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MORTGAGE MONEY IN THE 1970's

Remarks of

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MORTGAGE MONEY IN THE 1970's

I am most grateful that your Chairman asked me to speak on "Mortgage Money in the 1970's," rather than in 1970. From experience, I know the farther you move your conjectures into the future the greater your chances of accuracy. You are not bedeviled by all the cross-currents, failures in adjustment, movements in expectations, and policy decisions that make estimates so difficult for the year ahead--plus the fact people are less apt to check your statements after 10 years.

Let me summarize my views of the 1970's by three short questions and answers. I will then use the rest of my allotted time in explaining how I arrived at these answers.

1. How much mortgage money will be required in the 1970's? Less than the majority are guessing but, until the Census is available, most effort spent analyzing this problem will be wasted.

2. Will a shortage of savings make it impossible to achieve the Nation's housing goals? No. The sums involved are quite small, compared to total output or government expenditures. A failure to achieve these goals will be the result of an unwillingness to make the political decisions necessary to transform rhetoric about housing goals into concrete programs.

3. Granted that the total pool of savings will be sufficient to meet our investment goals, will we be able to channel it to the mortgage market? Probably yes, although we could create enough impediments to the normal flow of mortgage funds to cause a permanent shortage. The number of errors and degree of interference would have to rise a good deal beyond present levels, however, to keep a major financial market such as that for mortgages permanently out of equilibrium.

Waiting for the Census

A year ago, when I spoke here in Los Angeles, I stated that I believed most analysts and certainly the trade papers were overestimating the need for traditional housing starts--and, therefore, the need for mortgage money--by 20 to 30 per cent. Since then estimated requirements for the decade of the 1970's have been revised down sharply.

I still think many guesses are high. If I were a business economist concerned with markets or investments, I would differentiate rather carefully between a "goal" and a "projection." Webster defines a goal as "an object that one strives to attain." Unfortunately, no matter how hard one strives, goals are frequently missed. On the other hand, Webster defines a projection as "an estimate of future possibilities based on a current trend." This, I take it, would include careful studies of expected supply and demand.

From bitter experience, however, I know this is the wrong time to debate or discuss in detail the desirable or probable number of housing starts or volume of mortgage money. We are on the brink of the Decennial Census. Each previous Census has caused major revisions in our views as to the housing stock and the demand for shelter. Anybody trying to build on existing data is likely to find, when the new Census appears, that his foundation has disappeared. Rather than suffer in this way again, I will merely suggest that six months or a year from now we will have a much sharper picture of the mortgage demands for the 1970's than we do now.

The Total Pool of Savings

One approach to the housing market of the 1970's is to ask whether or not we can expect the pool of available savings to equal the desired level of investment for the economy as a whole. If the desirable (*ex ante*) investment level exceeds the scheduled (*ex ante*) desire to save, equilibrium must be reached by higher output if resources are available; otherwise by a cut in wanted investments through some combination of inflation, higher interest rates, and credit rationing.

Over the decade, the schedules should disagree in some years. The significant question is whether a disequilibrium is likely to exist for much of the period or whether one will occur so frequently that the decade's housing production will fall below appropriate levels.

To get a picture of a possible desirable schedule for investment and spending, I have drawn on the excellent discussion of future national output and the claims upon it contained in the 1970 annual report of the Council of Economic Advisers. Table 1 is my translation of key portions of their analysis into current dollars (assuming a 2.5 per cent increase in prices per year) and into the somewhat more familiar concepts of a savings and investment equilibrium.

Table 1

PROJECTED
GNP, SAVINGS, AND INVESTMENT
1971 - 1975

(Billions of Current Dollars)

	1971	1972	1973	1974	1975
GNP available	1030	1122	1217	1300	1400
Personal consumption	650	713	776	831	894
Personal saving 1/	35	38	41	43	46
Government purchases					
Federal	94	95	96	98	101
State/local	126	135	145	155	166
Government saving	2	3	8	10	18
Gross private domestic investment	160	179	196	210	225
Business investment	124	136	145	155	168
Business saving 1/	106	120	130	143	153
Net business deficit	18	16	15	12	15
Residential investment	36	43	51	55	57
Depreciation on residential structures	17	18	20	21	22
Net deficit	19	25	31	34	35
Shortfall of claims	0	0	3	7	14

1/ That portion of business and personal saving attributable to capital consumption of residential structures has been included in "Depreciation on residential structures." The estimated breakdown is as follows:

	71	72	73	74	75
Personal saving	13	14	15	16	17
Business saving	4	4	5	5	5

Let us examine the year 1975 in which available national output is estimated at $1400 billion. Personal consumption and transfers are assumed to average 93.5 per cent of disposable income--just about the average for the past five years. This would mean in 1975, $63 billion of personal savings.

The two government sectors, Federal and State and local, under existing programs with expected population growth and price increases are expected to spend $267 billion and lend $12 billion. With existing tax rates, their total revenues would be $285 billion. If, contrary to everybody's expectations, no additional programs were added or taxes cut, they would have a combined surplus of $6 billion.

In contrast to these two sectors which are net savers, we have the traditional borrowers. The investment in plant and equipment, inventories, and net foreign is estimated at $168 billion. Against this we can apply an estimated $153 billion of business saving (excluding housing), or the net requirement of funds by business from other sectors is $15 billion.

Finally, the requirements for investment in housing are shown as $57 billion, an amount stated to be consistent with the national housing goals. Part of this sum would be available from the $22 billion of depreciation on the existing housing stock. The difference, or $35 billion, would have to be borrowed from either households or the Government. There would also be a residual $14 billion based on existing patterns of spending, taxes, and saving which could be split among the four expenditure and investment spheres. Obviously, this is a minimal amount given all the ways we would like to increase our private and public spending patterns.

The listing of the various numbers merely serves to re-emphasize the fact that, on the assumption that the private sector will continue to react as it has in the past, obtaining an adequate pool of savings becomes a problem for fiscal policy, that is to say, of government spending, tax, and lending programs. This, of course, is the major point of the Economic Report.

The implications for housing policy and for the mortgage market are also clear. If the Federal Government desires to achieve certain housing goals, devising the necessary programs is not inherently impossible. There are some, but not great, technical problems. The critical problems are political. The Government must determine what priority housing has in our national scale of values. It must then determine to translate this priority into actuality by a proper selection of policies.

In picking proper governmental policies there are critical questions of design, production, and costs on the supply side of housing. However, we need not dwell on these today since we are only discussing funds. The Government can influence available housing funds in three traditional ways: (a) by altering relative prices and, therefore, private investment and savings decisions; (b) by altering the savings pool through changing the budget surplus or deficit; and (c) by direct expenditures, direct lending, or not selling loans already being made.

Price Effects

The Government has a vast number of programs in existence to alter private saving and investing decisions particularly in the housing sphere. Subsidies, tax credits, loan guarantees, special borrowing and lending rules for private and government-sponsored institutions, over-all monetary policy, and credit policies, all affect the costs and interest rates for housing, for competing investments, and for savings. How savings are used now reflects these existing policies.

Unfortunately, we have paid little attention to the total impact of these programs. Most analysis has been at the micro level for each separate program. Rarely has the effectiveness of different approaches been measured. Rarer still are considerations of their macro or over-all impacts. When a subsidy or tax credit program is instituted, it is assumed that it will increase housing. On the other hand, much of the discussion concerned with the over-all pool of savings and major investment flows makes it appear that all the individual price effects wash out and do not influence the amount of available savings or the level of investment. Such a dichotomy appears illogical. If there is no increase in real savings, all the programs are doing is redistributing the available sum to different uses. If so, many of the existing programs are probably doing no more than offsetting the impact of other policies.

The Budget Surplus or Deficit

Governments are direct contributors to the savings pool through any budget surpluses. Some have suggested that the Government could assure adequate mortgage money by running a large surplus. I side with those who believe that such a policy is like running after a mirage, since there is a modification of Parkinson's Law which states that distant budget surpluses disappear into increased expenditures or tax reductions. Furthermore, running a surplus is an indirect and inefficient method of doing what can be done more directly.

Expenditures, Net Lending, or Reduction of Asset Sales

The idea that housing should be supported primarily through a large surplus neglects the traditional and most important form of support by the Government, namely, inclusion in the budget. I see no logical reason why any item of high national priority should not have a place in the budget.

Housing has a very ambiguous role in the Federal budget. Subsidies exist for operating expenses. Immense guarantees are authorized. However, in contrast to many other areas in which the Government has an interest, few expenditures occur for housing capital. In the period of excess savings when most of our government housing programs evolved, such a lack of capital support may have made sense. If, however, the problem for the next decade is a shortage of savings relative to capital goals, failure to support capital investment is nonsensical.

No matter of principle appears to be involved. The Government does lend money on housing through GNMA, the Farmers Home Administration, and, in the past, through FNMA. The amount of private loans available for government purchase are virtually unlimited. Under current programs, however, the Government is not only not increasing available savings, it is actually reducing it. This subtraction from available savings occurs when the Government finances part of its budget through sales of mortgage and other loan assets already in the Government's hands. For the past five years, net financial assets sold have averaged over a billion dollars a year. These were in addition to sales of over $10 billion of participation certificates. The budget for fiscal 1971 shows this net sale-of-assets item at over $3.6 billion.

The net effect of selling off these mortgage and other loans is to reduce the contribution the Federal Government would otherwise make to the pool of savings assuming that the Government would otherwise achieve the same unified budget surplus. If the Government wanted to assist in reaching the housing goals, it does not have to increase its surplus. It could increase the pool directly either by halting the sale of loans or by increasing net lending. For the projected surplus to remain, of course, the halting of mortgage sales would have to be offset by a decrease in expenditures or an increase in taxes.

This analysis is one of the reasons why I have concluded that attaining the housing goals is more a political than an economic problem. Any potential imbalances between desired saving and investment are rather small in terms of a trillion-and-a-half dollar economy. The techniques are available to insure a decade balance. To achieve the goals, however, housing would have to be given an actual rather than a rhetorical position in our national spending priorities.

A Shortage of Mortgage Money?

The final question I asked is whether a shortage of mortgage money is likely if the over-all levels of saving and investment are in balance. Can a maldistribution among financial channels occur? The existence now of a major shortage of mortgage funds is only too evident. This raises the fear that major structural problems exist in the mortgage markets which could continue to hold back housing in the future.

In analyzing this problem, we must differentiate between short-run cyclical problems and those of longer duration. We all recognize that the current situation reflects primarily the manner in which our financial system reacts when investment desires far exceed planned saving. The necessary equilibrium has been brought about by inflation, but also by price and interest rate changes, and the rationing of credit to many potential borrowers. The last half of 1969 was a classic--although extreme--case of balance being brought about through disintermediation. The flow of funds through deposit institutions fell from 50 per cent of the total for 1965-68 to less than 11 per cent. Since deposit institutions traditionally put a large share of their funds into mortgages, potential borrowers in this sphere were particularly hard hit.

Why do I think that such imbalances are unlikely over longer periods? I have partially hedged by assuming that the Government will take the necessary policy steps to insure a balance of desired saving and investment so that there is no need for inflation or monetary policy to wrench financial flows from their normal channels. With this proviso, sufficient techniques exist to insure that structural problems need not exist for adequate mortgage flows in equilibrium.

One obvious reason for this optimism is the development of the sponsored agencies, particularly FNMA and the Federal Home Loan Bank Board. In the last half of 1969, these agencies were able to issue a wide variety of market instruments and to channel funds into mortgages at an annual rate exceeding $10 billion. Since this was more than half the total mortgage flow, I conclude that we already have the necessary tools to make mortgages, or instruments backed by mortgages, fully competitive with other debt instruments.

There seem to be three major reasons why people think there can be a mortgage shortage even in a period when saving and investment are in balance.

The Equity Argument

Some, observing the scramble by traditionally conservative institutions to enter the stock market, believe that debt instruments will not be competitive in the future. This is possible although improbable. I have too much faith in American investors to assume that no relationship between stock and bond yields exists which would enable the mortgage market to attract necessary funds. I don't know what equilibrium rates might result, but I cannot see why many people would be willing to accept a 5 per cent expected yield in order to invest in stocks if they were offered a 7 per cent expected yield on a mortgage. I think the necessary marginal shifts between markets will occur before tremendous disparities arise, but it should be clear that the equilibrium will arise in terms of expected real--not false nominal--rates of return.

Inability to Pay

Some people seem to worry that the equilibrium market rate at which mortgages could be sold will be so high as to bar too many potential borrowers from the market. This argument assumes a large gap between the socially desirable and economically viable family spending for housing. Such a gap is, of course, possible. It is the reason why the housing sphere is already full of many subsidies, tax credits, and other support programs.

Again, however, the problem seems more political than economic. We are already using from $6.5 billion to $8 billion of actual or potential tax revenue annually to support the housing market. I happen to think that as a Nation we are not getting our money's worth. To reach our housing goals may require a rethinking and readjustment of our current programs. There is no reason, however, to assume that any major necessity such as housing can price itself out of the market.

Institutional Inflexibility

Others seem to believe that mortgage money will be short because this type of borrowing has been too closely tied to a group of inflexible institutions. Part of this fear arises from a confusion of the cyclical and longer run periods. Some, however, apparently believe that existing deposit institutions will use the legislative process to commit hari-kari.

They point out there are a large number of bankers and savings and loan executives who seem eager to use legislation and the regulatory agencies to protect themselves from the market. Such action only results in protection if the institutions' monopoly position is strong enough to allow them to continue to attract funds even when the spreads between deposit and market rates become large. This, I believe, is unlikely.

Obviously, deposit institutions can attract some funds even with very low rates. Some people who want instant liquidity, safety, and convenience are willing to pay for it.

If you examine the statistics of wealth, however, you find that most savings are held by a small share of the population. Consequently, most of the economy's savings are in portfolios of a sufficient size so that the time and expense of changing portfolio composition is minimal, compared to the extra income to be derived by responding to changes in rates of return on financial investments. As a result, the larger the difference in rates and the longer they last, the more will savings flow through non-deposit institutions. Deposits can be held for limited periods with major rate differences, but they won't grow. As depositors become aware of other opportunities they will decline.

The fact that deposit institutions must compete with other markets for savings is one of the reasons why the form of the mortgage should change. Variable interest rates, equity participation, differences in amortization forms are all ways of allowing deposit institutions to bring their assets more in tune with their liabilities. Unless innovations are made, they will not be able to compete with other investments nor will they hold or expand their share of savings. I believe that viable financial institutions must follow the concepts of Lincoln--not Barnum.

While a decline in deposit institutions' share of the financial flows would slow adjustments, it need not cause a shortage of mortgage money. The history of financial institutions is that new ones arise if existing ones fail to adjust. One can picture many ways in which the mortgage market could continue to operate even if the share of deposits in total financial flows fell. The fact that agencies raised more than half the money for the net growth of mortgage funds in the last half of 1969 is a good example of how the system achieves an adjustment.

Conclusion

I think you can now see why, with guarded optimism, I predict a reasonably healthy mortgage market in the 1970's. There are no obvious or intrinsic reasons why one of our major financial markets should fail to function in the future.

On the other hand, if we establish a specific goal as a matter of national policy, there is no reason to assume that it will be reached merely by maintaining the status quo. The housing sphere contains a plethora of private-public relationships. Over time, these have been quite successful in insuring that the total number of housing units has grown roughly in line with household formation. They have not, however, protected the industry from major cyclical shocks, nor have they furnished the quality of housing deemed desirable on social grounds.

With a large number of existing and possible programs, the problem of constructing enough units to meet national goals does not appear any more difficult for the next decade than it has been in the past. The estimates show no large required shifts in resources or income. The basic tools already exist in the budget to insure that we can raise the total amount of savings needed to pay for the desired investment. Whether or not such decisions will be made will depend on the political process.

While, given the size of past programs and the economy, the additional resources needed for a desired equilibrium do not appear large, a specific effort may be required to achieve them. The important requirement is that the level of savings, including that produced by the Government's surplus or net lending, equal the desired level of investment. When such an equilibrium occurs, most of the problems of the mortgage market will disappear.

While other difficulties may be created if attempts are made to maintain outmoded practices, hold monopoly positions, or frustrate normal market reactions too long, such attempts are likely to be self-defeating over a period as long as a decade. Our institutional structure is unlikely to remain static. Adjustments, whether welcomed or fought, are likely to occur. The need is that they be recognized and planned for so that the costs and suffering to existing institutions from change can be minimized.

Those concerned with housing need to re-examine the logic of their position in several public policy spheres. Personally I believe--and have for many years--that too much stress has been placed on specific programs and hoped-for panaceas. In developing policies, many programs simply shift resources from one sector of the housing market to another without making more available. Others pay for the housing of people who could well afford to pay the entire bill themselves. More attention must be paid to the macro, or over-all, program. When a program is proposed, we should ask whether it really increases resources or saving available for housing or whether it simply reshuffles a limited total.