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MONETARY POLICY AND THE MORTGAGE MARKET

Remarks of

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The French have an old saying which translates roughly as "The more things change - the more they remain the same." That is my theme for today. While current mortgage market pressures are tremendous, the basic situation differs from previous ones only in degree. The main forces at work in the current mortgage market are neither unusual nor unexpected.

For two reasons, however, the intensity of the problem is somewhat magnified: (1) The mortgage market had been unusually expansionary in the four years, 1962-1965. That degree of ease probably could not have continued even if there had not been a basic change in the economy. (2) The upsurge in the economy to supply war production for Viet Nam and the accompanying splurge in business spending were far sharper than an ordinary peacetime movement. As a result the reactions in the money and credit sphere have also been sharper.

For the short run, the probabilities are that the pressures on the mortgage market will not increase. Most likely, we have passed the low point in the flow of new commitments.

For the long run, a major alleviation of the mortgage market's recurrent bouts with tight money will come only through the adoption of procedures allowing a more flexible use of fiscal policy. Unless we devise a system whereby Congress and the President can use fiscal policy with greater ease, we can expect mortgages to experience problem years akin to 1966 over and over again.

"The More Things Remain the Same"

I could have prepared my talk with you today on this subject with a minimum of effort. When I went back to my files, I took out some testimony I had given before the Joint Economic Committee in November 1957. Then I looked at the section on monetary policy and mortgage markets in my book, Financing Real Estate (McGraw-Hill). Next, I examined the speech I gave before a real estate group last December. I also looked at many others. In each case I found that if I updated some figures I could give the same speech today that I already had in my files.

Let me hasten to say I don't intend to do that, but the point is that this series of speeches and writing has attempted to explain the basic institutional relationships between the money market and the construction and mortgage markets. In each case, I pointed out the costs and advantages of the existing relationships. I also drew what seemed to be obvious conclusions. Clearly the construction and mortgage markets are more extremely affected than any other major market by the changes that result when monetary policy is used aggressively to counter destabilizing economic developments.

The real estate and housing industries in the long run would be far better off if they advocated a tax system which enabled flexible fiscal policy to substitute to some degree for the present reliance on monetary policy. While the rest of the country does not have as much at stake as you do in changing procedures, I think the whole economy would work better if there were a shift in emphasis.

I must say that if I were not a confirmed optimist, I would have felt depressed by the failure of this analysis to have much impact during these past ten years. That would have been particularly true during this last year. Last spring and summer it seemed to me that many leaders in housing and real estate were advocating policies whose effect threatened near disaster to your industry. They appeared to be giving minimal support for many of the changes which were indispensable if the situation was to show any lasting improvement.

Change is possible only if there is a widespread understanding of a problem and the forces which create it. Let us examine more carefully how monetary and fiscal policy work and how they affect mortgages and housing.

The Reasons Monetary and Fiscal Policies Change

Let us start with a simple picture of our economy. While we would like economic progress to move along a smooth growth path with all parts expanding together, this rarely happens. For numerous reasons, at times some expenditure streams show bursts of growth. If enough spurt together, they may force demand up so fast that it exceeds the possible growth in the supply of labor and plant and equipment. The result is an inflationary rise in prices and a threat to savings and industries such as yours dependent on a flow of credit.

For example, this year Viet Nam expenditures and business spending on plant, equipment, and inventories shot upward. Rapid expansion in both these areas, plus the related increase in spending by consumers out of their enhanced incomes, boosted the demand for goods and services faster than production could expand. This excess demand, plus cost-push influences at work in particular industries, caused prices to climb at an inflationary pace.

To hold down inflationary pressures, the growth in demand must be limited to the rates at which potential supply can expand. A curtailment of excess demand can be accomplished through either fiscal or monetary policy.

The fiscal path is simplest. The Government may cut back expenditures to reduce demand directly. Or it may increase taxes. With less after-tax income, people or corporations will reduce spending until it falls within the available supply.

How does monetary policy achieve a similar result? The monetary authority refrains from increasing reserves and hence the ability of banks to create money and credit as rapidly as customers would like to borrow to finance their inflated demands.

As a result, potential borrowers increase their bids to get more credit. Interest rates start to rise. Some potential borrowers find themselves squeezed out of the market. They cut their demand for goods to fit their income rather than their income plus hoped-for borrowings. By this process demand is eventually reduced--ideally to a point at which it just equals the expanding supply.

Policies' Differential Impacts

While these alternative policies aim at the same over-all effects--to achieve a growth in demand that fosters a non-inflationary expansion of production with full employment--they obviously have significantly different impacts on groups in the economy. The time required to bring about adjustment differs with the type of policy used and so does the likelihood that adjustment will occur.

The differential impacts can be seen from the groups immediately affected. With lower governmental spending, the impact depends upon which programs are adjusted: space activities may be cut; highways delayed; schools understaffed; hospitals not built. With higher taxes, the cut-backs will depend on whose taxes are increased and how he curtails his spending.

When monetary policy is used, the cuts will come,in the first instance, among those groups whose spending is highly dependent on credit. Within the credit sphere, the relative impact will depend upon the percentage of purchases made with credit, the willingness or ability of a group to absorb higher interest rates, the institutional character of lending, and lenders' own preferences.

An examination of each of these factors shows why real estate and construction are almost certain to experience the sharpest cuts.

The Impact of Monetary Policy on Lending

When the rate of expansion of credit does not match the inflated demand for it, then to be specific:

1. Interest rates rise.
2. Savers shift from financial institutions to direct investment in credit markets.
3. Losses are uneven among financial institutions.
4. Some financial institutions shift away from mortgages.
5. Since real estate markets are heavily dependent on credit, spending within them decreases because of the lowered availability of mortgages.

Each of these reactions is what one would predict as the result of the normal operation of a free enterprise system. The law of supply and demand operates to give funds to those most able and willing to pay for them. It shuts out those who can't or won't offer as much. Let us see how these forces have worked out this year.

The shift from financial institutions. In 1966, the total amount of money raised in the credit markets will be roughly the same as last year. Somewhat over $70 billion will be borrowed. Business corporations, FNMA, and savings and loan associations (through the Home Loan Bank) will have borrowed more, while the housing market will borrow a good deal less.

Actually, because of prior commitments, the shifts in funds advanced this year will not be great. The manner in which this money is raised, however, will be very different. The amount going through financial institutions has been cut about in half, while that raised directly in the capital and credit markets has been tripled. The bidding of firms to raise money directly from saver-investors rather than from financial institutions has caused this year's rapid run-up in market rates.

The shift among financial institutions. Among financial institutions, the shifts have been in the same direction although accentuated compared to the past. Insurance companies and pension funds will have grown about as much as last year. Based on their results in the first three quarters, deposits in commercial and mutual savings banks will have grown at a rate slightly more than one-half of last year's, while savings and loans will have increased their shares at less than a third of last year's rate.

Again, history and analysis show the logic of these results. The ability of an institution to withstand the challenge of the market depends on the existence of firm contractual relationships with savers or on its ability and willingness to raise rates in competition with the money market.

An unfortuante fact from your point of view, however, is also obvious. The appeal which an institution retains for savings vis-a-vis the market is inversely related to the share of its funds it puts in the mortgage market. The greater its concentration in mortgage lending and the slower its earning capacity adjusts to changes in market conditions, the more likely it is to fall behind in the battle for funds in a tight market.

The shift away from mortgages. While the statistical picture is blurred by the continued flow of loans made against prior commitments, financial institutions also appear to shift some of their funds away from mortgages to other parts of the credit market as interest rates rise. Their action reflects the emergence of relatively more appealing rates elsewhere. The amount of shifting they undertake depends on the institutional conditions under which they lend. Insurance companies, for example, can shift with greater ease than do savings and loans.

The Impact on Real Estate

I don't need to explain to you the combined effect of this decrease in the rate of increase in mortgage money during 1966 (note mortgage funds are still expanding) on your business or on housebuilding. We know that the rate of housebuilding has fallen about 30 per cent. This kind of movement is typical of most past periods of monetary restraint, but the 1966 contraction has been sharper than most.

I also won't attempt to weigh with you the pros and cons to the country of having housing absorb so much of the reduction in spending required to balance demands and supply. I know you all hold completely unbiased views on this matter, based only on what is best for the economy. The analysis is too complex for my time today and it is available in my writings.

We should, however, recall the reasons why construction is likely to have to bear a disproportionate share of the needed adjustment. Building is highly dependent on the availability of savings and credit.

When people and firms put fewer resources at the construction industry's disposal, construction must cut back to fit within its reduced share of available savings and credit.

If the period of curtailment is short, such a reduction does less harm than in many other areas. A relatively large inventory of building space--the good actually consumed--typically is already in existence. As a result, fluctuations in construction can be wider than in the production of other goods--for example, bread--without as immediate an impact on living standards.

In periods of investment booms such as the present when many businesses are strongly increasing their bids for construction labor, materials, and equipment, some users must reduce their demand. The problem is to devise something that will insure the fairest sharing. Most people feel inflation does not do so. It is probably better to have demand curtailed through credit or taxes rather than through an inflationary rise in wages and prices.

It is also probable that in the last few years the rate of housebuilding and the availability of mortgage money were running above a sustainable level. Many observers believed some contraction was inevitable. If this were to occur, it is better for it to result from outside pressures and not from financial disasters in the real estate field. Reaching an equilibrium of real estate supply and demand as a result of vacancies, mortgage foreclosures, and bankruptcies is an exceedingly expensive process both for the individuals involved and for the nation.

Still, granted all these factors, few would hold that the current contractionary pressures on your industry are either sustainable or tolerable for very long. Most would agree that the number of housing starts has fallen below the optimum. This is true both from the point of view of your industry but also from the vantage point of the country as a whole.

Next Year's Flow of Mortgage Funds

While the imponderables are numerous and the qualifications surrounding any statement must be large, I do feel that we have reached a low point in the flow of new mortgage commitments for the housing market.

There is a decided unfulfilled demand for mortgage money. Any general surplus of housing which was built up has now disappeared. The demands for new housing at reasonable prices would probably support a level of close to 1,500,000 starts this year.

This means that actual housing starts next year will depend essentially upon the flow of mortgage money and that will depend, in turn, upon the amount of savings coming into financial institutions and the competition for those funds.

I am not quite certain how to evaluate the Federal Government in this supply-of-funds picture. The Government this year has increased the size of its net surplus or savings in its total financial accounts by a small amount over last year. At the same time, it stepped up the amount of its borrowings on Federal agency securities issues in order to put a great deal of extra money into mortgages. Critics hold it should have increased its surplus by more and that its support of the mortgage market was at the expense of the money market in general.

Next year's plans are still in the process of formation. I would guess that the Government will raise as much and perhaps more money for mortgages. The size of the surplus or deficit will depend on Viet Nam and on whether or not a tax increase is voted. I think it likely that the Administration would welcome less pressure on the mortgage market. Its decision as to whether or not to ask for a tax increase will be based partly upon this desire, plus a careful weighing of the projected over-all pressures of demand against available supplies of labor and productive capacity.

The main imponderable is the business sphere. This sector had the largest increase in demand in the past two years. The expanded flow of funds to businesses through the securities markets and banks has been the paramount feature of this period. This shift in amount and the channels it has taken account for a great deal of the rise in interest rates. What is not clear is how much of this demand was abnormal or speculative.

The contribution of banks and insurance companies to the mortgage market will be highly dependent on how large the competition is from this business demand. I think that the rate of expansion in their mortgage loan portfolios will decline further, but not their level of new commitments.

The availability of mortgage funds through savings and loans and mutual savings banks should increase.

The reason I am more optimistic about mortgage commitments from thrift institutions is that I believe they have passed through a major period of adjustment which was partially of their own making. In the years after 1960, many of these institutions by their aggressive policies on rates and advertising attracted funds that could be properly characterized as "hot" money rather than real savings. This over-expansion was also reflected in an over-large volume of mortgage lending.

Money attracted on a rate basis is very likely to be lost when relative rates shift. This has historically been true. Because of past excesses, however, this year's reaction was more than normal. The "hot" money flowed back into the money market. Gross receipts of thrift institutions continued to rise this year, but their withdrawals shot up even faster.

By now much of the most interest-sensitive money appears to have departed. If these heavy withdrawals slow down, the net inflows should improve. One factor still to be reckoned with, however, is that some smaller savers seem to be becoming more conscious of the money markets. A learning process is at work. The more people become aware of market interest rates, the more they are tempted to give up liquidity and seek higher rates.

I should also say that the ceilings established on rates paid by the three main types of depository institutions seems to be accomplishing its purpose. The ceilings cannot insure non-bank savings institutions of a larger share of financial funds. In fact the danger has always been present that if ceilings were set too far from prevailing rates in the money and credit markets, an actual loss of funds would result.

Rather, the ceilings were established to halt a further escalation of a rate war among financial institutions. Still higher rates this year would not have improved the relative distribution of funds. At the same time, they could have done a great deal of harm to institutions locked into large-scale holdings of older mortgages at fixed rates. The ceilings now appear to be at levels that can help in maintaining viable financial institutions.

The Need for Stabilization Policies

What do all these considerations imply as to the proper course for public policy? They do not mean, as some may assume, that the shortages of mortgages should lead to a creation of more money. Clearly, unless some of the competition for the limited real resources is reduced, we get nowhere. We end up in the same spot. The mortgage market would still find itself out-competed by other demand. Only prices would be higher. The resulting inflation would probably mean a complete disorganization of your market in the future. This country has been fortunate to have a well-operating mortgage market. The experience of other countries makes it clear that if we experienced a period of sharp or persistent inflation, we could not expect to raise money on mortgages with our former ease.

Neither can the problem be solved through Government fiat by setting limits on individual interest rates at least as long as we maintain a free economy with free choice. Unless control could be and was established over all money flows, borrowing sectors with greater profitability or with traditional relationships to financial institutions would continue to come at the head of the line. They would continue to receive funds at the expense of others.

The long-run good health of the real estate industry as well as the rest of the economy depends upon policies that can equate supply and demand at a non-inflationary level. Stabilization programs which depend less on monetary policy will put less of a squeeze on mortgage availability during periods when general demand is excessive. Adoption of such policies should be your logical goal.

As a practical matter, monetary policy's role will be reduced only if procedures are developed which allow a more flexible use of fiscal policy. Many different proposals have been made as to methods of achieving such flexibility. I doubt if any will be adopted, however, until there is a more widespread understanding of their need, plus a popular demand for their enactment.

I feel, as I have for many years, that you and your industry should be among the foremost exponents of developing new means of increasing tax flexibility. Much of your postwar prosperity has occurred because of the significant reforms which have been achieved among financial institutions and credit markets by a progressive evolutionary process. Your future prosperity as well as that of the nation may well depend upon a similar progressive evolution in fiscal procedures. I urge you to give this matter your most careful and serious attention. I hope if I am asked to give a talk five or even two years from now I won't be able to use today's speech over again.