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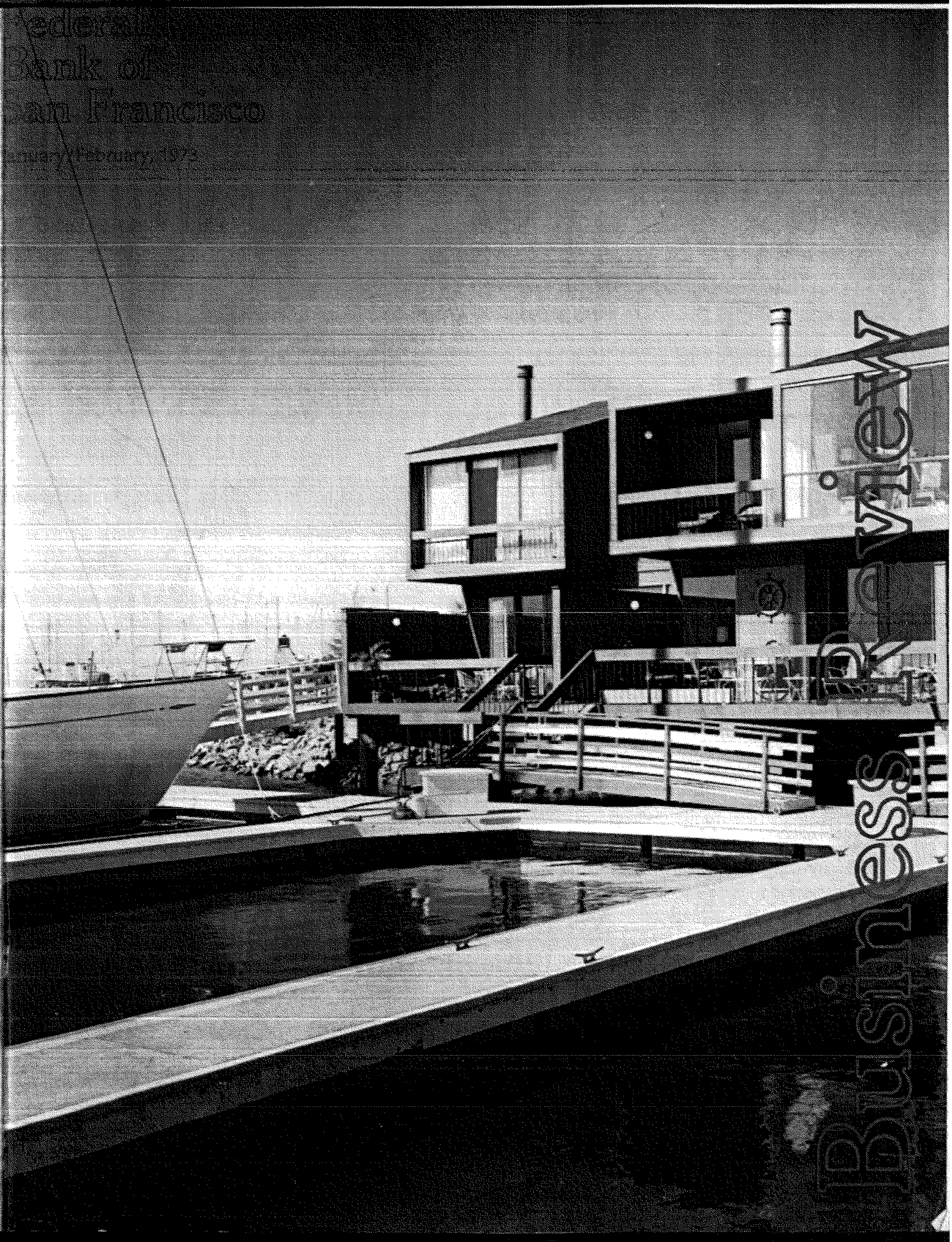

Business Review

Housing: On the Way Down?

After six years of sustained albeit uneven expansion, the Western housing industry appears due for a decline this year.

Where the Money Came From

Major Western banks expanded their sources of funds strongly during 1972, and allocated those funds almost entirely to loans.

Pollution Control: Two Industries

The copper and forest-products industries face heavy costs in cleaning up the air and water pollution they cause.

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Housing: On the Way Down?

The Western housing boom continued during 1972, as 550,000 new units—about 455,000 housing starts and about 95,000 new mobile homes—added up to a respectable 12-percent gain in activity for the year. However, after six years of sustained albeit uneven expansion, demand appears to be fairly well satisfied in most areas, and this consideration has led most industry observers to forecast a downturn in homebuilding in 1973.

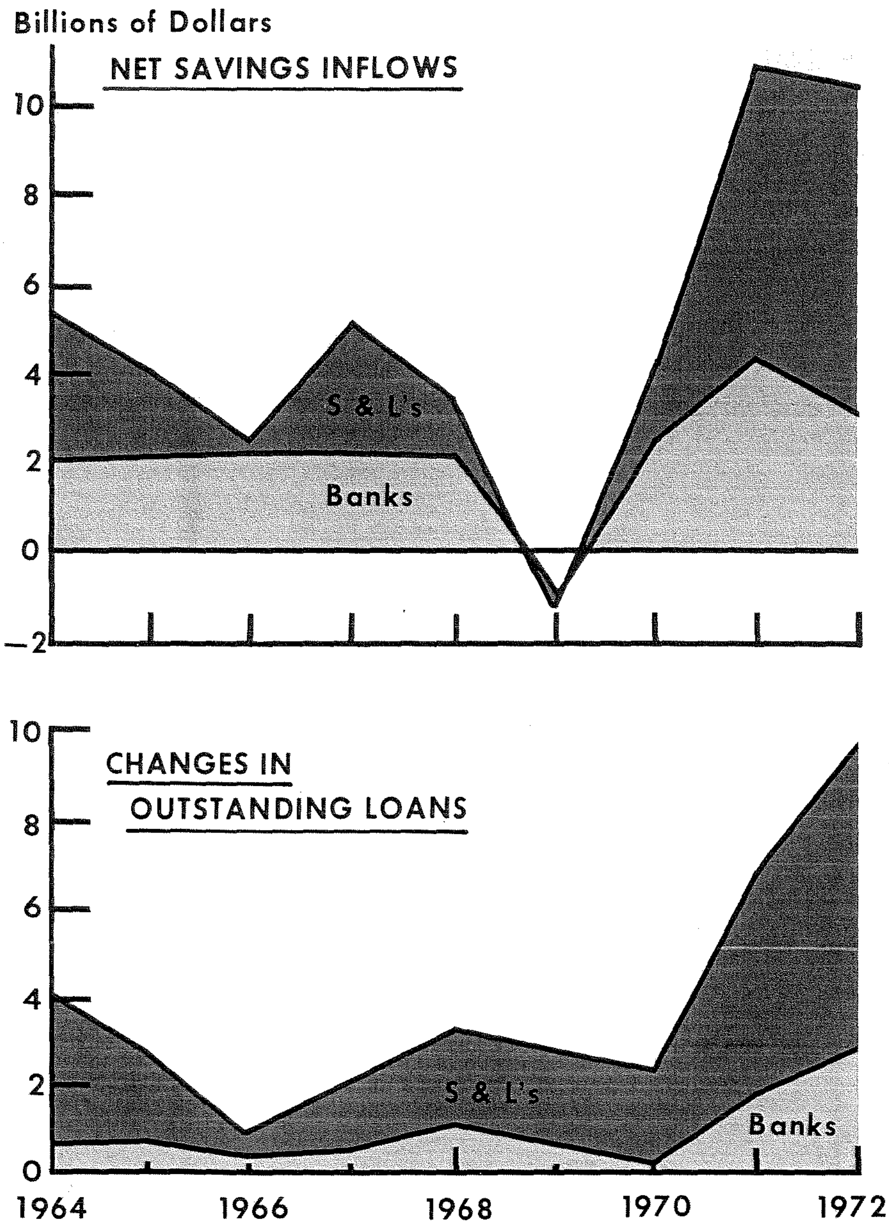
Last year's 12-percent gain was considerably below the 40-percent increase recorded in 1971. This slowdown reflected the relatively stable or even lower levels of homebuilding in such crucial markets as Los Angeles, San Jose, San Diego and Seattle. Los Angeles, in fact, accounted for less than half as many housing starts as it did in 1963, which until recently had ranked as the banner year for Western homebuilding.

Even so, Los Angeles continued to rank among the top home-building areas in the nation, as did also the San Francisco Bay Area, Orange County, Phoenix and San Diego. In the latter two areas, and in Portland and Salt Lake City as well, housing activity was well over twice as high as it was a decade ago.

Multiple units accounted for roughly half of last year's housing starts in the West as a whole, and for a somewhat larger proportion in California, Oregon, Alaska and Hawaii. In some local markets—most notably Los Angeles—multiples accounted for over three-fourths of all new units. This situation reflected an upsurge in buying of condominiums, largely by ex-renters; industry sources believe that more than two out of three condominium buyers were formerly renters.

Funds for the boom

The ample availability of both construction financing and permanent mortgage financing provided a basic support for the market, both nationally and regionally. Last year witnessed a record flow of funds to the financing of residential mortgages—about $47 billion nationally, or $20 billion above the previous year's level. This represented almost one-third of all funds raised in the nation's credit markets last year.



Funds for Western mortgage markets provided by the heavy savings inflows which almost inundated mortgage-lending institutions

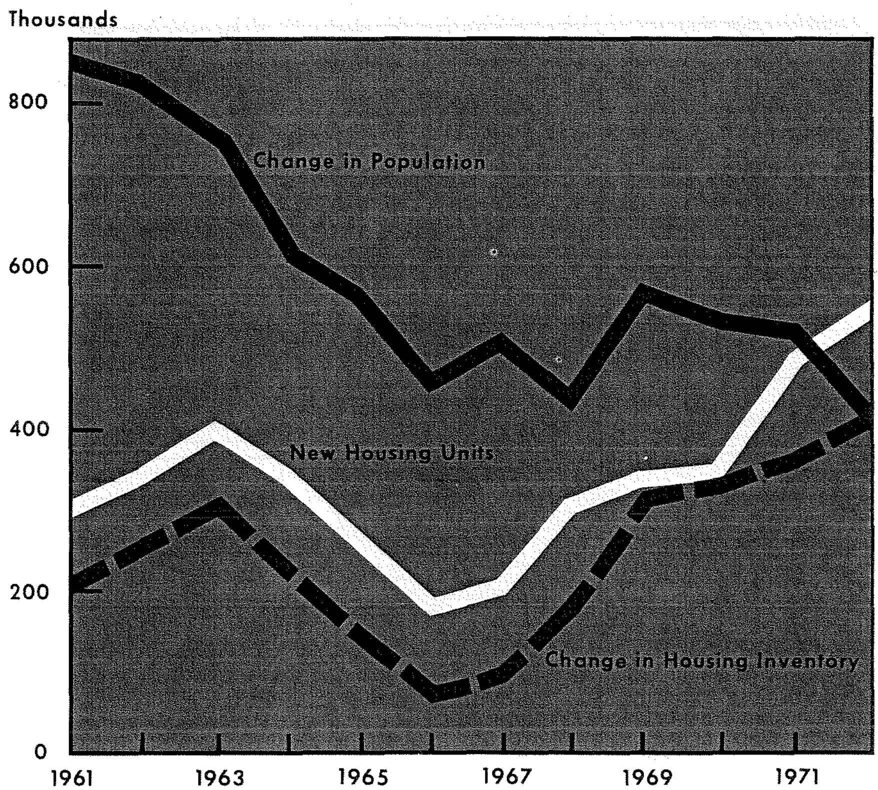
The major mortgage lenders in the West, savings-and-loan associations and commercial banks, vastly expanded their lending. The S&L's increased their outstanding real-estate loans by $6.8 billion, 36 percent more than in 1971; the banks expanded their mortgage portfolios by $2.8 billion, this gain being half again as large as in the previous year. With funds so readily available, liberalized lending terms prevailed; for instance, many S&L's utilized their new-found authorization to make conventional loans with only a 5-percent down-payment requirement.

Funds for the Western mortgage markets were provided by the heavy savings inflows which almost inundated the mortgage institutions for the second straight year. Savings deposits increased by a record $7.5 billion at the S&L's, and consumer-type time and savings deposits grew by $3.0 billion at the commercial banks. In both cases, over 80 percent of the new inflows occurred in higher-yield certificate accounts, thereby raising the average cost of funds and also the potential floor under mortgage rates.

Consumers nationwide reduced their volume (and rate) of savings in 1972, especially during the middle two quarters of the year. But at the same time, thanks in part to an increased willingness to finance current expenditures by borrowing, they acquired financial assets at a record rate. Over two-thirds of the total went into savings deposits in response to favorable yield spreads, although this spread narrowed somewhat in the latter part of the year.

How much of a drop?

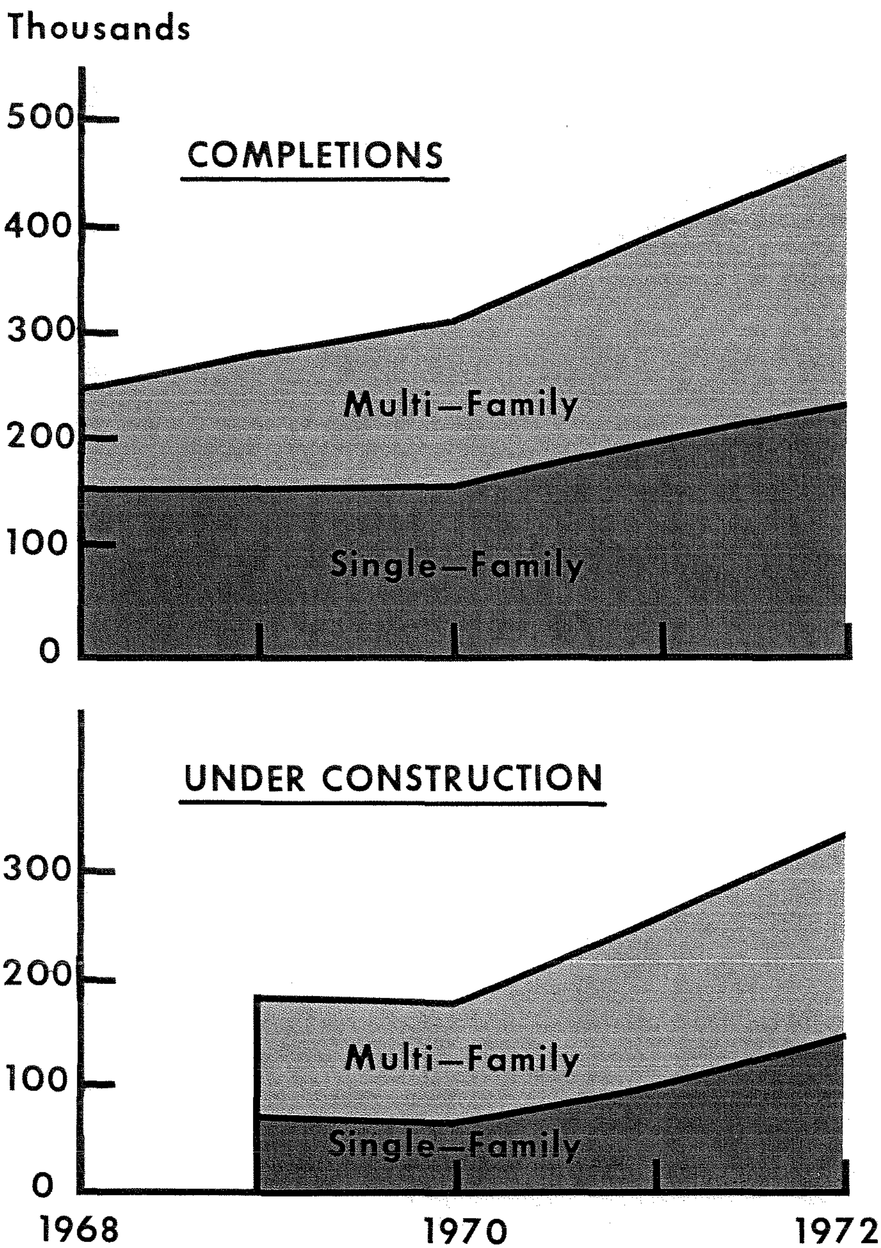
The Western housing boom probably reached its peak last year, and a decline which might extend into 1974 now seems reasonable to expect. Total new housing units—housing starts plus mobile-home sales—could fall by about 18 percent to 455,000 units, on the basis of a sharp reduction in housing starts and no more than stability in mobile-home sales. But even with this decline, total production will be the third highest on record, still exceeding the number of units built in the 1963 boom year. Most of the weakness in homebuilding is expected to occur in California and Arizona, although decreases are also anticipated in every other state except possibly Washington.



Housing inventory rises sharply during last several years, despite declining trend in Western population growth

The cause of the expected decline can be traced to the industry's success in producing homes for the private market during the past two years. (Some reduction in subsidized housing starts also is expected, in line with the Administration's recently announced freeze, on top of a fairly significant decline recorded in 1972.) Indeed, the short-fall in housing stemming from the reduced levels of home-building during the 1965-70 period now appears to have been largely overcome.

The net supply of housing, including the large number of units currently under construction, may have outpaced basic demand in the Twelfth District states by about 80,000 units during the last year or so. This



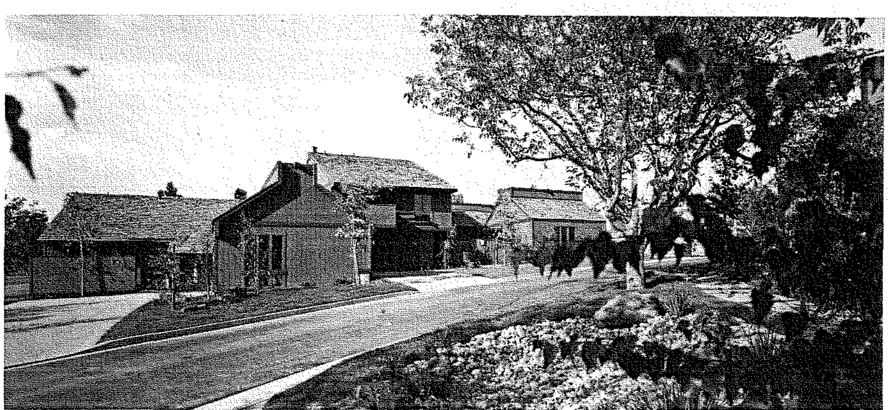
Housing completions reach peak in '72, and will probably remain high in '73 because of large number of homes under construction

assumes a basic annual demand consisting of about 120,000 removals from the housing inventory plus an estimated 310,000 household formations. That household-formation figure may be rather conservative, in view of a recent sharp increase in Census Bureau estimates for the nation. But despite the tentativeness of regional household estimates, a shift in the supply-demand relationship is indicated by the 1972 downtrend in Western housing starts, with a 21-percent decline between the first and fourth quarters of the year.

Warning signals

Evidence of a growing excess supply is provided by the rise in vacancy rates on rental units—as high as 8 to 10 percent in some areas—although rates regionwide still lag considerably below the levels of the mid-1960's. In addition, the number of houses available for sale has risen faster than sales; the inventory of unsold new single-family homes alone approached 100,000 units at year-end, or almost double the level of two years ago. The situation could worsen further as the very large numbers of single and multiple units under construction—325,000, or 28 percent higher than a year ago—are brought to completion and placed on the market.

The impact of rising vacancy rates on new construction may be delayed, however, because of the relatively high level of unused building permits and loan commitments, and perhaps because of some tendency for vacancies to show up first in older rather than newer units. The initial impact may be to stabilize rents; indeed, over the past year, rents have risen more slowly in major Western metropolitan areas than they have nationally. A second effect may be to delay the downturn but also to increase the magnitude of the correction when it takes place.



New homes harmonize with rustic surroundings.

Despite the projected reduction in homebuilding, most analysts expect housing costs to continue their inexorable rise in 1973. The median price of new single-family homes has risen 50 percent in less than a decade, and was up 11 percent last year alone. (However, the average home size has also increased.) Lumber and other materials costs may descend from the stratosphere in response to any decline in demand, but the costs of land and labor seem destined to continue upward, albeit perhaps at a reduced rate. Consequently, unless builders are willing or able to trim profit margins, the increased costs will translate themselves into higher home prices.

How much financing?

The intense competition for funds likely to develop under the expansionary economic conditions of 1973 may also be a limiting factor on homebuilding activity in any case. The Federal sector will place very large demands on credit markets, because of the continuation of substantial Federal deficits. The corporate sector, despite its strong cash-flow position, undoubtedly will be a major source of credit demand because of its very strong anticipated level of demand for plant, equipment and inventories. Nonetheless, there should be ample funds left over for a reduced level of mortgage borrowing, although not necessarily at the current level of interest rates.

Much will depend upon the amounts of savings channeled by households into depository institutions. Since yield differentials have been narrowing recently, new funds are not likely to flow into the banks and the S&L's at the spectacular levels of the past two years. Even so, these institutions are likely to garner a substantial share of such flows—and they may keep a strong grip on the funds they obtained last year, which are concentrated in higher-yielding certificates. Moreover, with the funds available from amortized mortgage loans—well over

$5 billion annually at District S&L's—and with the funds potentially available from various Federal housing agencies, a severe credit shortage of the 1969-70 variety seems unlikely.

Housing vs. ecology

One final influence on the housing outlook should be noted—the environmental movement. For a period last fall, all construction work in California appeared stymied by the State Supreme Court's ruling calling for "environmental impact" reports on all construction projects whose impact was likely to be "significant." In December the legislature invoked a 120-day moratorium on the filing of such reports, and the Court itself, in a supplementary opinion, stated that the original ruling was not meant to apply to minor projects such as single-family homes. Nonetheless, the appropriate public agencies now have the task of laying down specific guidelines for the implementation of environmental impact reports.

Clearly, concern is increasing over the environmental impact of construction, and by no means is the concern limited to California. One national building-trade journal recently said, "There has been enough bad building—and enough bad land use—to give local conservationist movements a very sound basis for their resistance to bad projects." From this and other sources have come a rising tide of warnings about the many interrelated aspects of growth, resources and the environment; as an extreme example, one building industry official recently declared that fuel shortages virtually could eliminate homebuilding in little more than a decade.

At this point it is impossible to foretell just what kind of consensus will eventually emerge regarding the trade-off between economic growth—that is, jobs—and environmental balance. Nowhere, however, are the issues more likely to remain alive than in the West—an area whose magnificent natural endowments have been a major inducement to in-migration, and consequently to a succession of housing booms.

Verle Johnston

Annual Report

The Federal Reserve Bank of San Francisco **Annual Report for 1972** is just off the press, and individual copies are available to interested readers. The **Annual Report** contains a review of western business and financial developments, as well as information on the operations of the central bank of the West.

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