ago levels for the first time since early 1975. Florida and Alabama associations accounted for most of the decline in year-over-year performance, while lending was up in Tennessee and Mississippi.

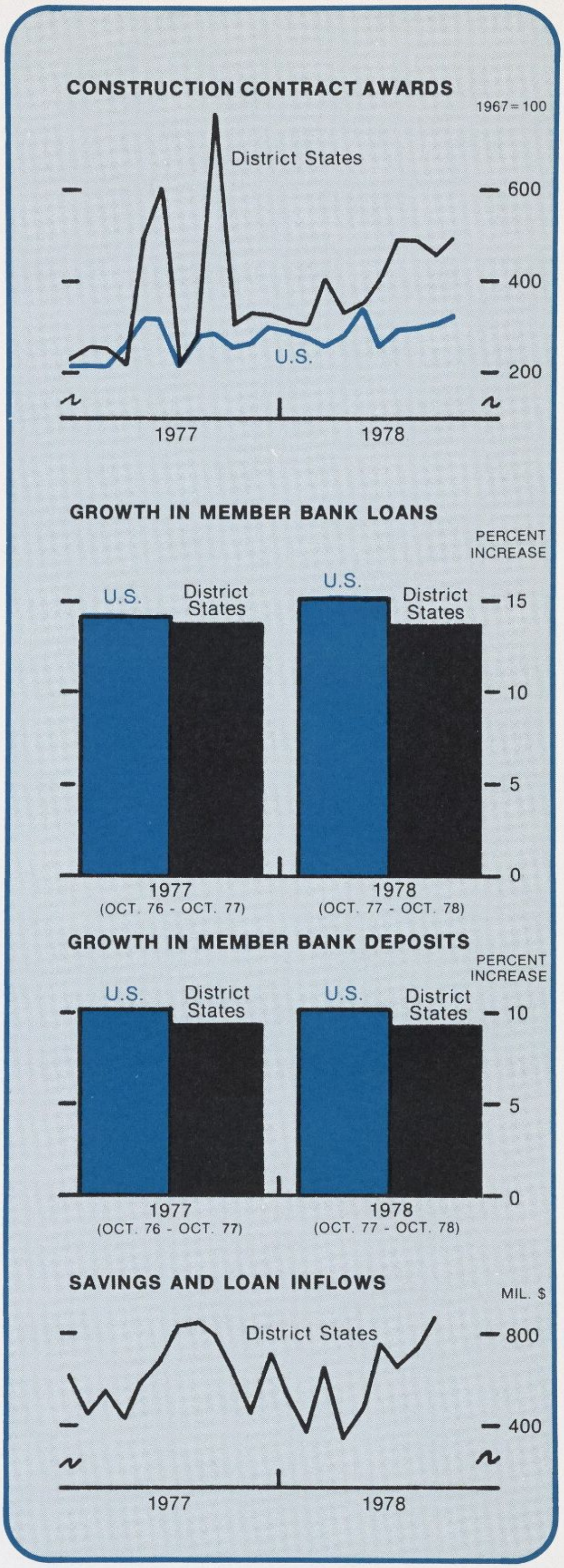
In light of the rise in interest rates and the somewhat slower growth in the economy, this small decline in the growth of mortgage lending was an unexpectedly strong performance. Strong demand for single-family housing, both as a consumption good and an inflation hedge, accounts for some of the strength. In the region as in the rest of the nation, the number of families in the age groups that normally occupy single-family housing was expanding rapidly. Migration gave an extra push to southeastern home demand.

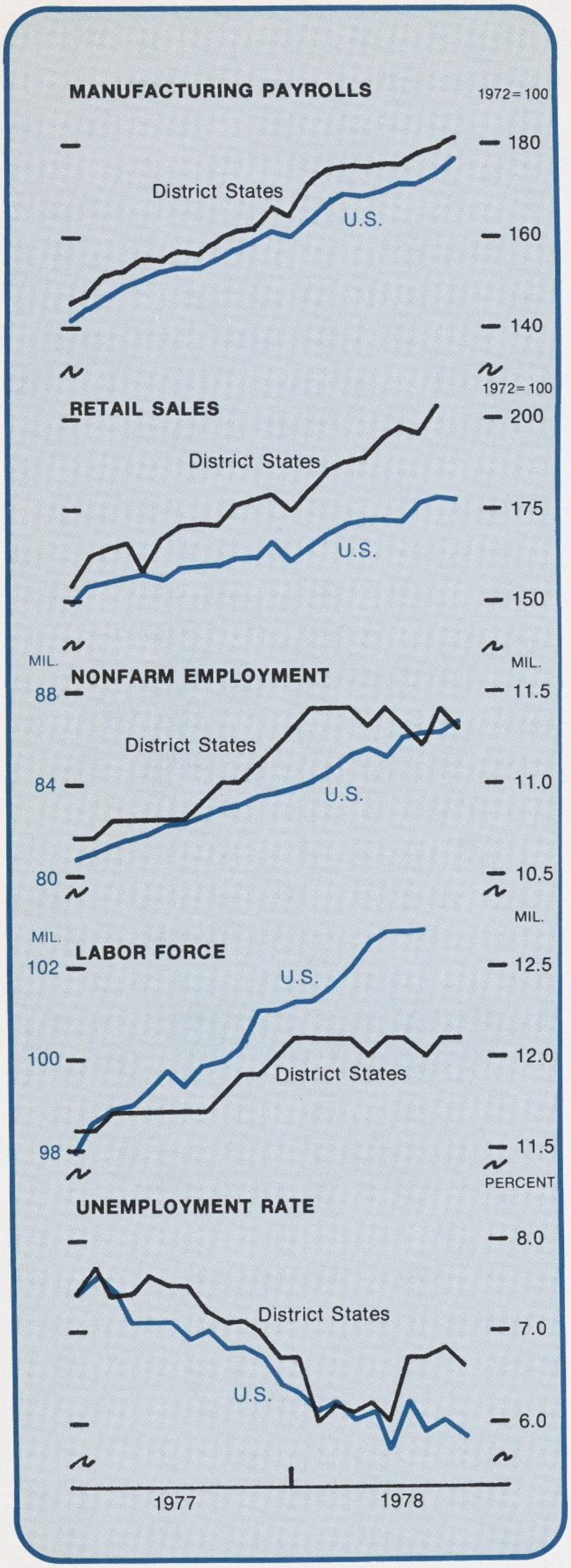
In response to the strong demand for housing and the strong mortgage demand derived from it, savings and loan associations in the region actively sought funds to use for mortgages. They were limited during the early part of the year by regulatory ceilings on depositors. Consequently, deposit inflows were below year-earlier levels in each month from January through May. So the associations turned more of their attention to borrowings from the Federal Home Loan Banks, sales of existing mortgages, and reduction of liquid assets for lendable funds.

Capacity to raise funds from these sources and deposit inflows declined as summer approached. In response to this, the bank regulatory agencies and the Federal Home Loan Bank Board allowed the institutions that they regulate to offer both eight-year certificates of deposit with attractive interest rates and six-month certificates with rates tied to the six-month Treasury bill rate. Of the two new instruments, the latter, called money market certificates, was the more attractive to the public. Their issuance helped the savings and loan associations to keep some old deposits and to attract some new ones. Though hard numbers are not yet available, these money market certificates probably already make up 5 percent or more of savings and loan liabilities in the region. Their effect may be seen in the fact that, even in the face of rapidly rising interest rates, Construction contracts continued to grow strongly in 1978.

Bank loan growth outstripped deposit gains, resulting in some liquidity pressure for banks.

The issuance of money market certificates of deposit by savings and loan associations starting in June reversed the downward trend of savings inflows.





Manufacturing employment gains and higher wage rates resulted in good growth of incomes of factory workers.

Retail sales, spurred by anticipatory buying, higher incomes, and heavy use of credit, rose substantially over 1977 levels.

Employment gains were more moderate in 1978.

Labor force growth was quite slow for much of 1978.

The unemployment rate fluctuated between 6.2 and 6.8 percent throughout the year after falling sharply in 1977.

GROWTH OF NONFARM EMPLOYMENT BY INDUSTRY SEPTEMBER 1977—SEPTEMBER 1978

(thousands, seasonally adjusted)

Industry	September 1977	September 1978	Amount Increase	Percent Increase
Total Nonagriculture	9,449.6	9,766.9	317.3	3.4
Construction	550.6	586.4	35.8	6.5
Manufacturing	2,057.5	2,131.4	73.9	3.6
Durables	902.4	958.1	55.7	6.2
Nondurables	1,155.1	1,173.3	18.2	1.6
Transportation and Public Utilities	571.4	590.5	19.1	3.3
Wholesale and Retail Trade	2,173.8	2,236.0	62.2	2.9
Finance, Insurance, and Real Estate	500.2	511.1	10.9	2.2
Government	1,850.7	1,920.4	69.7	3.8
Federal	344.7	348.4	3.7	1.1
State and Local	1,506.0	1,572.0	66.0	4.4

savings and loan inflows exceeded year-ago levels in three of the first five months since their introduction.

Although residential construction and mortgage lending remained stronger than one might have expected in 1978, some trouble for these activities remains on the horizon. Usury ceilings have begun to constrain conventional mortgage loans in each of the southeastern states. Further rapid increases in money market rates since the summer have already begun to have their effects on long-term rates (including mortgage rates) and on savings and loan associations' ability to compete for funds. These efforts certainly will raise the costs of mortgage funds and may limit their availability to some extent. Nevertheless, basic housing and mortgage demand factors remain strong and very likely will until income growth slows or inflation abates.

JOB GROWTH SLOWER IN 1978

District employment growth over the first nine months of 1978 slowed considerably from the comparable 1977 period. Monthly gains in 1978 averaged only 14.3 thousand, well below the 22.4-thousand monthly increase during 1977. The table shows employment gains by industry.

The District's labor force also grew at a slower rate than in 1977. After increasing an average of over 30,000 per month in 1977, the District's labor force growth slowed to only 22,000 per month last year. Slower labor force growth enabled the unemployment rate to fall despite slower job growth. By September 1978, the District unemployment rate had been cut by a full percentage point from September 1977. On the other hand, the monthly improvement to the District joblessness was not as impressive as year-over-year comparisons. After reducing the level of unemployment by approximately 2,000 per month in 1977, the southeastern economic growth was not sufficient to reduce the number of people jobless last year. Instead, the number of persons unemployed rose an average of 2,000 per month in 1978.

Many have speculated as to the reasons why employment growth has been sluggish. The advanced age of the current economic expansion and fear of a slowdown in 1979 have probably hampered District employment growth. However, we are of the opinion that the boost of the Federal minimum wage from $2.30 to $2.65 per hour was a primary cause of slower job growth last year. In a previous issue of the **Economic Review,**[2] we argued that the increase in the minimum wage could constrain employment growth in the District by nearly 160,000 by midyear. Other studies reached similar conclusions for the nation. According to our study, southeastern employment growth was more adversely affected by the increase in the minimum wage, since a large fraction of our work force earned minimum wages or less. Moreover, the "bumping-up" effect of the minimum wage hike intensified the problem. Our study found that the January increase in the minimum wage should not have a significant effect on the overall unemployment rate but would adversely affect unemployment of youths. Therefore, in view of our earlier findings and those of others, the slower growth of southeastern employment was not surprising. In addition, other effects such as reduced overtime and shorter workweeks have resulted from the minimum wage hike.

Secondly, studies designed to examine the effect of higher minimum wages on labor force participation conclude that higher minimum wages reduce labor force participation. This, it is argued, is due to the reduction in employment demand caused by higher wages. Thus, the reduction in labor force participation due to lack of job availability is a plausible explanation for slower labor force growth last year. Reduced labor force growth is not limited to reduction in labor force participation but also to slow growth of the working-age population. The Bureau of the Census had projected earlier that a slower population growth would begin in 1978.

A third possible explanation for slower growth in employment is technical rather than economic. Beginning in January 1978, the Bureau of Labor Statistics instituted a new procedure to estimate employment and unemployment in states and local areas. The new procedure was designed to reduce year-end revisions. Under the old procedure, current estimates of employment were revised downward at year-end to reflect the so-called December employment bench marks. Evidence from an earlier study shows that use of the new procedure will require fewer downward revisions in the employment estimates at year-end.

What's in store for 1979? Unfortunately, the new year will bring much of the same. The minimum wage has just been raised from $2.65 to $2.90 per hour, again constraining employment growth and labor force participation. However, since the 1979 increase in the minimum wage is less than last year's increase, the adverse employment effects are not expected to be as severe. The Bureau of the Census projects even slower increases in the working-age population this year, which will mean slower labor force growth. Secondly, since state labor departments will be in their second year of the new procedure for estimating employment, the year-over-year comparisons will not be distorted. Third, this year's increase in Social Security taxes will take a larger proportion of workers' weekly earnings and raise business costs.

STRONG CREDIT GROWTH BEGINS TO PRESS DISTRICT BANK LIQUIDITY

During the fourth year of economic advance, District member banks continued to experience substantial requests for credit. By continuing to lend, however, banks faced increasing liquidity pressures, as deposit gains failed to keep pace with credit extensions. As a result, liquidity pressures, as measured by the loan-to-deposit ratio, advanced from 0.69 to 0.73 through the year. Despite the increasing liquidity pressures, District banks were able to accommodate their existing customers and generally reported strong income gains.

District bank credit rose an estimated $5.5 billion during 1978, nearly 14 percent. By far, the largest part of the increase was comprised of new loans, but holdings of municipal securities also advanced at a solid pace. Deposits, however, gained only $3.2 billion, about an 8-percent increase. To acquire these funds, banks had to attract

[2] Charlie Carter, "The New Minimum Wage: A Threat to Southeastern Jobs," **Economic Review,** March/April 1978.

more expensive and interest-sensitive money market funds. In addition, the country banks sharply reduced their sales of Federal funds.

The large banks also issued sizable amounts of large-denomination certificates of deposit and other large deposits to acquire funds for lending. While these funds are technically deposits for liquidity purposes, they resemble more closely other forms of borrowed funds such as Federal funds and securities repurchase agreements because of their short maturity and interest-sensitivity. Therefore, greater reliance on these funds may tend to limit the liquidity of some banks in ways that do not readily show up in the more traditional measures of bank liquidity.

Strong Credit Expansion. Last year marked the second year of solid lending gains for the larger banks and over three years for the moderate and smaller size banks. There were some shifts in the sources of the loan strength. Fueled by a strong demand for auto loans, consumer credit rose nearly 20 percent. Real estate lending also continued to rise at a brisk pace. Home buyers continued to seek mortgage loans to purchase homes, and business firms used bank credit to finance construction of new projects and to finance investments in commercial property.

Business borrowing in general was strong but advanced at an irregular pace. Interest rates on business loans rose sharply during the year; the prime rate moved from 7¾ percent to 11¾ percent, with most of the advance concentrated in the fourth quarter. During the year, banks became more selective in approving loan commitments to both new and existing customers and have tried to maintain high credit standards. The lessons of tight credit in the mid-70s were not forgotten by bankers as they again felt the pressures of monetary restraint and the problems that could occur if loan commitments rise excessively.

At the larger banks, business loans were up at only an 8-percent annual rate, about three-quarters of 1977's pace. Only in loans to wholesale and retail trade firms, service firms, and textile and apparel goods manufacturers did gains approach those of the previous year. In contrast, construction firms, businesses involved in mining and other extractive lines, and durable goods manufacturers sharply curtailed the growth of their bank borrowing in the Southeast. Bank loans to sales and personal finance companies posted small gains during the year (following two years of reductions), but bank lending to other financial institutions fell by nearly 25 percent.

The continued strength in lending caused banks to redirect the acquisitions for their security portfolios. Bank holdings of U.S. Government securities declined modestly as banks found lending to be a more profitable use for their funds. Banks made portfolio adjustments by trimming their holdings of Treasury bills and some medium maturity coupon issues and by acquiring additional higher yielding, longer maturity governments. They obtained better yields but reduced their holdings of the more liquid assets. District banks sharply increased the amount of new state and local government securities. Not since the early Seventies have District banks' earnings been strong enough to justify adding nearly $1 billion in such investments in a single year.

Deposit Gains Slow. Deposit inflows remained sizable but at a slightly slower pace than in 1977. Slower deposit growth at this stage of a business cycle is not unusual. Demand deposits, however, continued quite strong, advancing at nearly a 10-percent rate. Gains in time deposits were varied, reflecting the more attractive yields available on alternative investments. Household passbook savings accounts, which for three years had provided District banks with the bulk of their time deposit inflows, advanced only slightly. By late February, small outflows from these 5-percent accounts had begun at the larger banks. In contrast, small-denomination time deposits (under $100,000) rose over $1.25 billion. The major factor accounting for the strong showing in these accounts was the introduction of the six-month money market time certificates in June. These time deposits, issued in $10,000 minimums with rates tied to the six-month Treasury bill auction rate, totaled over $1 billion by year-end.

Decreases in these deposits came partly at the expense of bank savings and other short maturity time deposits. The gain in money market certificates represented to some extent new funds for lending. Consumer time deposits maturing in four years and over rose over $400 million.

OUTLOOK FOR 1979

This time last year, forecasts for the national economy were calling for 4 to 5 percent real growth and a 5- to 6-percent increase in prices. Both proved to be too optimistic. Inflation has been much worse than was forecast, and real growth was under 4 percent.

For the Southeast, developments have been less of a surprise, except possibly for food prices. Employment was up, nonresidential building improved, and consumer spending was strong for the first half of the year.

As we look ahead to 1979, there are some dark clouds on the horizon. Interest rates have risen to near record levels, inflation has gotten worse, and households have taken on debt at record rates. These developments are anything but auspicious. Many forecasters are now calling for a recession in 1979.

In the Southeast, we still have a heavier-than-national dependence on construction, and that could be a problem if interest rates remain at present levels or go higher. A slowing in construction activity could severely hamper job growth in 1979. If housing, capital spending, and auto sales slow nationally, as many expect they will, durable goods employment, which enjoyed a good year in 1978, will almost certainly be weak if not down in 1979. Service employment growth, which seems to be less sensitive to economic fluctuations, will probably continue upward. Fortunately, nondurable goods employment is less sensitive to business cycle fluctuations and much of southeastern manufacturing is in the nondurable category.

Livestock producers are expected to benefit from higher animal prices. Other farmers may not get the kind of increase in receipts they had in 1978, but with favorable weather, should have a good year. Retailers of durable goods such as autos are probably going to have a slower year in 1979 than they have had in the past two years.

In sum, 1979 may be the slowest year we have had since 1975. ■

INFLATION AND HOME BUYING

by Charles J. Haulk

Rapid appreciation of house values continues to make homeownership a good way to cope with inflation. Rising incomes and available credit have allowed American families to take advantage of this investment opportunity, while longer mortgage maturities have helped keep their repayment obligations within their means. Some of those who already own homes have used their inflated equities to finance purchases of a variety of goods and services as well as new or existing housing. Although inflation tends to redistribute real income or wealth from savers to borrowers and investors in real property, the upsurge in mortgage borrowing has left household balance sheets illiquid and debt heavy.

A GOOD INVESTMENT

Investment in single-family residences has been heralded as one of the best protections against inflation's assault on one's standard of living and wealth. A home's effectiveness as an inflation hedge, of course, depends on the extent to which the increase in its value exceeds the overall inflation rate.

That home prices have risen rapidly can be verified readily. In 1949, the median sales price of a new single-family home was $8,800. By 1977, the price had reached $48,800, a 450-percent increase (see Table 1). Over the same period, consumer prices rose 154 percent. Much of the house price growth relative to consumer prices occurred from 1949 to 1966, when median house prices advanced 143 percent while consumer prices gained only 36 percent. In the period from 1966 to 1977, prices of new single-family homes sold moved up 128 percent and consumer prices, 87 percent. So, while house prices are still increasing more rapidly than consumer prices, the margin of difference has narrowed.

TABLE 1

MEDIAN SALES PRICES

Year	New Homes	Existing Homes*
1949	$ 8,800	
1954	12,300	
1955	13,700	
1956	14,300	
1959	15,200	
1963	18,000	
1965	20,000	
1966	21,400	
1968	24,700	$20,100
1970	23,400	23,000
1974	35,900	32,000
1976	44,200	38,100
1977	48,800	42,900

*No data available for years earlier than 1968.
Sources: New Homes - Bureau of the Census; Existing Homes - National Association of Realtors.

Rapid price increases have not been limited to new homes. The median sales price of existing homes rose from less than $20,000 in 1967 to $43,000 in 1977. This enormous gain in home prices, combined with a record rate of home construction, has pushed the estimated value of the nation's single-family housing stock from $890 billion in 1970 to $1,905 billion in 1977.[1]

As an investment alternative, the single-family home has, on average, performed extremely well compared to other readily available investment opportunities. The National Association of Realtors has estimated returns on investment for various alternatives,[2] weighing their average earnings or price appreciation

[1] **Existing Home Sales,** 1977, National Association of Realtors, Washington, D.C., p. 22.

[2] *Ibid.*

against inflation. These estimates, shown below, indicate that homeownership is probably the best investment a family could have made in the past decade.

VALUE OF ONE DOLLAR INVESTED IN 1967

Investment	Purchasing Power of the Dollar		
	1967	1972	1977
Single-Family Home	$1.00	$1.14	$1.23
Corporate Bond	1.00	1.13	1.18
Savings Account	1.00	1.04	.93
Common Stock	1.00	1.08	.80
Cash	1.00	.80	.55

Source: National Association of Realtors.

However, because the quality of newly constructed homes changes over time, prices alone do not necessarily reflect the true appreciation in the value of homes. Houses built in 1977, by and large, are bigger and include more amenities than houses built in 1967.[3]

Another measure of investment performance is the implicit return on equity. Henry Kaufman's estimates of return to house equity, listed below, take account of interest payments and tax breaks as well as price appreciation. These rates of return contribute further evidence that housing is an excellent investment.

Year	Implicit Return on House Equity
	(percent)
1974	11.1
1975	21.2
1976	12.3
1977	24.3
1978 (September)	21.3

Source: Henry Kaufman, address to American Bankers Association, Annual Convention, October 25, 1978.

FINANCING THE INVESTMENT

One would be tempted to believe that the fantastic growth in house prices would have priced many potential home buyers out of the housing market. In fact, however, this has not been the case. One explanation for this is that the ratio of new-home prices to median family income has tended to stay in a fairly narrow range (see Table 2). In 1970, a heavy volume of construction of lower priced, subsidized houses caused the ratio to dip to 2.37; otherwise, the ratio's range seems to be centered on 2.90. In the most recent years, the ratio has moved up from its long-term average. The ratio of existing-home prices to family income, available from 1968 forward, has exhibited an uptrend as well. At its recent rate of increase, it could reach the long-term average of the new-home-to-income ratio in a few years.

TABLE 2

RATIOS OF MEDIAN SALES PRICE TO MEDIAN FAMILY INCOME

Year	New Homes	Existing Homes*
1949	2.83	
1954	2.94	
1955	3.09	
1956	2.98	
1959	2.80	
1963	2.88	
1965	2.87	
1966	2.88	
1968	2.86	2.32
1970	2.37	2.33
1974	2.78	2.48
1976	2.95	2.54
1977	3.05	2.68

*No data available for years earlier than 1968.
Sources: Calculated from data presented in Table 1 and estimates of median family income from Bureau of the Census.

Increases in the price-to-income ratios have been accommodated by a lengthening in the maturity of conventional mortgage loans and an increase in the loan-to-price ratio. After averaging just under 74 percent throughout the Sixties for new-home loans, the loan-to-price ratio fell to 71.7 percent in 1970. It quickly returned to 76 percent and has been at least that high during most of the Seventies. Years to maturity on new mortgage loans reached 27.9 in 1977, an addition of nearly 3 years since 1970 and about 3.5 years longer than the average of the Sixties. Comparable increases in maturity

[3] My thanks to Frank King for calling attention to this important point.

REGIONS SHOW WIDE DIFFERENCES IN NEW-HOME PRICES

Median Prices of New Homes, by Region

	1962*	1967	1972	1977	1978**
Northeast	$21,300	$25,400	$31,400	$51,600	$68,000
North Central	18,500	25,100	29,300	51,500	59,900
South	16,100	19,400	25,800	44,100	49,400
West	18,100	24,100	27,500	53,500	65,100
All U.S.	17,900	22,700	27,600	48,800	55,600

Percent Changes in Prices for New Homes

	1962-67	1967-72	1972-77	1962-77
Northeast	19.2	23.6	64.3	219.2
North Central	35.7	16.7	75.8	223.8
South	20.5	33.0	70.9	206.8
West	33.1	14.1	94.5	259.7
U.S.	26.8	21.5	76.8	210.6

*Fourth quarter data.
**Preliminary July estimates.

Source: Department of Commerce, Bureau of the Census.

New-home prices and the rates at which they have appreciated vary considerably among regions of the country, as the tables above illustrate. The Northeast's new homes remain the costliest, on average, but new-home prices have risen most rapidly in the western region. Inflation of new-home values in the South has lagged other regions, except in 1967-72, keeping this region's new-home price a little more than 10 percent below the national average. No allowance was made for quality changes.

and the loan-to-price ratio have occurred for existing houses. Mortgage interest rates have also risen; recent postings have been about three percentage points above mid-Sixties rates.

Therefore, home buyers are borrowing more per dollar of house value purchased and paying a higher rate over a longer term. The ratio of home mortgage debt outstanding to disposable personal income, after rising rapidly through the mid-Sixties. leveled off through the early Seventies and started to increase again after 1972. The share of disposable income going to repay principal and interest has risen since 1970 as well.[4] The longer maturities have acted to hold down the repayments-to-income ratio, but now that the average maturity on new loans is approaching 30 years, it is unlikely that much further help in holding down repayments can be expected from additional lengthening of maturities.

Leveraging. In addition to rising mortgage interest rates, longer maturities, and higher loan-to-price ratios, there has been another significant change in the U.S. housing market. Since the early Seventies, there has been a substantial increase in the rate of existing-home sales relative to new-home sales. In 1972, the ratio of existing- to new-home sales was about three to one after reaching as high as four to one for short periods during 1969 and 1970. From 1973 until 1975, the ratio of existing- to new-home sales climbed steadily to well over four to one as new-home sales plummeted. The ratio has remained at or above four to one since, even though new-home sales have

[4] Charles A. Luckett and David Seiders, "Household Borrowing in the Recovery," **Federal Reserve Bulletin,** March 1978, p. 159.

risen sharply from the depressed levels of 1974. In September 1978, the ratio reached 5.8 to 1. The annualized rate of existing-home sales reached 4 million units in the fourth quarter of 1977 (and has remained close to or above that level since). This represents a sharp rise from the 2.0- to 2.5-million rate which was prevalent from 1971 to 1973 and the 1.5-million rate of 1968 and 1969 (data for existing-home sales are not available for years prior to 1968).

The increasing rate of existing-home sales and rising prices have allowed homeowners to monetize accumulated equity in large amounts. As a matter of fact, since 1960, homeowners have raised mortgage funds in excess of the amounts expended on new residential construction. The table below gives estimates of mortgage money generated through resale, second mortgages, and refinancing in excess of new construction expenditures by households.[5] As a rough check on these figures, the Federal Reserve Board's estimates of excess net investment in new residences are shown for 1970-77. The negative signs mean that funds have been taken out of home equity; i.e., the volume of mortgage borrowing has exceeded the value of net additions to the housing stock. Moreover, as David Seiders of the Federal Reserve Board staff has pointed out, the resale of homes may easily generate increases in mortgage debt that are larger than the capital gains realized.[6]

EXCESS MORTGAGE BORROWING
($ billions)

Year	Mortgage Funds Raised in Excess of New Residential Expenditures	Excess Net Investment in New Residences
1950	- 5.1	
1955	- 4.0	
1960	0.1	
1965	10.8	
1970	16.6	- 2.5
1971	17.5	- 8.3
1972	26.1	-15.7
1973	31.0	-19.0
1974	24.6	-12.3
1975	29.8	-17.2
1976	42.2	-28.4
1977	60.6	-43.2

Sources: Mortgage Funds in Excess of New Residential Expenditures, 1950-1970, estimated by Bernard Gelb; 1971-77, estimated by Charles J. Haulk; and Excess Net Investment in New Residences, Federal Reserve Board, Flow of Funds Accounts.

ECONOMIC EFFECTS

Some economists have argued that some of the capital gains created by escalating house prices have financed consumer expenditures for goods and services other than housing. Seiders has presented evidence which suggests that large amounts of mortgage funds raised against housing equity have been used to bolster consumption expenditures since the last recession.[7]

The excess funds raised by monetizing equity, though large in absolute amount, are small when compared to disposable personal income. For example, the estimated excess $60 billion raised in 1977 was about 4.5 percent of disposable income. Still, if all these funds were spent on consumption, the result would be a substantial increase, accounting for about half of the growth in expenditures from 1976 to 1977. It is very likely that much of the spending financed by excess mortgage funds was for expensive items, such as cars, furniture, education, or perhaps foreign travel.

Some borrowing against housing equity may have been used to retire consumer debt that carried a higher interest rate or to purchase other financial assets in order to improve household liquidity. Household liquidity has been declining in recent years, as families have sought to invest in real assets such as consumer goods and houses to protect themselves from inflation. The ratio of financial assets to liabilities has dropped from 5 to 1 in the Fifties to 2.8 to 1 in 1978. As inflation continues, it generally becomes less and less attractive to hold financial assets.

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[5] Bernard Gelb, **Mortgage Debt for Non-Real Estate Purposes,** The Conference Board, New York, 1972. Gelb's estimates are gross of amortization. The Federal Reserve estimates are net of amortization.

[6] David Seiders, **Mortgage Borrowing Against Equity in Existing Homes, Measurement, Generations and Implications for Economic Activity,** Staff Economic Studies, Board of Governors of the Federal Reserve System.

[7] *Ibid.*

In an economy producing well below potential output, borrowing against equity in homes for consumption purposes would lead to a temporary increase in consumption relative to income, thus raising aggregate demand and physical output. In an economy operating close to capacity, the increase in demand would be inflationary and generate little or no real output increase. Income would then be redistributed from those who save to those who choose to convert wealth in the form of house equity into current consumption. As consumer prices rise faster than the value of the liquid assets of savers, buying power is transferred to those who consume out of house equity.

In an environment of stable prices, consumers would find little incentive to become less liquid, so that the remarkable upsurge in excess mortgage funds which we have described would not have occurred. During the Fifties, when house prices were rising at a much faster rate than overall prices and when real incomes were making solid gains, there was on balance no liquidation of equity in housing. However, in the Sixties and the Seventies, when price increases for goods and services have approached the pace of home price growth, we have seen the phenomenon of large amounts of money raised through equity borrowing.

How long can the raising of massive amounts of funds through house equity continue? If nominal family income begins to slow relative to house-price growth, then a slowing of housing transactions will occur as credit worthy borrowers become scarcer. Further lengthening of loan terms or increases in loan-to-price ratios will likely come gradually, if at all, and probably won't be large enough to offset the deterrent effect of rising home prices and interest rates. Government programs which subsidize home buying could help counter the effects of relatively slower nominal income growth, but the more probable impact of these programs will be added pressure on home prices. If the new era in residential markets is to last, real interest rates on mortgage loans must remain low or negative. But profitable mortgage lending requires a continued large wedge between the rates that savers receive and the rates that home buyers pay, which further redistributes wealth and income from savers to mortgage borrowers. Should the highly inflationary environment of recent years come under control, it is likely that households would reduce their leveraging activity and resume a more normal pattern of behavior. ■

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