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Domestic Credit by Richard Freeman

Interest rates will end housing 'boom'

How long can government pump-priming and private speculation on mortgage paper keep going?

Averaging an annualized 1.67 million new home starts for the first five months of 1983—compared with 1.06 million starts for 1982—the U.S. home construction market is the prop of the fake U.S. economic recovery. It will take a huge tumble in the second half of this year, as the current increase in short-term interest rates accelerates this summer.

The essence of the housing recovery is a finance-pyramiding scam unique in U.S. home market history.

Look at the housing market over the past few years. In 1978, the year before Federal Reserve Chairman Paul Volcker took office and began raising interest rates, the number of housing starts was 2.036 million. By 1981 and 1982, the total was 1.100 and 1.067 million, respectively.

Then Treasury Secretary Donald Regan and the Council of Economic Advisers decided to brake the rate of collapse of the U.S. economy, by using U.S. tax monies to build up housing and buy a short-lived economic recovery, starting with the fiscal year 1983 federal government budget, which went into effect in October 1982.

The price of the government-financed housing recovery is the ballooning federal budget deficit.

The method of increasing home purchases was to reintroduce 30-year, *fixed-interest-rate* mortgages, at rates homebuyers could afford. Fixed-rate mortgages had scarcely been seen for a year and a half.

There were two ways in which the government could accomplish this objective.

The first is for the government itself to issue fixed-rate mortgages. And in fact for 1983, the Federal Home Administration (FHA) and the Veterans Administration (VA), the two government mortgage-issuing agencies, have tripled the number of mortgages they offered over the 1982 level.

The other method is for the private sector—S&Ls, pension funds, insurance companies, commercial banks—to originate fixed-interest mortgages, and sell them in packages—called mortgage pools—to U.S. government agencies in the secondary housing market, Ginnie Mae, Freddie Mae, and Freddie Mac.

The private institution is not stuck with long-term, fixed interest rate paper—the U.S. government is. The government agencies issue bonds to pay for these mortgage pools; the private institutions buy the bonds, and earn a good rate of return.

The financial investors bought the Ginnie Maes, for example, in the first quarter, at an average yield of 11.96 percent. The financial investors financed the purchase of Ginnie Maes by either borrowing money, or taking deposits, or the equivalent, at the prevailing short-term money market rate.

According to James O'Leary, chief economist for U.S. Trust, "the financial investors are not buying Ginnie Maes as long-term investments, but short-term high yield investments. They are as safe as Treasury securities and have higher yields."

But if the cost of short-term funds rise, all the investors will try to dump the Ginnie Maes onto the market at the same time. "The Ginnie Maes will be unmarketable," O'Leary declared.

In 1981, the U.S. government accounted for 28 percent of all funds advanced for housing. But in the fourth quarter of 1982, the start of the 1983 fiscal year, the government accounted for $88 billion, or more than 100 percent of the total $84.1 billion housing money advanced in that quarter. (The S&L's and commercial banks drew down their mortgages in that quarter.) In the first quarter of 1983, the government accounted for $76.9 billion, or 57 percent, of all funds advanced.

Short-term interest rates have risen 1.0 percentage point since the first week of May, and now stand at 9.0 percent.

An increase of another 1.5 percentage points this summer would raise the level to 10.5 percent. Since it costs banks and financial investors 1.0 to 1.5 percent to service their deposits, the total cost of short-term funds will effectively be over 12 percent.

At this point, the institutions will rush to sell their Ginnie Maes, and the housing "boom" is over.

This tells us all we need to know about those statistics that purport to show the U.S. economy's "recovery."

Basically, "supply-side" economic theory, which claimed it would build up capital stocks by taking from the consumer sector, revealed its absurdity some time ago. So, for political reasons, relating to the perceptions of debtor-nations and others, Paul Volcker and Donald Reagan decided to pump up the consumer sector. They didn't get a recovery, but they got what they wanted—some improved, but very temporary, statistics.

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