

# BUSINESS REVIEW

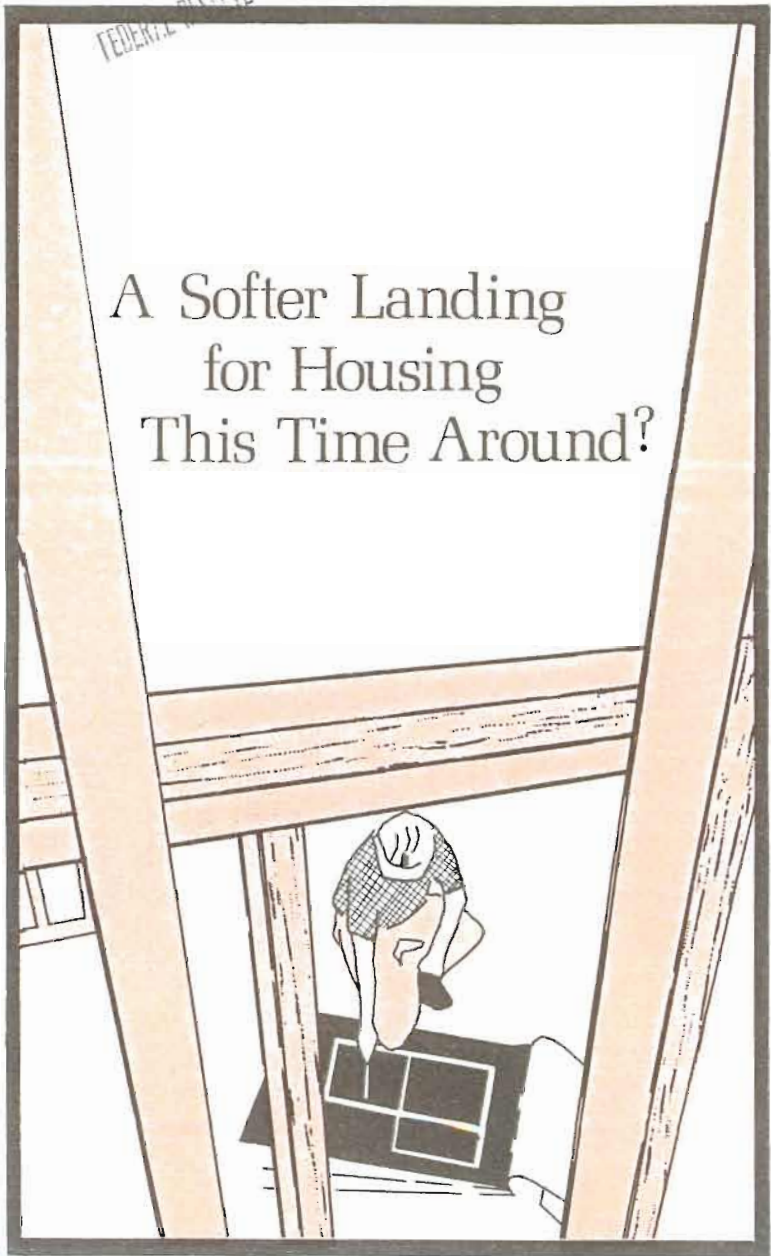
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Federal Reserve Bank of Philadelphia

SEPTEMBER/OCTOBER 1979

A Softer Landing  
for Housing  
This Time Around?

AND  
Thrifts  
Compete  
with  
Banks



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**A SOFTER LANDING FOR HOUSING  
THIS TIME AROUND?**

*John Bell*

. . . Recent changes in the home mortgage market may soften the effects of recession on the housing industry.

**BUSINESS  
REVIEW**

**Federal Reserve Bank of Philadelphia**  
100 North Sixth Street  
(on Independence Mall)  
Philadelphia, Pennsylvania 19106

**THRIFTS COMPETE WITH BANKS:  
GETTING A CLEARER VIEW  
OF A CHANGING PICTURE**

*Howard Keen, Jr.*

. . . Figures for the Third District as a whole show commercial banks with a slight edge over thrifts in competition for savings deposits, but figures on local markets tell a different story.

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# A Softer Landing for Housing This Time Around?

By John Bell\*

With many economists claiming that a recession has arrived or is waiting just around the corner, the fate of the housing industry has become a subject of growing concern to American policymakers and the public. Why does housing receive such special attention? The surface answer is simple: decent housing is considered a basic requirement by most individuals, and many people believe that housing is among the most important industries to the welfare of the economy at large.

People are interested in housing for several reasons. Besides providing for one of the basic human needs—shelter, owning a house is a sign of achievement in our society.

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Moreover, in inflationary times, many people find that buying property is one way to preserve the purchasing power of their dollars.

So far as impact on the economy is concerned, housing is right up there along with a few other industries such as autos and consumer durables. When a house is bought, a wide range of goods and services will be required to complete the transaction and to maintain and run the household thereafter. The demand for these goods and services translates into jobs and incomes, and it helps to keep the economy chugging along.

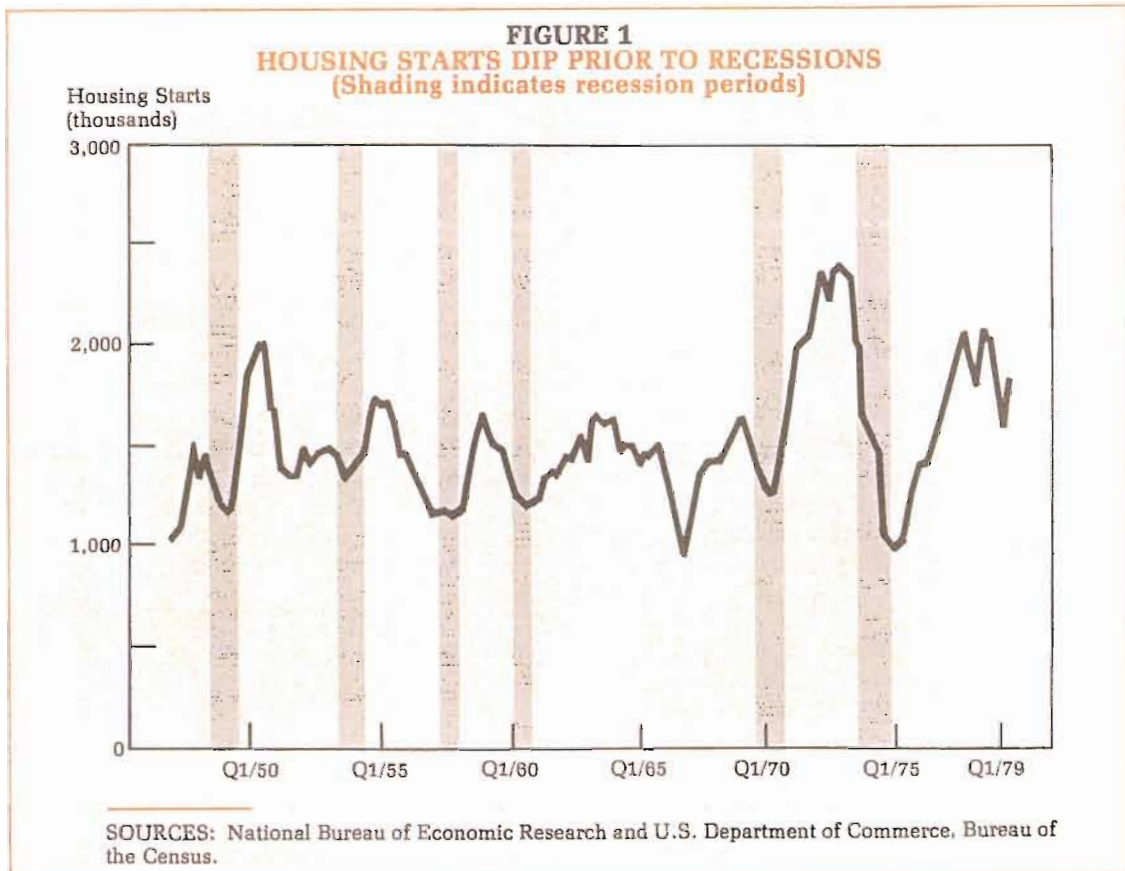
When the nation's economy has gone into a downturn in the past, housing usually has been hit quite hard. Whether it will be hit as hard again, though, is open to question. Developments in the housing and mortgage markets in recent years may make things easier for housing this time around.

**AS THE RECOVERY SLOWS,  
HOUSING SINKS**

Since the end of World War II, the U.S. economy has undergone six major recessions. Over this time, a clear pattern has developed which links the pace of overall business activity to the housing industry; as each economic expansion has matured and the U.S. has approached another recession, the number of housing starts has dropped off dramatically (Figure 1). The economic forces underlying this behavior are well known to economists. There are three of them. The first is that very few people in our society have enough cash to buy a home outright, and thus they rely on mortgage financing. The second is that the level of interest rates

rises during an economic expansion. The third is that governments often put a legal cap on interest rates to keep them from going too high.

**When the Cost Goes Up, Buying Goes Down.** When a home purchase is to be financed with a mortgage loan, the borrower must consider the interest he will pay on the loan when he figures out what monthly payment he can afford. For a mortgage of a given size, a higher interest rate means a higher monthly payment. At an interest rate of 10 percent, for example, the monthly payments on a \$50-thousand mortgage that matures in 25 years are \$454.36. But at a rate of 10 1/2 percent, payments are \$472.10 per month for that same \$50-thousand, 25-year



mortgage.

As an economic expansion wears on, growing business activity and credit demand drive up all interest rates, including the mortgage rate. With each jump in the mortgage rate, some people who could have afforded a mortgage at the old rate no longer can do so, and so they may stay at the old address, find a preferable rental unit, or, possibly, buy a less expensive home. In response to this diminished demand, the number of housing units on which construction is started tapers off.

So it seems as though reduced demand should cause a dropoff in housing starts as the recovery matures. But this is not the only reason we see a slowdown in housing prior to U.S. recessions. There are two others, both connected with the supply of funds, which have to be coupled with decreasing demand to account for the dramatic housing dropoffs.

**Mortgage Rate Ceilings: The Second Cause.** Because housing is so important to so many people, there are always cries of unfairness when rising interest rates keep people from buying the units they want. In many cases, state governments have responded to these cries by setting a legal maximum on mortgage rates. They have attempted to keep the mortgage rate low despite rising rates in other markets so that people would not be kept from buying houses. Ironically, this interest-rate capping probably has hurt those it was intended to help.<sup>1</sup>

Like any other market, the mortgage market is governed by supply and demand considerations. Suppose that the current mortgage rate is 10 1/2 percent and that, at this rate, demand equals supply; every qualified borrower who wants a mortgage at 10 1/2

percent can get one. Now assume that interest rates in other markets rise. The natural response of mortgage lenders in this situation is to cut back on the amount of funds they supply to mortgage borrowers in order to buy more profitable assets, which causes the supply of funds available for mortgages to shrink. Where lenders used to offer, say, a million dollars per day at the rate of 10 1/2 percent, now they perhaps offer only 80 percent of that amount. The market is out of balance not because demand has risen but because supply has shrunk. With demand exceeding supply, the interest rate will be bid up to the point where some borrowers drop out of the market. At this higher rate, lenders will offer more funds, but borrowers will demand less. The final result is a higher mortgage rate but a market where demand and supply are balanced.

But what would happen if the mortgage rate were restricted by law to 10 1/2 percent and could not be bid higher regardless of demand? In that case, the supply deficiency would persist. No matter how much money people wanted to borrow, mortgage lenders would offer only 80 percent of the former volume. In fact, if market rates continued to rise and the supply of home loan funds dwindled further, the discrepancy between supply and demand would become even larger.

Clamping a legal lid on mortgage interest rates is a quick-fix way to keep those rates low. But it provides a Pyrrhic victory at best. When there is a shortage of mortgage money and rates cannot be raised, lenders may ration what is available to creditworthy customers by means other than price, such as requiring larger down payments. To the would-be homeowner who can't afford a larger down payment, an artificially low mortgage rate provides little consolation.

**Deposit Rate Ceilings: The Final Nail.** Ceilings on interest rates that banks and thrifts can pay to depositors have much the same effect on the market for deposits as mortgage ceilings have on the mortgage

<sup>1</sup>For a more complete discussion of how usury ceilings affect mortgage market activity, see Helen Frame Peters, "The Mortgage Market: A Place for Ceilings?" *Business Review*, Federal Reserve Bank of Philadelphia, July/August 1977

market: they create artificial shortages of funds.

When market interest rates rise, people with large savings accounts at banks or savings and loan associations typically make withdrawals in order to buy government bonds or other financial instruments that pay higher interest rates. This process of disintermediation—going around the financial intermediaries to invest directly in higher yield bonds, for example—slows the supply of funds to banks and other mortgage lenders. In the absence of deposit rate ceilings, the normal result would be a higher interest rate on bank deposits. But that rate is limited by Federal regulatory authorities—the Federal Reserve for banks and the FDIC and Federal Home Loan Bank Board (in cooperation with the Federal Reserve) for thrifts. If market pressures otherwise would push the rate beyond the ceiling, a shortfall of funds develops exactly as one did in the mortgage market.

The impact of a shortage of deposits on the mortgage market is fairly clear. Lenders can make available only the funds they have. So if deposits are limited, mortgage funds will become scarce and rates will be pushed up. But in many states the mortgage rate cannot be raised beyond a certain level, and the result is a shortfall of mortgage money.

Thus deposit ceilings tend to reduce the amount of funds available to mortgage lenders in periods of high interest rates, and financial institutions will reduce the amount of mortgages they originate as they reduce their acquisition of all assets.

So there are several explanations for the slowdown in housing prior to each recession. But while there is widespread feeling now that we are heading into a recession that will last into 1980, we haven't seen as dramatic a dropoff in the housing industry as those to which we've become accustomed. If the forecasters are right about the recession, what is different about housing this time around?

#### CHANGES IN HOUSING: A CUSHION FOR A SOFTER LANDING?

Many changes have been instituted in the housing industry since the last recession, and they affect both demand and supply sides of the market.

**Buying Continues Despite High Interest Rates.** One thing that appears to be different about the later stages of the current business cycle is the continued relative strength in the demand for housing, despite record mortgage rates.

Some observers trace this strength in demand to demographic causes. They note that many of the children born in the postwar baby boom now are entering the household formation years when they will either marry and start a family or set up housekeeping on their own. These baby-boom children could be bolstering the demand for housing. Although statistics and projections by the Bureau of the Census indicate that the real surge in household formations as a result of the baby boom came in the early 1970s, formation rates still are expected to stay above the average rate of the 1960s for the next five years or so.

Others find the key to strong housing demand is a new innovation by mortgage lenders—the graduated payment mortgage (GPM). With a GPM, the borrower pays lower than usual payments at the beginning of the mortgage term instead of paying a fixed monthly payment for the life of the loan. These payments increase by a certain percentage each year through the first five to seven years of the loan. (Payments at the beginning of the term may be so low as not even to cover interest expense at that time. Thus the loan balance actually may increase for the first several years.) Because payments in the early years of the mortgage are so low, buyers who would have been shut out of the home market by high mortgage rates can go ahead and buy anyway if they can get a GPM. Some have done so.

A third explanation of continued demand, and possibly the most important, has to do

with inflation. Recent trends in inflation rates provide a double incentive for prospective home buyers. One incentive can be traced to the fact that housing price boosts have far outstripped increases in the overall price level. Since 1963, the average price of a new house has risen 244 percent, according to the U.S. Department of Commerce. Over that same period, the overall consumer price index has gone up by only 121 percent. Hence buying a house appears to offer a good way to protect an otherwise shrinking dollar.

The other inflation-based incentive for homebuyers has to do with expected future inflation and the current mortgage rate. Economic theory suggests that homebuyers are less concerned with the nominal rate quoted by a lending institution than with the real rate of interest. This real mortgage rate is defined as the difference between the quoted mortgage interest rate and the expected annual rate of inflation over the life of the loan. Of course, inflation expectations, which are difficult to measure in any case, are virtually unknown for periods as long as the 25 to 30 years for which a typical mortgage contract is written.<sup>2</sup> But some information on shorter term inflation expectations is available. And it indicates that, over the past 15 years or so, anticipated inflation has been rising more quickly than the conventional mortgage rate (Figure 2). This suggests that the real mortgage rate may not be moving up as rapidly as the quoted rate and makes it easier to understand why the demand for housing has not fallen off so far: a ten-percent mortgage rate appears much less forbidding when expected inflation falls in the range of eight percent to nine percent than when prices are expected to be fairly stable.

<sup>2</sup>For an in-depth look at how inflation expectations are formulated, see Donald J. Mullineaux, "Inflation Expectations in the U.S.: A Brief Anatomy," *Business Review*, Federal Reserve Bank of Philadelphia, July/August 1977.

**FIGURE 2**  
**INFLATION EXPECTATIONS**  
**HAVE MOVED UP MORE QUICKLY**  
**THAN THE MORTGAGE RATE**



SOURCES: Board of Governors of the Federal Reserve System and Joseph A. Livingston's semi-annual survey of leading economists.

So this is one change on the demand side of the housing scene that makes things different this time around—buyers are not being driven from the market by high real mortgage costs. But what about the supply side of the story?

**Governments Relax Constraints on Interest Rates . . .** Most of the supply constraints that have helped push housing over the brink in the past have not been in the housing market per se but in the mortgage market. In many cases, these constraints can be attributed to government regulation of interest rates.

Since the last recession, however, many regulations have been relaxed, allowing the mortgage market to operate more freely and to allocate available funds more efficiently. One example of such regulatory reform is the raising or abolition of mortgage rate ceilings in many states. The turmoil that can be induced by rigid ceilings was demonstrated vividly in Tennessee in 1978 when

many credit agencies closed their doors because they couldn't lend money profitably at the maximum legal interest rate. Figure 3 shows that some states have reformed their mortgage rate ceiling laws since 1974. By allowing the mortgage market to operate more freely, they have removed or reduced artificial shortages of money and made it less likely that the housing industry will be pushed over the cliff.

**FIGURE 3**

**SINCE 1974,  
MANY STATES HAVE MOVED AWAY  
FROM FIXED MORTGAGE CEILING RATES**

Number of States with	1974	1979
Fixed Ceiling	39	19
Floating Ceiling	0	15
Selective Ceiling	4	7
No Ceiling	7	9

SOURCE: Office of the State Legislative Council, American Bankers Association. This is a summary table prepared by researchers at the Federal Reserve Bank of Philadelphia. It applies only to conventional first mortgages and does not reflect all the exceptions and special provisions associated with state ceilings.

Recent changes in deposit ceilings have helped out somewhat, too. This past June, the interest rates payable on passbook and other savings-type accounts were raised by one-quarter percentage point. This increase may help banks and thrift institutions somewhat in their fight to retain funds being lost through disintermediation. But a far more significant change was made on June 1, 1978. A major channel of disintermediation prior to that date was the U.S. Treasury bill market. When the market-determined rate on Treasury bills would rise high enough, people would start to draw money out of banks and thrift institutions to buy the bills. Thus the amount of funds available for mortgage lending was reduced. On June 1, 1978, banks and thrifts were authorized to issue certificates of deposit with a \$10-

thousand minimum denomination (the same as for a Treasury bill) that carried the current six-month T-bill rate. This change was met by a sigh of relief from the housing industry. Response to the new CDs was strong, and it appears to have helped housing as intended. The new money market certificates may have made as many as half a million additional housing starts possible in their first six months.<sup>3</sup>

Finally, a January 1979 rule change by the Federal Home Loan Bank Board, one of the many Federal agencies involved in the mortgage market (see **AGENCY INVOLVEMENT . . .**), may help S&Ls to get around the disintermediation problem should it become serious again. Under the changes, S&Ls were authorized to issue short-term commercial paper. This development is still relatively new and untested, so it is not yet possible to judge its impact on the housing market. But some observers believe that it offers institutions suffering from disintermediation the opportunity to attract capital from nondeposit sources and thus to maintain an adequate supply of mortgage funds.

All in all, the reform of certain regulations imposed on the mortgage market probably has helped to prevent a housing slump in recent months.

**. . . And Try To Lend a Helping Hand.** In addition to reforming regulations, the Federal government also has taken a more active role in the mortgage market in the last few years through its credit agencies. This role

<sup>3</sup>See statement attributed to G. William Miller, *New York Times*, December 21, 1978. But recent changes in the rules for CDs may make them slightly less effective. Previously, all institutions could compound the stated interest rate on CDs, and thrifts could offer an additional quarter-point on them. Now, however, these practices may not be carried on in general. Savings and loan associations now may offer a quarter-point differential on the rates they pay on MMCs only when the Treasury bill rate is 8 3/4 percent or less. And when the T-bill rate is 9 percent or higher, they may offer no differential at all. Also, as of July 1, 1979, financial institutions no longer may compound interest earned on MMCs.



## AGENCY INVOLVEMENT IN THE MORTGAGE MARKET

**FHA-VA.** The Federal Housing Administration and the Veterans Administration were established in 1934 and 1944 respectively. They represent two of the earliest attempts by the Federal government to lend a hand to housing. With very few exceptions, they do not make loans outright but rather insure repayment to the lender.

**FNMA.** The Federal National Mortgage Association (FNMA)—Fannie Mae—was established in 1938 to provide liquidity to mortgage lenders when it was needed most. FNMA issued government bonds and used the proceeds to buy existing FHA-VA underwritten mortgages, thus increasing the supply of loanable funds in the market. In 1954, FNMA started issuing common stock. In 1968 it became a private corporation, and two years later it started dealing in conventional as well as insured mortgages. FNMA no longer issues government bonds but raises funds in the private capital market by issuing her own bonds and debentures.

**GNMA.** When FNMA became a private corporation in 1968, Congress created her sister, the Government National Mortgage Association (GNMA)—Ginnie Mae. Although their aims are similar, FNMA and GNMA operations are different.

Ginnie operates mainly through mortgage backed pass-through securities—securities backed by a specific package of mortgages and insured by Ginnie Mae. These are, in effect, government securities, with one difference. Whereas the holder of an ordinary government note or bond gets periodic interest payments and a check for the principal when the security matures, the holder of a GNMA security receives a monthly check that is part interest and part principal, just as any mortgage holder would. Repayment of the mortgage in the package is passed through to the security holder, hence the name. An arrangement such as this means that the holder of the GNMA security is subject to fluctuations in return stemming from prepayment or default.

**FHLBS.** The Federal Home Loan Bank System was created in 1932 for the purpose of supplying credit to its member institutions—savings and loan associations and some savings banks. It does this by lending funds to those institutions at a stated rate of interest for a stated period of time. (This period can be as long as ten years.) By granting an advance to an S&L, the Federal Home Loan Bank increases the inflow of funds to the mortgage market. The Federal Home Loan Banks raise capital through the issuance of consolidated notes and bonds in the money market.

**FHLMC.** The Federal Home Loan Mortgage Corporation—Freddie Mac—was established in 1970 and is a branch of the Federal Home Loan Bank System. Freddie is a cross between Fannie and Ginnie. He raises funds through the private money market by issuing notes and bonds and by selling securities backed by mortgages. The path of his impact on the mortgage market is similar to that of GNMA's.

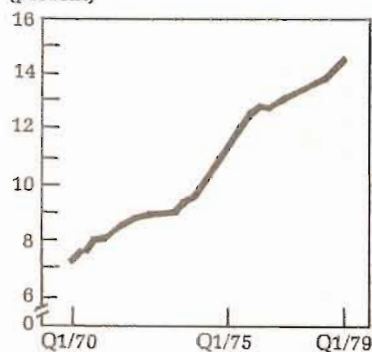
**FMHA.** The Farmers Home Administration operates a direct loan program. It makes home loans to individuals buying a house in a rural political subdivision who have been turned down for conventional financing. Loans are made at below-market interest rates. The funds from which the lending takes place are raised by issuing fully guaranteed FMHA government securities. These are backed by a pool of mortgages but are not of the pass-through type. They are hence very similar to Treasury securities but carry a higher interest rate because they are less marketable.

**FLB.** The Federal Land Banks were established by the Federal Farm Loan Act of 1916 and now operate in accordance with the Farm Credit Act of 1971. Their purpose is to make direct loans on farms, rural houses, ranches, and farm-related businesses through local Federal Land Bank associations. Funds are raised by market sales of consolidated issues of the 12 Federal Land Banks.

has been not so much making outright loans to borrowers as channeling funds to private lenders by buying previously issued mortgages from them. Growth of programs in this area has been impressive. The Federal government now backs about 15 percent of all mortgage debt in some way or other—about one and a half times the percentage it backed at the end of the last recession (Figure 4).

**FIGURE 4**  
**THE FEDERAL ROLE**  
**IN THE MORTGAGE MARKET**  
**HAS GROWN APPRECIABLY**

Outstanding Mortgage Debt Held  
or Backed by Federal Agencies  
(percent)



SOURCE: Board of Governors of the Federal Reserve System.

Many economists say that by buying existing mortgages with funds raised in other markets, these Federal agencies increase the volume of mortgage funds available, thus closing the gap between supply and demand created by artificial interest rate ceilings (but see A DIFFERENCE OF OPINION).

Looking at all of these developments together—continued strength in demand, regulatory reform, and government participation in the mortgage market—the fact that the housing industry has not taken a nosedive so far in this business cycle is easier to understand. But many of the economic fore-

#### A DIFFERENCE OF OPINION

Many economists argue that agency operations in the mortgage market have a positive effect on housing. They say that by offering low-risk securities, like GNMA pass-throughs and FNMA bonds, the agencies attract to the mortgage market the money of some investors who might have directed their funds elsewhere.

While many researchers concede that this may be the case in the short run, there is some evidence that the effect of government mortgage activity in the long run is negligible.\* There are two explanations for this. The first is that at least part of the money used to purchase government-guaranteed mortgage-backed securities and the like comes from investors who would participate in the home loan market anyway but find agency securities more attractive than mortgages. In this case, the supply of funds is not really increased but merely rerouted. The second explanation is that agencies must finance their activities by selling debt. When they do this, the market interest rates on instruments that are close substitutes for their debt (such as Treasury bills) rise. These higher rates cause investors to channel their funds out of the mortgage market to take advantage of the higher yields available elsewhere.

Thus the effect of the capital injected into the mortgage market by official agencies may be partially offset by funds withdrawn from the market by private investors.

\*See, for example, Dwight M. Jaffee, "An Econometric Model of the Mortgage Market," *Savings Deposits, Mortgages, and Housing* (Lexington: D. C. Heath and Company, 1972) and Dwight M. Jaffee and Kenneth F. Rosen, "Estimates of the Effectiveness of Stabilization Policies for the Mortgage and Housing Markets," *Journal of Finance* 33 (1978), pp. 933-946.

casters are expecting a larger drop fairly soon.

#### WHAT ARE THE FORECASTERS SAYING?

The real issue is not whether housing will be affected by business cycle movements but

just how severe the impact will be. Depending on how heavily economic forecasters weight the changes in the mortgage market since the last recession, they offer a range of answers.

Housing starts were at their peak—about 2.1 million per year—in the second quarter of 1978. Since that time they have faltered and recovered twice, and in the second quarter of 1979 they stood at slightly over 1.8 million per year. Most forecasters now foresee a steady decline in the number of starts, but they differ over where the decline will stop. Some of the more pessimistic predictions put starts as low as 1.4 million in early 1980, while others project a trough of about 1.6 million. Relative to peak activity, starts are expected to drop between 24 and 33 percent.

Is this a soft landing? The answer to that depends upon what's chosen as the standard. From the 1950s forward, housing slowdowns have ranged from as little as 23 percent to as much as 60 percent. By this standard, the currently predicted slowdown in housing would be neither the softest nor the hardest, though it would be toward the lower end of the scale.

But it may not be fair to compare current observations with the whole of this past history. The reason is that, in 1966, a major change in the financial-institutions industry raised the possibility of much deeper housing declines than had been seen prior to that time. In that year, with interest rates taking an unusually sharp rise, deposit rate ceilings were extended to nonbank thrift institutions, the nation's major source of mortgage funds. Since then, we have undergone our two worst housing slumps, one in 1966 and the other in 1974, with housing starts dropping by 39 percent and 60 percent respectively. In this light, the projected drop of 24 percent to 33 percent looks better than the housing industry reasonably might have expected.

Finally, another way to consider what would count as a soft landing is to look at how steep the housing dropoff is—how fast

housing starts fall from peak to trough. One way to measure this is to take the average rate of decline in housing activity per quarter in each of the past slumps. Again, history yields a wide range of figures, with the steepest drop coming in the 1966 housing crunch. Housing starts dropped then at an annual rate of 9.7 percent per quarter. The softest drop so far occurred between 1954 and 1958, at 2.6 percent per quarter. But here again the watershed appears to be the 1966 extension of deposit ceiling regulations to thrifts, and comparison of years on the two sides of that watershed may not be appropriate. The more appropriate standard to use is what has happened since 1966.

Current forecasts indicate that the present housing slowdown should show starts dropping off at about 4.4 percent per quarter. A slowdown as gradual as this would be comparatively mild by post-1966 standards. Thus it looks as if the current business expansion may finish up with a relatively moderate slowdown in the housing sector.

#### OUTLOOK

Concern with the housing industry has become ingrained in the minds of U.S. policymakers and the public. The health of that industry affects consumers directly, when they look for a place to live, and indirectly, in complex ways, through its varied impacts on other sectors of the economy. With the threat of a recession on the horizon, the state of the housing industry may be drawing more attention than ever before.

But for the present, at least, indications are that housing has become less vulnerable than it was in the past. Real mortgage interest rates are not high by historical standards, and government has strengthened the mortgage market through regulatory reforms and credit agency efforts. Barring developments that now are unforeseen, and as measured by some of the more common yardsticks, housing may be able to weather the storm with only a mild contraction.

## From the Philadelphia Fed . . .

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