THE DECLINE OF CYCLES IN THE HOUSING INDUSTRY

Lending institutions have restructured their methods to adjust to the rises and falls of mortgage interest rates.

by Lee Sternlight

For the past four years, the housing-industry was in a down cycle due to the major changes in financial institutions. A decline trend is an important development since it reduces housing construction costs and is reflected in lower housing prices. This decline in cost partially offset the sharp rise since 1978 in real mortgage interest rates—a rise that is not unlikely to disappear in the next decade.

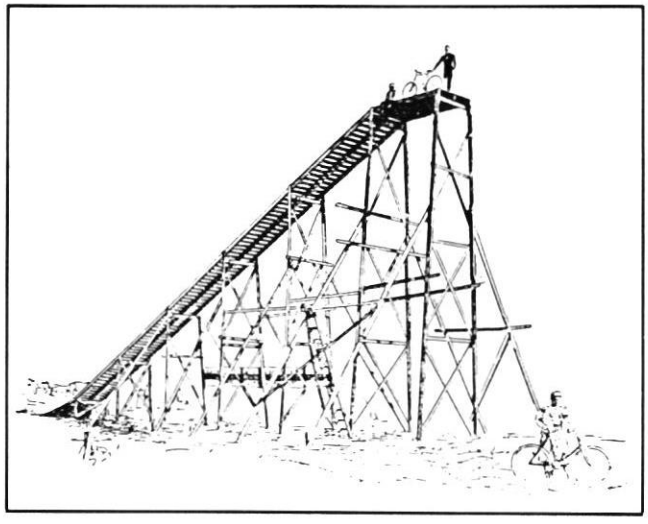
Also significant is the reduced sensitivity of the economy to the Federal Reserve's monetary policy. Interest rates need to rise substantially to rein in booms and inflation as well as fall considerably to stimulate recovery from recessions. The impact of Federal Reserve policy will be broader in future recessions and housing will no longer be its scapegoat.

An Analysis Of The Cycles

Most housing construction in the United States is carried out by contractors who seek profits. Changes in this industry typically have led business cycle peaks and troughs by about one year.

Previously, the magnitude of housing industry cycles was most severe. Private housing starts at troughs amounted to an annual rate of one million and at peaks rose to 100% or two million.

Before 1978, pent up demand and renewed availability of low-interest mortgages allowed housing construction to pick up at the bottom of the business cycle. Housing construction was cut off ahead of the business cycle peaks because of disintermediation, an outflow of funds from savings institutions, resulting in fewer available home mortgages. Disintermediation, in turn, resulted from the gap at cyclical peaks between high market interest rates and low regulated rates at savings institutions.[1] Figure 1 illustrates the cyclical variability of net savings deposit inflows and the corresponding variability of housing starts until 1978. It also indicates declines in housing starts as disintermediation proceeded, and the pickups as savings flowed back into savings institutions.



After 1978, Regulation Q interest rate ceilings were dismantled and disintermediation ceased to cause problems in the construction industry.[2] There was some variability in savings inflows but little corresponding irregularity in housing starts. When savings inflows appeared in 1980, housing starts kept on sinking and in 1981-82 they averaged only 1.1 million, or nearly 10% below three previous cyclical lows.

Cyclical variations in housing starts now are related to interest rates on housing mortgages which have risen to match other long-term rates. Borrower resistance to increases in the interest rate costs is feasible since the decision to buy a house can be postponed. As shown in Figure 2, before 1978 there was no obvious relationship between home mortgage yields kept down by state usury laws and housing starts. However, a sharp rise in new

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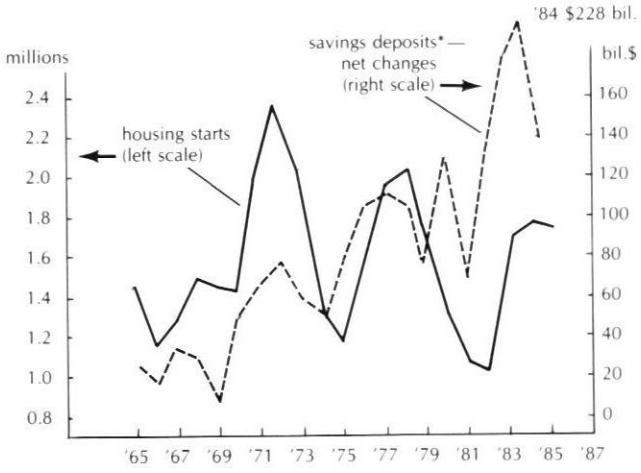
FIGURE 1

Private Housing Starts and Net Changes in Savings Deposits

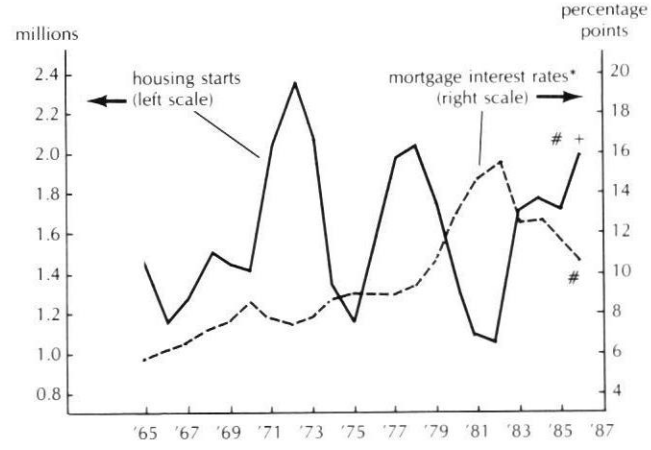


*Time and savings deposits of households
Sources: Dept. of Commerce and Federal Reserve

home mortgage yields from 9.5% in 1978—before a federal override of state usury ceilings on mortgages—to 15% in 1982, was associated with a drop in housing starts from 2.0-1.1 million.[3] Declining mortgage rates to 12.5% in 1983 and 1984 were associated with a rise in housing starts to 1.7 million each year. Mortgage rates kept dropping to 11.5% in 1985 and 10.5% in the first half of 1986. Housing starts leveled at 1.7 million in 1985 but, apparently in delayed response to the rate decline, increased in 1986 to 2.0 million between January and June.

FIGURE 2

Private Housing Starts and Mortgage Interest Rates



*New home mortgage yields
#1986: first half
+annual rate
Sources: Dept. of Commerce and Federal Home Loan Bank Board

A reasonable conclusion is that before 1978, when mortgage yields stayed below 10%, house buyers considered home mortgage rates to be a bargain. This seems especially feasible after considering the expected impact of inflation on housing prices and the inflation caused by declining real cost of mortgage payments. Drops in housing starts before 1978 stemmed mainly from the lack of available mortgages. As of 1978, mortgages became continuously available at market rates due to the end of the disintermediation phenomenon. Nonetheless, high nominal market rates discouraged home buyers since they substantially added to monthly carrying costs and limited the number of potential buyers financially acceptable to lending institutions. After 1980, there was evidence that the value of home ownership as an investment was lessening due to the slowing of inflation.

Assistance From Expansion Of Secondary Mortgage Markets

Savings institutions now may obtain savings if they pay market interest rates matching those paid by other financial intermediaries, primary business borrowers, and the U.S. Treasury. However, savings institutions have become increasingly unwilling to make and hold long-term, fixed-rate mortgages at rates acceptable to borrowers. They were badly burned when they used short-term savings inflows to invest in low-rate, long-term, fixed-rate mortgages.

Until the mid 1980s, home buyers refused to borrow on any other terms. The situation was saved when a secondary home mortgage market was developed dominated by three government agencies: the Government National Mortgage Association (GNMA or Ginnie Mae), the Federal National Mortgage Association (FNMA or Fannie Mae), and the Federal Home Loan Mortgage Association (FHLMC or Freddie Mac). Home mortgage lending institutions, especially the financially troubled savings and loan associations, shifted from originating mortgage loans and holding them, to originating mortgages and selling them in secondary markets. For VA and FHA mortgages guaranteed by GNMA, savings institutions and mortgage bankers often created mortgage pools, selling certificates of participation to investors. Another disposal route was to sell conventional mortgages to FNMA or FHLMC. In turn, the institutions held the mortgages and guarantees and sold mortgage-backed securities to investors. During 1985, approximately 80% of all originations entered the secondary mortgage market.

Assistance From Adjustable-Rate Mortgages (ARMs)

Savings and loan institutions were allowed to offer ARMs beginning in 1979. Even though they may be formatted in different ways, ARMs have become increasingly acceptable to borrowers following a lengthy education program by lending institutions. In the fourth quarter of 1983, for the first time[4] originations of ARMs exceeded those of fixed-rate mortgages. In the last quarter of 1985, 55% of all savings and loan association

mortgages and 60% of all savings bank mortgages were structured as ARMs.[5] Thrifts unwilling to add their fixed-rate mortgages often will keep variable-rate mortgages since they shift much of the risk to the borrower. ARMs appear attractive to some borrowers because of lower rates initially; if taken out during booms, they do not lock borrowers into high interest rates as do fixed-rate mortgages.

Outlook For Future Housing Construction Cycles

Cyclical fluctuations probably will remain modest in the next five years if there are no dramatic changes in government policy toward housing i.e., sharply reduced government role in the secondary mortgage market. The rise in housing starts from trough to housing cycle peak may reach 50% rather than the previous 100%. Variability could increase from a trough of 1.5 million annual rate to 2.2 million.

The cycles of housing construction should diminish for two reasons. First thrifts and banks will be able to obtain funds during the business cycle either for fixed-rate or adjustable-rate mortgages. If they are converted to more liquid MBSs, or simply disposed, they will often be sold to FNMA or FHLMC. Secondly, home buyers will be able to obtain mortgages during booms. Though market interest rates may be as high during past cyclical peaks, home buyers will not be locked into high rates by taking out ARMs. If this happens, housing starts may become a coincident rather than a leading indicator of the business cycle.

In making this forecast, it has been assumed that legislation reducing the ability of quasi-governmental agencies to sustain secondary mortgages will not become law. Another assumption is the U.S. Congress and the president will agree on a program to substantially reduce federal deficits. Most economists anticipate that providing the economy approaches full employment in the late 80s, large structural federal deficits would displace a substantial share of private investment, including housing construction, and reverse the recent decline in the cycles of the housing industry.

NOTES

1. The relationship between interest rate gaps and net savings inflows can be seen in Chart 5-1, *Economic Report of the President, 1984*, p. 152.
2. By the end of 1983, fewer than one-fourth of interest-bearing deposits were in rate-restricted accounts. *Economic Report of the President, 1984*, p. 153.
3. The state usury laws were overriden for FHA mortgages in 1979 and for other types of mortgages in 1980. *Savings and Loan Sourcebook, 1983*, U.S. League of Savings Institutions, p. 53.
4. Cited in Henry Kaufman (1984, February 3). *Comments on Credit*. Salomon Bros.
5. *Savings Institutions Sourcebook*, 1986, p. 10.