2

Chapter 2

The Business of Real Estate

In This Chapter

Business and real estate cycles are influenced by many factors. They both respond to supply and demand, inflation, and interest rates. Real estate markets and the mortgage industry are interrelated. Real estate can be affected positively or negatively by interest rates; interest rates depend on supply and demand for money; loan activity depends on availability of money; and property values depend on the health of the economy. This chapter looks at the four broad forces influencing real estate cycles: Physical, economic, governmental, and social. Following that is a look at some government influences on real estate finance, focusing on fiscal policy and taxation, and monetary policy. We'll also look at how the actions of the Federal Reserve affect interest rates.

At the end of this chapter, you will be able to:

- Identify broad influences on the real estate market.
- Discuss how fiscal policy and monetary policy are made.
- Explain the role of the Federal Reserve System.
- Identify tax laws affecting real estate.

Key Terms

Business Cycles
Discount Rate
Economic Base
Fed Funds Rate
Federal Open Market Committee (FOMC)
Federal Reserve Board (the Fed)
Fiscal Policy
Inflation
Interest Rate
Monetary Policy
Moral Suasion
Open Market Operations
Real Estate Cycles
Reserve Requirements
Supply and Demand

Factors Affecting Real Estate

To be an effective mortgage professional, it is important to have some understanding of how the real estate industry functions as a whole. Economic factors have a broad influence on the real estate market, such as business and real estate cycles. As you will see, there are many forces that affect those cycles.

Business Cycles

Business cycles are *general swings in the economy over a period of time* which may be broadly categorized as periods of economic growth and expansion or stagnation and decline. These periods can last an unpredictable amount of time, depending on a number of different economic factors, such as inflation and the job market.

Many of these business cycle activities and factors are so interrelated that they increase and deflate other businesses along with them. It's difficult to stabilize these cycles as it's hard to know when they will begin or what's causing them (although the government does try). Most of the time, though, a cycle must ride itself out, either to a point where interest rates or other costs become so high that purchasing slows and prices begin to fall, or to a point where interest rates or costs are so low that even those people previously reluctant to spend can't pass up such low rates or prices and spending increases.

The economic factors that influence business cycles also influence real estate cycles, for example, supply and demand, inflation, and interest rates.

Supply and Demand

The concept of **supply and demand** says that *for all products, goods, and services, when supply exceeds demand, prices will fall, and when demand exceeds supply, prices will rise.* This economic theory says that supply and demand seek to balance each other and, thus, the market responds. When demand for a product (such as housing) exceeds supply, the price for that product will rise, stimulating more production. As production increases, more of the demand is satisfied until, eventually, the supply outstrips demand and a buyer's market is created. At that point, prices will fall and production will slow until demand catches up with supply, then the cycle starts over. In a healthy economy, supply and demand are more or less in balance, but the forces affecting supply and demand are constantly changing, thereby shifting the balance.

Inflation

Inflation is an *increase in the cost of goods or services over a period of time, which impacts a buyer's purchasing power.* This may be **cost inflation**, which mostly affects new home prices as builders pass on to buyers their increased costs of labor and building materials. Or it could be **demand inflation**, which mostly affects existing home prices as too many people seek to live in an area with a limited supply of housing. High inflation could affect a real estate cycle more than a business cycle because the actual costs are so much higher. A person usually thinks twice about buying a $100,000 house that has increased in price by $10,000, but is more likely to shrug off a $5 rise in a $50 pair of shoes, even though both prices rose by the same percentage.

Interest Rates

The **interest rate** is the *amount charged by a lender to a borrower for the use of assets, expressed as a percentage of principal.* This is the **cost of money** that people or businesses must pay to use another person's money for their own purposes. Inflation is one factor that can cause interest rates to rise or fall. And while most big-ticket items are affected by high interest rates, they hinder real estate more than other goods because mortgages are long-term, high-dollar commitments. In fact, the single most important factor in determining demand in the real estate market is interest rates. Low interest rates tend to increase demand for property; high interest rates tend to decrease demand. All other things being equal, a drop in interest rates can spur activity in the real estate market for home purchasing or refinancing.

Real Estate Cycles

Real estate cycles are *general swings in real estate resulting in increasing or decreasing activity and property values during different phases of the cycle.* Real estate cycles last for varying lengths of time. They are the response of the real estate and mortgage markets to the forces of supply and demand, but there are two factors that separate the housing market from other supply and demand models.

First, with real estate there's a **lag time** that exists for market forces to respond to perceived changes in supply and demand. This lag time is the result of the time it takes for a house to be bought, sold, or built. If people lose their job today, they can't expect to sell their homes tomorrow. Or if construction companies see a need for housing, it takes time for them to build houses; and when they see that there's no longer a need for housing, they often have some houses started that still must be finished. Because of this, real estate cycles generally take longer to respond to upturns and downturns than other businesses. When the real estate market is in balance, there will be slightly more properties available than there are buyers.

The second factor that makes the real estate market different is the **limited supply** of land in any given area. This constraint will surface again when value is discussed.

Broad Forces Influencing Real Estate Cycles

Imbalances in supply and demand may be short-term or long-term, depending on the causes. Some of the causes of real estate cycles are supply of land, inflation, cost of money, availability of credit, construction costs, and health of the economy. Important factors can include fiscal and monetary policies. Other influences on real estate cycles are demographics, population shifts, and growth. All of these factors can be divided into the four broad forces that affect real estate (remembered easily as the acronym P E G S):

- Physical
- Economic
- Governmental
- Social

Physical

Physical forces that affect real estate cycles can be on a property or external to it, natural or man-made. Physical forces can include location and popularity, as areas within a city or entire regions go in and out of favor with the public because of location, jobs, climate, or other reasons. Land availability and desirability are important factors in real estate cycles, as well as overall supply and demand. The environment can also have an impact on real estate cycles, sometimes in a positive way as from a natural waterway or man-made lake, or in a negative way as from pollution that affects an entire area.

Economic

Local economic trends have a big impact on real estate cycles. This is best understood by the concept of economic base. The **economic base** of an area is *the main business or industry that a community uses to support and sustain itself.* While the presence of a good economic base is important for all businesses in an area, it's critical to maintain home values in real estate markets. This is due to the immobility of real estate and customers. Houses can't be moved to where there are buyers and, usually, buyers can't just move their jobs to where a specific house is.

The economic base of an area is a primary factor in determining the supply of housing. In prosperous areas, there should be funds available to finance the purchase and construction of housing and, in theory, the marketplace will function smoothly.

The past several years have shown that national economic factors are increasingly important. Although local economic health is still a major factor, it is being influenced more and more by the national economic picture where inflation, cost of money (interest rates), and availability of credit are also considerations.

Governmental

Government activities affecting real estate can be divided nationally and locally. National government influences include taxation, fiscal and monetary policies, secondary markets, government financing programs, and federal regulations. The federal government also influences interest rates via the Federal Reserve Board. And since the federal government is the largest borrower in the country, its spending has a huge influence on the national economy.

Local government activities are also having a greater effect on the real estate market. State and local governments have two types of laws that influence real estate: Revenue-generating laws and right-to-regulate laws.

Revenue-generating laws deal with taxes, and although they're passed primarily to raise revenue, they can have other effects on real estate. **Right-to-regulate laws** deal with the police power that governments reserve for themselves. These laws can take the form of land use controls, zoning laws, environmental protection laws, eminent domain, and escheat—all of which can affect real estate by limiting land usage. Furthermore, in many areas of the U.S., overcrowded cities are beginning to enact no-growth policies, which limit the number of new houses. If no-growth becomes widespread, the housing supply will be squeezed more and lead to price increases.

Social

Social forces also have an interrelated effect on real estate cycles. These factors include demographics, migrations, family size, population shifts, growth, and age. As populations grow and change, so do their housing needs. Social behavior patterns and population distribution can have major effects on supply and demand in the real estate market. For example, an increase in the number of people in their prime home buying years can push up housing prices and supply. Smaller families, high divorce rates, and a trend toward later marriages also stimulate demand, because there are fewer persons per household. Finally, the general aging of the population means that more changes are likely on the horizon.

Migrations of the population are also powerful forces. This social factor may actually be the result of an economic factor (e.g., a factory moving into or out of an area) or a governmental factor (e.g., higher or lower state/local tax rates). Housing values can benefit from an influx of people, or be devastated by an exodus.

Government Influence on Real Estate and Mortgages

Government has a large influence on many aspects of real estate markets and the mortgage industry. This was seen in the discussion of the creation and oversight of the secondary market and the creation of the Federal Housing Finance Agency (FHFA) in Chapter 1. It will be seen again in later discussions regarding the impact of federal legislation and regulations as well as government loan programs. The mechanisms used to affect interest rates in the United States also have a significant influence. The next few topics focus on the federal government's fiscal and monetary policies, as well as the actions of the Federal Reserve Board. These are important means of control and influence over the supply and cost of money.

As we examine the federal government's use of fiscal policy through the U.S. Treasury Department (including taxation) and monetary policy through the Federal Reserve Board (which affects interest rates), keep in mind what we have just learned about business and real estate cycles. As we shall see, fiscal and monetary policies have direct and indirect influences on real estate, including interest rates charged by lenders for all types of loans, including mortgages. This is because, to a large degree, the supply of money in the United States is controlled by the federal government, and interest rates, like the cost of most things in a market economy, are controlled primarily by the law of supply and demand.

Remember, the law of supply and demand says that for all products, goods, and services, when supply exceeds demand, prices will fall, and when demand exceeds supply, prices will rise. This is true for real estate, for houses, and for money itself. If the supply of something is large—in this case, if there is a large amount of money in circulation—then the price will fall, so interest rates will tend to fall. Falling interest rates tend to increase business activity, real estate activity, and borrowing activity. Conversely, if the supply of money is small, then the price of borrowing money will tend to rise and be reflected in higher interest rates. Of course, there are other factors that affect interest rates, but the forces of supply and demand have the greatest effect. This leads us back to how the federal government uses fiscal and monetary policy via the United States Treasury and Federal Reserve Board to control the supply of money and influence interest rates in the U.S. economy.

Fiscal Policy and the U.S. Treasury Department

Fiscal policy is the *government's plan for spending, taxation, and debt management*. The legislative and executive branches of government enact fiscal policy by passing legislation that sets the government's priorities for how much money will be collected, from whom it will be collected, and how it will be spent. The ultimate goals of fiscal and monetary policies are supposed to be economic growth, full employment, and international balance of payments. Unfortunately, there's much debate over which policies actually promote those results. Worse yet, the government's fiscal policy is subject to tremendous political pressure.

The United States Treasury Department is part of the executive branch of the federal government. The Treasury Department, as fiscal manager of the nation, is responsible for carrying out the nation's fiscal policy by doing the actual spending, taxing, and debt financing through an account it keeps with the Federal Reserve. Treasury funds come from a number of sources, but the largest source is personal and business income taxes. The Treasury Department issues all government checks, uses the Internal Revenue Service to collect taxes and enforce tax laws, and issues interest-bearing notes (called securities) to cover any spending deficits. Deficit spending and taxation are the two main policy tools that the Treasury Department can and does use to implement fiscal policy. Both of these policies are a means of controlling the supply of money in circulation and thus, also indirectly affect interest rates.

Deficit Spending

Deficit spending occurs when the *government spends more money than it takes in from tax revenue.* When federal income is less than federal expenditures, a shortfall called a federal budget deficit results. When a deficit occurs, the Treasury obtains funds to cover the shortfall by issuing interest-bearing securities to investors. Depending on their term, these securities are referred to as Treasury Bills or T-Bills (less than one year), Treasury Notes (one to ten years), or Treasury Bonds (30 years). In issuing these securities, the federal government is borrowing from the private sector and accumulating debt. When the government borrows money to cover deficits or debt, less money is available for private borrowers.

While some economists believe that federal deficits and debt have little impact on interest rates, others believe that large-scale federal borrowing can have a dramatic effect on interest rates as private borrowers compete for limited funds remaining. Government borrowing (whether through deficits or debt), as well as the compounding effect of interest that is paid on the bonds or debt instruments. is the single largest drain on the supply of mortgage loan funds.

Taxation

The second tool of fiscal policy is taxation. Taxes directly impact the spending habits and abilities of all businesses and individuals. Lower taxes mean taxpayers have more funds for lending or investing. Higher taxes mean they not only have fewer funds to lend or invest, but will also be more likely to invest in tax-exempt securities instead of taxable investments, like mortgages. While some would argue that government spending is necessary and has the same net result on economic activity, higher taxes result in people having less money to buy homes.

Taxation can also have direct and deliberate secondary effects on real estate and mortgage financing. Along with raising revenue, tax provisions are used to implement social policies by encouraging or discouraging certain behaviors or activities. This is done through tax deductions and exemptions. For example, the deduction for mortgage interest from taxable income effectively stimulates housing and encourages home ownership. Tax code changes beginning in 1988 have limited the deductibility of home mortgage interest, which was previously fully deductible. If the money is used to buy or improve a primary residence, then mortgage interest is deductible for loans up to $1,000,000. Interest on home loans for purposes other than buying or improving a home is deductible to a much lesser extent, depending on filing status.

Provisions of the **Tax Reform Act of 1986** also limited or eliminated tax benefits previously available for real property owners. The capital gains exclusion for long-term capital gains was eliminated, as were accelerated cost recovery methods, while straight line cost recovery periods for income and investment property were increased. The ability to offset losses from income property (termed "passive losses") against income from wages and salaries was restricted for many taxpayers. All of these served to make real estate investing less attractive.

Still, investors can deduct expenses and depreciation for commercial and investment properties. **Depreciation** is *expensing of the cost of business or investment property over a set number of years, determined by the IRS to be the asset's useful life.* For example, the cost of a residential building is divided by a depreciation life of 27.5 years, whereas the cost of a commercial building is divided by a depreciation life of 39 years. For a property to be depreciable, it must be used in a trade or business. Thus, a house rented to tenants is a depreciable asset, whereas your personal residence is not (even if you use part of it for a home office). Only buildings and improvements are depreciable; land is not. Repairs are expensed in the year they are incurred. Rules are complicated, though, so professional tax advice is always encouraged.

The **Taxpayer Relief Act of 1997** added some beneficial tax treatment for homeowners, by adding a new tax exclusion on the sale of a principal residence. The exclusion is $500,000 for married couples filing jointly and $250,000 for single taxpayers. Anyone selling a home can claim the exclusion as often as every two years—without having to buy another home of equal or greater value—as long as three conditions are met:

1. The seller must have owned the home for at least two of the five years preceding the sale,
2. The seller must have used the property as a principal residence for at least two of the five years preceding the sale, and
3. The seller must not have used the exclusion for a sale during the prior two years.

The IRS has clarified these rules such that in certain circumstances (such as a job relocation), if the person did not own or use the home for the entire two-year period, the exclusion amount may be prorated.

Real Success

Other tax-related programs come and go. For example, with the **American Recovery and Reinvestment Act of 2009**, Congress authorized a tax credit of up to $8,000 for qualified first-time home buyers purchasing homes on or after January 1, 2009 and before December 1, 2009.

These tax laws are mentioned here simply to make you aware that fiscal policy and tax laws can affect real estate, and you should make a point of **staying current**. However, you should never give tax advice to anyone. Refer people to tax professionals because tax laws are complicated and change frequently.

Monetary Policy and the Federal Reserve

Monetary policy is the *government's mechanism through which it can exert control over the performance of the economy, primarily through the supply and cost of money.* Monetary policy is conducted by the Federal Reserve System—the Fed for short—and it influences demand mainly by raising and lowering short-term interest rates.

The **Federal Reserve Act of 1913** established the **Federal Reserve System** as the nation's central bank with 12 regional Federal Reserve Banks (FRBs). The FRBs serve as lenders of last resort to provide funds to banks to avoid the bank panics that were common in the late 1800s and early 1900s.

Federal Reserve System

The Federal Reserve and state and federal agencies supervise and regulate the nation's financial institutions to ensure their financial soundness and compliance with banking, consumer, and other applicable laws. The Fed is made up of the Board of Governors (Federal Reserve Board), Federal Open Market Committee (FOMC), Federal Advisory Council, Federal Reserve Banks, and more than 5,000 member banks.

The **Board of Governors**, called the **Federal Reserve Board**, is a seven-member committee that controls the Federal Reserve System. The governors are appointed by the President and confirmed by the Senate for 14-year terms. The Board members control the Fed's monetary policy by implementing various policy tools. The Board also has substantial control over regulations affecting the activities of financial institutions and oversees federal regulations dealing with money.

The **Federal Open Market Committee (FOMC)** controls the Fed's open market operations—the sale and purchase of government securities. The FOMC consists of the seven members of the Federal Reserve Board, plus the President of the Federal Reserve Bank of New York, and four other Federal Reserve Bank Presidents. FOMC actions are a very important way of controlling the money supply.

The **Federal Advisory Council** consists of 12 members, one elected by each of the 12 Federal Reserve Banks, as district representatives. They meet quarterly with the Board of Governors to discuss business conditions and make policy recommendations.

Figure 2.1: Federal Reserve Map of the United States.

Federal Reserve Banks

Federal Reserve Banks have one main office located in each of the 12 Federal Reserve districts. In addition, there are 25 branches and 12 offices. FRBs provide services to all financial institutions and are referred to as "the bankers' banks," storing currency and coin, processing checks and electronic payments. All national banks chartered by the federal government are required to join the Federal Reserve and purchase stock in its district reserve bank, making each Federal Reserve Bank technically owned by the member banks in that district. Each Reserve Bank has a nine-member board of directors. State-chartered banks and other depository institutions may join if they meet certain requirements.

Each member bank has some input into the Fed's policies via the election of six directors to its district Federal Reserve Bank. All member and non-member banks are subject to the rules and policies implemented by the Fed—such as maintaining required reserves of depositors' funds.

Monetary Policy

The goal of any central bank is to stabilize the economy. The Fed's primary mission is to ensure that enough money and credit are available to sustain economic growth without inflation. These are the tools used by the Fed to implement its monetary policy:

- Open market operations
- Discount rates
- Reserve requirements

Open Market Operations

The major tool used by the Fed to affect the supply of reserves in the banking system is **open market operations**, which is the *buying and selling of U.S. government securities (bonds) on the open market.* The **Federal Open Market Committee** (FOMC) is responsible for open market operations. The FOMC meets eight times each year to discuss the present and future state of the economy, including where interest rates should ideally be to accomplish the Fed's long-term objectives of economic growth and stability with minimal inflation.

One of the things the Fed does at its FOMC meeting is try to exert indirect influence over long-term interest rates by establishing a target **federal funds rate**. The federal funds rate affects the short-term interest rate that banks charge when they borrow money in the Fed funds market (usually very short-term loans for a day or two to help banks cover reserve requirements caused by the normal daily fluctuations in their deposits).

To hit its target federal funds rate, the Fed will sell or buy **securities** (also called bonds). When the Fed *sells* federal fund securities, it is *increasing* its stockpile of cash and taking money out of circulation. Since the banks have less money available to lend, the federal funds rate rises. Conversely, when the Fed *buys* securities, it is *decreasing* its stockpile of cash and putting more money into circulation. Since the banks that sold the security (or the banks of the customers that sold the security) have more money available, the banks want to quickly re-lend the money to earn interest on it instead of just letting it sit in their banks. Since the banks have more money to lend, the federal funds rate falls.

Keep in mind, though, that other factors, such as inflation, may be applying upward pressure on interest rates at the same time that an increase in money supply is exerting downward pressure. And the Fed can only exert influence on short-term federal funds interest rates. The Fed does *not* set the prime rate, but while the Fed's actions have no direct effect on the prime rate, long-term rates do usually follow the lead established by the federal funds rate movement.

Discount Rates

The **discount rate** is the interest rate the Federal Reserve Banks (FRBs) charge financial institutions for short-term loans of reserves, although the Fed discourages banks from borrowing funds from them directly unless the bank is in financial trouble and not able to borrow from other banks on the open Fed funds market. The FRBs offer three discount window programs:

- **Primary credit.** Under the primary credit program, loans are extended for a very short term (usually overnight) to depository institutions in sound condition. The primary credit rate is set above the usual level of short-term market interest rates.
- **Secondary credit.** Institutions that are not eligible for primary credit may apply for secondary credit to meet short-term liquidity needs, but at a higher rate than the primary credit rates and with more restrictions.
- **Seasonal credit.** This is extended to small depository institutions in agricultural or seasonal resort communities with the interest rate being an average of selected market rates.

Even though each of the discount windows have their own interest rate, note that the generic term "discount rate" may sometimes be used to describe the primary credit rate.

Unlike open market operations, which interact with financial market forces to influence short-term interest rates, the discount rate is set by the Boards of Directors of the Federal Reserve Banks, and it is subject to approval by the Board of Governors. The discount rate is, therefore, less of a policy tool. Changes in the discount rate, however, can cause financial markets to respond to a potential change in the direction of monetary policy. A higher discount rate can indicate a more restrictive policy, while a lower rate may be used to signal a more expansive policy.

Reserve Requirements

Reserve requirements are the *percentage of funds that depository institutions must hold in reserve against specified deposit liabilities in the form of cash or in an account at a Federal Reserve Bank.* The original purpose of reserve requirements was to help avert financial panic by giving depositors some confidence that their deposits were safe and accessible. The Federal Reserve sets reserve requirements for all commercial banks, savings banks, savings and loans, credit unions, and U.S. branches and agencies of foreign banks.

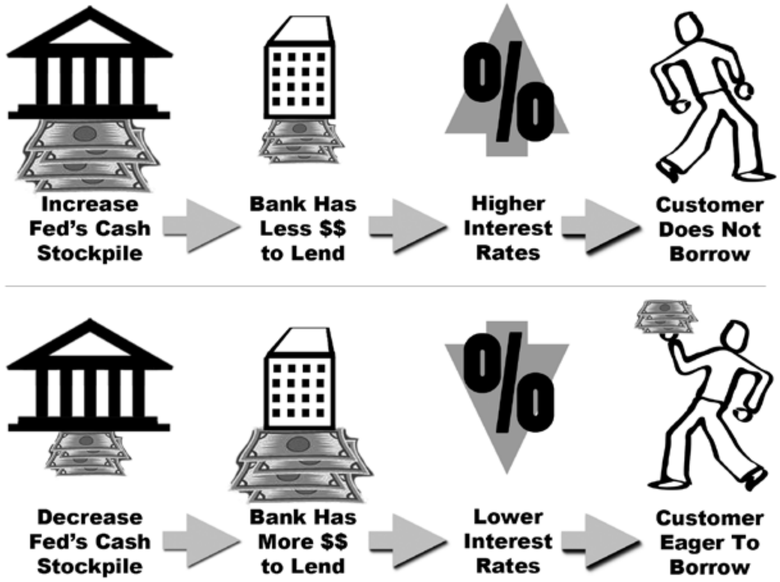

Figure 2.2 How Federal Reserve Actions Affect Interest Rates.

By raising or lowering reserve requirements, the Fed controls the supply of money, which then affects the cost of money. For example, if the Federal Reserve Board wanted to raise interest rates or make credit tougher to get, it would raise the reserve requirements, which decreases the money supply available for banks to loan. When there's a smaller supply of money, higher interest rates should decrease demand. (See Part A in Figure 2.2.)

Conversely, if the Fed wanted to lower interest rates or make credit easier to get, then it would lower the reserve requirements. Lowering the reserve requirements increases the money supply available for banks to loan out. When there's a larger supply of money, lower interest rates will result, increasing demand. (See Part B in Figure 2.2.)

So even though the Fed does not directly set long-term interest rates, changing the supply of money through reserve requirements does have that effect. Using this strategy to adjust interest rates and control inflation, however, has become a less important near-term Fed tool because it has a large effect on the money supply by affecting all of the deposit assets of banks. Instead, the Fed is able to have a similar outcome on a smaller, more manageable scale with FOMC open market operations.

Adjusting Interest Rates

The balancing efforts of the Fed are directed at managing the growth of the money supply to allow adequate growth of the economy at reasonable interest rates, without fueling inflation or fears of inflation that could lead to higher interest rates. Prior to 1979, the Federal Reserve attempted to moderate interest rates by increasing the money supply when interest rates started to rise, with the intent of causing rates to fall. This policy led to high inflation as more and more money was pumped into the economy to satisfy borrowers' demands.

In October of 1979, the Fed adopted a different approach. Rather than try to control interest rates by adjusting the money supply, the Fed instituted a policy of controlling the money supply (and inflation) by adjusting interest rates. The discount rate reached as high as 14% in 1981. The result was a much tighter credit market, since the only way to slow the rampant growth of the money supply was to discourage borrowing by raising interest rates. As inflation was brought under control, the Fed was able to lower the discount rate.

Part of the Fed's role in managing interest rates is not only to deal with actual inflation, but also with anticipated inflation. In recent years, the Fed has adopted a policy of trying to anticipate future economic conditions rather than simply reacting to them as it had in the past. This has also involved trying to further reduce the size and impact of swings in the business cycle. Most economists and businesses watch the Fed's actions when the FOMC meets to see if they will raise the discount rate to reduce growth and head off inflation, or lower rates in an effort to spur economic growth and head off recession. Although many believe that inflation is less of a threat in our current global economy, the Fed still plays an important role in managing economic growth and interest rates. Even though the Fed does not directly raise long term interest rates, by changing the supply of money, the Fed is causing the price of money (interest rates) to rise. This change affects the cost of money to the bank; the bank then passes that increased cost on to the customer.

Moral Suasion

Moral suasion is *using persuasive influences of authorities on the public so that they will behave in a certain way*. For example, a mayor appeals to community spirit as a way of increasing voluntary participation in a recycling program. Within financial markets, moral suasion is often a factor in how the public perceives credit. For example, the Chairman of the Federal Reserve Board may make a speech stating that the Fed is concerned about rising stock prices fueling inflation. Even though there may not be any intention of actually raising interest rates, the Chairman's statement may, nevertheless, still produce the desired effect of having the public and financial markets do less speculating in the market for fear of higher interest rates without actually having to raise interest rates to achieve this result.

Chapter 2 Summary

1. **Business cycles** are general swings in business activity. Real estate lags behind business cycles. The law of **supply and demand** says that for all products, goods, and services when supply exceeds demand, prices will fall and when demand exceeds supply, prices will rise.
2. **Inflation** is an increase in the cost of goods or services; cost inflation is when manufacturers pass along increased costs; demand inflation is when too many people with money want to buy the same thing. **Interest rates** are fees people or businesses must pay to use another's money for their own purposes. Interest rates are a primary factor in determining demand for real estate.
3. **Real estate cycles** are the response of real estate and mortgage markets to the forces of supply and demand. Two things separate the housing markets from other supply and demand models: The lag time for construction industry response and limited supply of land.
4. **Physical, economic, government**, and **social** forces (P E G S) affect real estate cycles. **Physical:** Location, popularity, climate, environment, internal or external. **Economic:** Economic base of an area (critical for home values), cost of money. **Government:** Federal includes fiscal policy (taxes), monetary policy (interest rates), regulation; state/local government includes revenue-generating (taxes) and regulating (police power, which addresses land use controls, zoning, environment, eminent domain, escheat). **Social:** Demographics, migration, family size, population shift, growth, age.
5. **Fiscal policy** is the government's plan for spending, taxing, and managing debt. The Treasury Department carries out fiscal policy by issuing checks, collecting taxes, and issuing notes to cover deficits. Tools of fiscal policy are deficit spending and taxation. Deficit spending occurs when expenditures exceed revenues. Taxation is a way to collect revenue and implement social policies, such as giving tax deductions for mortgage interest to promote home ownership.
6. **Monetary policy** is government's way to control supply and cost of money. The Federal Reserve Board (the Fed) is responsible for monetary policy, maintaining economic stability, and regulating banks. Policy tools include: **Open market operation** (Fed sells/buys bonds to adjust money supply and demand); **discount rate** (interest rate charged to member banks on overnight loans); **reserve requirements** (banks must keep money on deposit—can't lend it out).
7. **Moral suasion** is using persuasive influences on public and financial markets.

Chapter 2 Quiz

1. ***The cost of money***
   A. does not affect demand for real estate.
   B. greatly influences a homebuyer's decision.
   C. has no influence on a homebuyer's decision.
   D. is not the same as interest rates.

2. ***The economic base of an area***
   A. creates buyer's markets but not seller's markets.
   B. does not influence the local housing market.
   C. gives stability to a region, supports real estate values, and determines housing supply in an area.
   D. is responsible for government money coming in to support an area.

3. ***In a healthy economy, supply***
   A. fluctuates significantly.
   B. is in balance with demand.
   C. is less than demand.
   D. significantly outweighs demand.

4. ***The law of supply and demand says that***
   A. for all products, goods, and services when demand exceeds supply, prices will fall and when supply exceeds demand, prices will rise.
   B. for all products, goods, and services when supply exceeds demand, prices will fall and when demand exceeds supply, prices will rise.
   C. real estate doesn't respond at all.
   D. there will always be a shortage of houses due to population growth.

5. ***The United State Treasury***
   A. gets most of its funds from federal income taxes.
   B. is considered the nation's fiscal manager.
   C. manages the government's finances.
   D. all of the above

6. ***The interest rate charged by the Fed to member banks that borrow money against their deposits is called the***
   A. deposit insurance.
   B. discount rate.
   C. prime rate.
   D. reserve requirement.

7. ***The percentage of deposits that banks are required to maintain on deposit with the Federal Reserve System is called the***
   A. deposit insurance.
   B. discount rate.
   C. prime rate.
   D. reserve requirement.

8. ***Excessively high levels of government borrowing could lead to***
   A. excess funds for real estate investment.
   B. government securities disappearing from the open marketplace.
   C. high interest rates.
   D. low interest rates.

9. ***The agency responsible for supervising the growth of the nation's money and credit supply and regulating banks is the***
   A. FDIC.
   B. Federal Reserve Board.
   C. Office of Thrift Supervision.
   D. U.S. Treasury.

10. ***The Federal Reserve Board influences interest rates with***
    A. federal discount rates.
    B. open market operations.
    C. reserve requirements.
    D. all of the above