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Statement of

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before the

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of the
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Mr. Chairman, I appreciate your invitation to participate in these hearings. I would like to make it clear that the views I present are my own and not necessarily those of the Board of Governors of the Federal Reserve System.

The requirement of the 1968 Housing Act that the President transmit an annual report on national housing goals seems to me a very valuable one. Housing has suffered from a lack of long-term planning, from wide fluctuations, and from too little sustained attention to its many critical problems. The preparation and presentation of an annual report on recent progress and future plans plus hearings such as this should help fill some of these gaps.

Today, I would like to speak briefly on three issues raised by the report.

First, I would like to discuss certain technical problems of setting housing goals.

Second, I would like to discuss the difficulties of insuring adequate resources--both financial and real--to do the required production job in this coming fiscal year.

Finally, I want to explore some longer run problems of meeting our national housing goals.

Clarification of the Ten-Year Goal

The first Annual Report on National Housing Goals for the next decade represents a milestone in our attempts to meet the ideal initially proclaimed in the Housing Act of 1949 of a decent home and a suitable living environment for every American family. However, the assignment of numbers of housing units to that goal raises many problems. Some problems are purely conceptual. Others involve questions of statistical fact. These questions arise with respect to the estimates of needs. Separate and even more difficult issues exist with respect to feasibility and the general economic conditions within which priorities to meet the needs will be set.

One major area of uncertainty is how to relate our statistics on housing starts as reported by the Bureau of the Census to the 26 million new and rehabilitated housing units which the Housing Act says should be produced if our national goal is to be met within the next decade. A key to this question is how many units will be produced through rehabilitation and how many from other production, such as mobile homes, which are not reported as housing starts in the Census Bureau statistics but do provide shelter.

As an example, some readers of Tables 1 and 3 of the first Annual Report on National Housing Goals have assumed that a total of 24,200,000 new Census starts are called for during the 10 years, or an increase from 1,625,000 starts in the fiscal year 1969 to 2,975,000 units in fiscal year 1978.

I am not certain whether or not this is a proper interpretation of the Report. In stark contrast I have seen estimates that our national housing goal might well be met by a total of less than 19 million Census starts for the 10-year period. Clearly, the difference between 19 and

24.2 million units is major. One estimate, in effect, sees a need for only a moderate expansion in the productive capacity of the house-building industry. The other estimate would require more than an 80 per cent expansion by the industry.

These major differences arise in part because of a lack of clarity in the definitions of "rehabilitation" and "production." These definitional problems are noted on page 18 of the Report and also on page 12 where the significance and potential of mobile housing units is discussed. However, nowhere in the Report are rehabilitation and non-standard production directly related to the future target levels. Since these potential problems are so large and so critical, both for projecting goals and measuring results, they should be carefully considered and resolved.

Another part of the difficulty--and one which requires major attention by this Committee--is our current inability to measure actual year-to-year changes in our housing stock. We have very poor information on annual levels of production, or rehabilitation, or changes in quality of the existing stock of housing. It seems obvious to me that if our nation is to achieve the 10-year housing goal set for it, Congress must insure that the necessary data are produced upon which to judge progress. At the moment, we must rely on uncertain and often conflicting subjective opinion. We may be planning for much too small or much too large a program.

Although the Housing Act of 1968 requires the President to report to the Congress each year on the number of completions of new or rehabilitated housing units and on the reduction in occupied substandard housing, no one has the information needed to make such a report. This information could be obtained by an annual sample survey which would permit an estimate of the required data on a comparable basis and in a manner similar to that provided by the "Components of Inventory Change" in the 1960 decennial housing census. Progress toward our goal and useful surveys require that we improve our measurement of substandard housing. Various estimates of existing substandard units currently differ by several millions.

Without annual and timely sample surveys of the components of inventory change, we can have only a dim view of whether or not we are making progress toward fulfilling our national housing commitment. As I indicated, the current views as to shelter needs in terms of housing starts differ substantially. Given the social and economic importance of achieving our housing goals, it seems clear at least to me that provision of more complete and current information as to where we are and where we are going is required.

Prospects for Housing in Fiscal 1970

Let me now turn to the prospects for housing production next year. I wish I could be as hopeful as the Report that 1,900,000 housing units will be started in the next fiscal year as reflected in the Census series. I believe that the basic demand for houses will be at least that large. However, unless there is a major deceleration in our commitment in Vietnam and a much larger Federal budget surplus than is now projected, I think housing construction will fall below that level. The result could be an intensified housing shortage and inflationary increases in dwelling prices and rents.

Currently, governmental policy, including that of the Federal Reserve, aims at limiting growth of aggregate demand. This is obviously an appropriate posture for a time when widespread inflation has reflected an excessive demand pressing against a limited supply of goods and services. Unfortunately, however, given the current make-up of our financial institutions and credit markets and the fact that housing is inevitably financed heavily with borrowed funds, the impact of monetary restraint is again likely to fall more heavily on housing during fiscal 1970 than on most other types of spending.

Inflation is caused by too large a demand pressing against limited real resources. The Vietnam war, rapid increases in business investment in plant and equipment, continued growth in State and local spending, plus the consequent increase in consumption from higher incomes, have combined to overtax our economic resources. The shortage of productive capacity--including labor--has led to a rapid acceleration of prices.

National policy has been set with a view toward bringing demand more in line with available resources so as to ease inflationary pressures.

As part of this program, fewer monetary reserves are being created. Consequently, less credit is available in relation to demand and its price is higher. In these circumstances, the ability to raise capital funds for housing or other purposes in the mortgage market is in danger of sharp curtailment. This leads to a problem for potential purchasers of houses and borrowers on mortgages.

The mortgage problem, as has been demonstrated time and again, is really the opposite side of the resource problem. Housing loans must draw from the general credit pool, just as housing production must draw from the national production pool. The amount of expansion in the pool of credit is in turn related to the amount of the economy's savings. For mortgage funds to be maintained at an adequate level, either there must be more savings (unused spending) or a moderation of demands from other claimants for funds from this pool.

Currently, the demands from the Government sector, and for capital equipment and consumption, remain exceptionally great in spite of attempts now under way to reduce them. While savings flows to thrift institutions have largely been maintained, those to commercial banks-- an important direct and indirect supporter of the mortgage market-- clearly have not been. Moreover, mortgage repayments flows have been limited as prepayments have remained moderate and there has been increased reliance on assumptions of existing mortgages in transactions on used houses in order to avoid new financing under current high interest cost conditions.

This means the greater the surplus the Federal Government can achieve in fiscal 1970, the greater the potential availability of mortgage funds. It also means the greater the success in achieving some moderation in the present extraordinarily high business plans for plant and equipment expansion and in consumer expenditures, the greater the potential for the mortgage market.

In any case, it does appear that financing for residential construction will be hit more moderately in 1969 than it was in 1966. Since 1966, we have achieved a number of institutional and other adjustments. The liquidity positions of the thrift institutions have improved, while the Federal Home Loan Banks can make available a firmer support. In addition, ceilings on rates paid on deposits maintain rate differentials for savings which make possible a more stable distribution of funds between commercial banks and the thrift institutions. The development of savings certificates at higher rates for longer maturities as a substitute for across-the-board adjustments on regular accounts, and the elimination of most "hot" money from liability portfolios also have meant that thrift institutions could weather even such incidents as the recent withdrawal period, when surtax payments were a special factor, with relatively less attrition than had been generally expected.

Within the Government-assisted sector, the market has benefited appreciably from the freeing of the ceiling rates for Government-underwritten mortgages to levels more consistent with market requirements. Also, the position and role of FNMA as a "market-maker" has been redefined and considerably improved, and the possibility of a new type of mortgage bond, guaranteed by a new agency--GNMA--appears imminent.

In the market for existing houses, consumers have learned to economize on new mortgage funds through reliance on assumptions of existing mortgages. And in the important multi-family area, builders have increasingly resorted to various types of equity and non-traditional financing for necessary funds. At the same time, a number of important builders have considerably broadened their capital base as well as their ability to tap other sources of funds by mergers with larger, more diversified materials producers and other types of companies.

Further improvements, including, of course, a better mix of fiscal and monetary policy as well as implementation of a number of promising provisions included in the Housing and Development Act of 1968, can hopefully be anticipated. Altogether, there is no question that, with the major exception of commercial banks, market participants are in a far stronger position and mood to compete for necessary funds, than was the case in 1966.

In its concern about the disproportionate impact of general credit restraint on the housing sector, the Federal Reserve Board has recommended on several occasions that consideration be given to ways of shifting more of the burden to other sectors of the economy. In that connection, I would like to include as part of my testimony a copy of the report which was transmitted recently by the Board to the Commission on Mortgage Interest Rates. This report goes into greater detail about the effects of credit restraint on home building, discusses the general subject of housing goals, and calls attention to some additional reforms needed in the mortgage market.

I would also like to point out another matter that probably requires legislation. This would be the authorization for inclusion of variable interest rate clauses in mortgages insured by the FHA, guaranteed by the VA, or issued by federally regulated lending institutions. Variable interest rates should not alter the borrowers' monthly payments but rather should increase or decrease the amount of repayments on principal made each month and, therefore, the ultimate term of the mortgage. However, it is not clear whether existing statutes limiting the maximum term of a mortgage would allow constant payments to be maintained.

While the recent changes and the proposed ones to improve mortgage market operations will be useful, I think all of us should recognize that they will only dampen the impact of monetary restraint on housing finance and construction. A large share of fluctuations in the availability of credit will still be felt in the housing sphere. Such a result follows directly from the choices that must be made in establishing national priorities. If monetary policy is used for restraint purposes, the attainment of a given housing goal will be more difficult. This means that the question of priorities must be faced up to directly. Over the next several years, for example, if military or related expenditures stay large, Congress may well have to make certain that funds are available for needed housing by specific legislation. This could be done either by voting the necessary funds in the budget; or, if present indirect systems of mortgage aid are maintained, by increasing the size of the Federal surplus sufficiently to insure a credit pool adequate to meet the needs of housing borrowers.

Housing for Moderate- and Low-Income Families

Finally, I must say that I am even less sanguine that the goals for low- and moderate-income housing will be met than I am about next year's level of starts. Even though the Housing Act of 1968 made major and important improvements, I believe that our ability to achieve either the short- or long-run goals of public policy will depend heavily on further major progress by the Congress and the Administration in this sphere.

What is the basis for my conclusion? Under present procedures, low- and moderate-income housing is likely to be so costly that too little may be built. The procedures entail so many delays that production is likely to grow more slowly than needs. The programs' size and availability of land and financing are so uncertain that progress can be difficult.

Moreover, these deficiencies are all closely inter-related. The uncertainties and delays lead to high costs. What is required is better technology, better entrepreneurship, and better programming. If policies are reshaped it is quite possible that needed improvements can be achieved simultaneously.

The history of the past 20 years has shown that through Government aid to the private market, major improvements in efficiency and operations have been possible for middle- and upper-income housing. The question is whether a similar range of programs can be made available to that part of the housing market left behind by existing programs.

I believe, contrary to many, that our suburban, single-family, mass market for new homes is relatively efficient. People who can afford to pay $20,000 or more for a house have had their needs met quite adequately--although in this market, too, rapidly accelerating costs have been decidedly harmful. In the lower cost area, however, far less progress seems to have been made. Housing units built in central cities, particularly those of a multi-family type, show fewer improvements in productivity and efficiency. It is because of this development that I am pessimistic about meeting the six million "new and rehabilitated" portion of our national housing goals.

While the achievement of real mass production in multi-family housing has been a chimera over the years, given the determination of the Congress to meet our housing goals, perhaps this need no longer be the case over the next decade. Cities are developing more open land in their centers. Congressional action ought to be able to guarantee a sufficient market to make it worthwhile for large firms--whether such as those entering the national housing partnership or others--to be willing to make the necessary commitment to large-scale production. These firms will require sizable contracts, considerably larger than in the past, and perhaps a different tax or subsidy treatment.

I also believe that some of the stress on non-profit organizations in the development of moderate- and low-income housing may be self-defeating. Just as our housing programs should draw upon the widest possible variety of financing techniques and institutions to provide funds for housing, so should they make the greatest possible use of the physical resources and technical know-how of private developers, operators, and builders. All aided housing programs should, in my opinion, be open under proper safeguards to profit-oriented organizations as well as to nonprofit, cooperative, or limited dividend corporations to which certain programs are now restricted. Restrictions against normal corporations--which arbitrarily exclude the majority of all housing producers--shrink rather than expand our production horizons.

The profit motive, particularly in an activity as localized as housing, can serve as an incentive to improved efficiency and productivity as well as to the dynamic institutional changes required for expanded output. We have recently seen a few large, profit-making industrial organizations drawn into the housing field,backed by established access to varied sources of credit and with a potential for realizing economies of larger scale production. This is the kind of structural change that improves the chances of achieving our annual housing goals.

As I have said frequently in the past, I would also urge your Committee to re-examine ways of improving our direct, credit, and tax subsidy programs to housing.

In striving toward our longer run housing goals, the general scheme of tax incentives for real estate, housing, and home ownership seems far from ideal if it is recognized that it is the needs of the lower income households that presumably merit the most attention. Indeed, present tax incentives may operate in exactly the contrary fashion.

As the Douglas Commission and others have pointed out, present tax laws and regulations give no preferential treatment for investment in lower income housing relative to other types of rental housing. Moreover, incentives for home ownership actually work in favor of higher rather than lower income groups.

It is the higher income homeowner, for instance, who is most likely to benefit because the imputed rent value of his home is not considered part of his gross income subject to taxation. Also, higher income groups undoubtedly benefit more from permissible homeowner deductions for property taxes and mortgage interest, owing to the progressive nature of the income tax rate schedule and the wider use of itemized deductions by higher income groups.

Nor is it clear that lower income groups may obtain even a proportionate--not to mention preferential--share of total housing tax benefits coming from other sources. These include provisions for rapid depreciation, related capital gains, and other special features affecting rental properties. They also encompass the special tax treatment of thrift institutions primarily related to their function as home mortgage lenders.

While traditionally we have thought of special subsidies as the way to channel aid toward those most in need of assistance, in actuality, our tax programs may be directing the largest share of Government revenues spent or foregone toward aiding those least in need of help. Further clarification--and where appropriate, resolution--of this issue along with a clearer distinction between the role of the public in aiding occupancy in contrast to aiding production could help to focus policy more effectively on fulfilling our over-all housing goals.

Conclusion

In conclusion, may I congratulate this Committee again on the fact that a Report on National Housing Goals has now become part of our programming process. It should lead to a clearer view of national needs and priorities. I wish I could be more optimistic about the near-term future. An increase of one-fifth in Census housing starts next year as projected in the Report would put us solidly on the road toward meeting our national housing goals. To reach that level of production would, however, require a considerable reorientation of our current national priorities. Without such a change, we are likely to see housing production fall farther behind needs.

Housing Production and Finance

The Commission on Mortgage Interest Rates—established by the Congress last year and composed of four Senators, six Congressmen, and five public members—submitted to the Board of Governors of the Federal Reserve System background questions relating to housing production and finance. Answers to the questions are contained in the following Staff Memorandum which the Board in February 1969 authorized to be forwarded to the Commission.

1. It has been estimated that the Nation's housing needs during the coming years require, on the average, construction or rehabilitation of 2 million housing units a year for the general commercial market plus 600,000 units a year for low-income families.

a. Do you foresee an adequate *supply* of mortgage funds to finance this volume of homebuilding (or whatever volume you feel will meet the Nation's needs)?

b. Do you foresee that these funds will be available at "reasonable" *cost* (i.e., at reasonable interest rates) to builders and home buyers?

c. Do you favor a combination of sufficient fiscal restraint and monetary ease to assure that the needed real and financial resources are available to support this volume of homebuilding, while maintaining reasonable price stability?

Any steps to meet our housing goals within the framework of a free market system obviously will have to be taken in the context of over-all public and private requirements for all types of goods and services—including defense and other priority Government programs. If these demands in aggregate continue to press against our growing but still limited resource capacity—which we think likely—then it will be necessary to employ meaningful economic restraint in public economic policy—through monetary or fiscal measures, or both. It follows, therefore, that to the extent social priorities call for an easier monetary policy than otherwise would be indicated, fiscal policy must be commensurately more restrictive.

Stating housing goals in terms of number alone, however, can be misleading in any determination of over-all credit requirements. First, there is the question of whether credit flows can be diverted from other uses into housing through improvements in markets, subsidies, and other inducements. Second, there is the question of how much credit will be needed to finance the housing goals. What proportion of starts in the regular market will consist of lower-cost multifamily units, for example? What allowance in either the regular or subsidized market is to be made for lower-priced mobile homes, which do not count as starts but do provide shelter? What shifts in the regional distribution of housing starts are to be expected? Different assumptions about these and related compositional factors would obviously yield significantly different estimates of financing requirements.

Stating housing goals in terms of funds required just for *new* housing may also be misleading in terms of the total credit burden implied. An annual starts average approaching 2.6 million housing units—or nearly three-fourths above last year's total—would, for example, involve a large—though perhaps less than proportionate—increase in the number and dollar volume of supporting transactions to be financed in the market for existing homes. In addition, it would require a commensurate increase in outlays for schools, streets, and other elements of the necessary infrastructure with comparable pressures on funds from both public and private sources.

So far as residential and other mortgage funds are concerned, under present institutional arrangements the principal source of credit will continue to be the four major financial institutions—commercial banks, savings banks, savings and loan associations, and life insurance companies—and Federal National Mortgage Association–Government National Mortgage Association. For the year 1968, when private housing starts reached a 4-year high of 1.5 million units, these groups made gross investments in mortgages for all types of properties totaling about $62 billion. The increase in housing starts postulated, along with associated demands, could require gross mortgage funds for all purposes each year of over $100 billion from these four lender groups and FNMA–GNMA alone, assuming no change in prices and no significant change in the housing mix. And this would not include such funds as would also be required from other private and public sources.

Of course, some allowance may be made for greater efficiency in the use of mortgage funds for new as well as existing residential construction. Examples of changes related to such efficiency are larger downpayments, greater assumption of first mortgages (with private placement of seconds), and lower costs per unit of housing. And some allowance can be made for (a) further increases in equity or bond market financing, particularly in the case of multifamily structures and for (b) increased subsidy allotments from Federal funds even under the assumption of relatively tight budgetary constraints. New lenders, such as pension funds, may also be attracted increasingly into mortgage investments. But it still appears that ultimate results will continue to depend mainly on the ability of depositary institutions to compete for the funds necessary to expand their mortgage lending volume.

The future ability of these mortgage lenders to attract more loanable funds through regular depositary channels may be limited by the shifting population distribution, which—unlike the early 1960's—will involve most rapid growth for adults under 35 years of age. This age group, of course, tends on the average to incur debt rather than to provide savings. Ability to attract more funds will also be limited by the increased saver-sophistication about relative yields available on instruments other than savings deposits, as events since 1965 have proved. Thus, we are not prepared to say that the principal financial institutions as a group will be able to provide gross mortgage flows at an average in excess of $100 billion annually over the years immediately ahead.

Repayment flows (based on regular amortization or prepayments) from growing mortgage portfolios held by lenders will be a growing source of funds supporting savings flows. But as in the past, a very large share of mortgage repayment volume will be needed to support transactions in the growing stock of existing homes at prices that will usually be higher than they were when the mortgages to be replaced were originated. Nor can it be assumed that all mortgage repayments will necessarily flow back into housing.

Under these circumstances and given the pressure for as rapid an expansion in starts as possible, mortgage interest rates required of builders and home buyers will have to remain high enough relative to other capital market yields to attract the funds required. Elimination of mortgage interest-rate ceilings—or at least a more flexible policy with respect to them—would obviously remove this structural barrier to competition for necessary funds and would alleviate the discount burden that currently must be borne directly by builders and other home sellers. Moreover, mortgage interest *costs,* in the final analysis, are a function of not only the contract interest *rate* but also the price of the house, the downpayment, and the loan maturity. Thus, any reduction in construction and related costs per unit would help not only to spread the available mortgage credit more widely but also to moderate or reduce the burden of interest costs.

d. Do you see any other ways to reduce interest rates in general and mortgage rates in particular from their present high levels to facilitate homebuilding in a noninflationary environment?

Any lasting progress that can be made toward a noninflationary environment should serve to promote investor interest in debt instruments as opposed to equity instruments. Also, any steps that will help reduce per-unit construction costs and hence limit capital requirements will help to lower the general structure of interest rates and particularly of mortgage rates. Beyond this, it does seem feasible to develop further mortgage market features that could narrow the differential required to encourage investment in mortgages as against bonds or other types of investments. These include:

1. Removal of market imperfections that impede the allocation of available mortgage funds, including unrealistic statutory limits on contract interest rates.

2. Improvement of the mortgage instrument by greater standardization of laws on foreclosure, origination costs, and other fees.

3. Development of a debt instrument supported by mortgages—along the lines authorized by the 1968 Housing Act—that would appeal to investors not interested in amortization of principal or the handling of many relatively small financing units.

These and other possibilities are discussed in answers to some of the other questions below.

e. Do you feel that the interest- and rent-subsidy programs provided by the 1968 Housing Act are adequate to meet the housing problems of low-income families?

At the least, these programs would appear to point in a fruitful direction. However, since they are designed to subsidize occupancy—not construction activity—they will tend to add to the aggregate of private credit demands. Nor will they obviate the need for supplementary programs of public housing and other assistance. Also, these programs can be of only limited value unless they are adequately funded.

On the rent-subsidy program, it may be questioned whether major reliance on nonprofit sponsors will not serve to limit the potential of the program, as has been typical in other instances in the past. Moreover, in the case of both this program and the homeownership-subsidy program, excessive reliance on new as opposed to existing units may also have a limiting effect.

2. A number of structural or institutional reforms have already been instituted to improve the mortgage market since the 1966 housing crunch. What specific additional reforms do you recommend to assure that mortgage credit is more readily available and at a more reasonable cost than indicated in your answers to the preceding questions?

In a report to the Congress in 1967 on "Monetary Policy and the Residential Mortgage Market" (published in Federal Reserve BULLETIN for May 1967, pages 728–40), the Board suggested, without necessarily endorsing them at the time, a number of proposals that might be considered for improving the mortgage market. Among the potential reforms mentioned in the Board's 1967 report which have yet to be instituted are the following:

(a) Flexible secondary-reserve requirements for nonbank thrift institutions;

(b) Federal chartering of mutual savings banks;

(c) FNMA trading desk for Government-underwritten mortgages; and

(d) Reexamination of geographical and other barriers to mortgage investment to make them more nearly uniform, or to eliminate them. This includes a review of the mortgage investment powers and origination practices of financial institutions; mortgage, usury, foreclosure, and related State statutes; and geographical, type-of-structure, and nonrate restrictions affecting different types of mortgage lenders.

On several occasions, the Board has recommended legislation to the Congress that would permit member banks of the Federal Reserve System to borrow from the Federal Reserve Banks on the security of any sound assets—including mortgages—without paying the "penalty" rate of interest required whenever technically ineligible paper is presented. This legislation would replace present provisions of the Federal Reserve Act that permit borrowings without a penalty interest rate only on the security of Government obligations or of paper meeting certain outmoded "eligibility" requirements. As the Board has noted, amendment of these restrictive provisions would facilitate rather than penalize efforts by banks to meet the public's changing needs for mortgage as well as other kinds of credit.

3. The following suggestions for institutional reforms have been made in previous studies of the mortgage market. Please comment on the merits and weaknesses of each, pointing out what adjustments in other policies—particularly with respect to monetary and fiscal policies—would be necessary to maintain full employment and price stability if any of these suggestions were adopted.

a. Change the lending policies of the Federal Home Loan Banks so that savings and loan associations can borrow with greater certainty, at lower cost, and/or for a longer time than at present.

The Board's affirmative position along these lines is set forth in the 1967 report.

b. Require financial institutions to direct a certain percentage of their new loanable funds into mortgages.

Present policy, in effect, requires nonbank thrift institutions to hold a large share of their total assets in home mortgages in order to qualify for preferential tax treatment. The suggestion outlined above would obviously broaden such policy beyond the home mortgage field, but it would also extend the restriction—apparently without tax benefit—to other major financial institutions. We are most dubious about the equity aspects of such a proposal.

It is difficult to evaluate the effects that the restriction might have in the absence of precise definitions about the types of institutions, mortgages, and loanable funds contemplated, or the exact percentage of new loanable funds that would have to be directed into mortgages by each type of institution involved within any particular time period. Moreover, it is not clear whether the proposed requirement would apply to the proportion of new funds flows that would have to be placed in mortgages or to the institutions' ultimate portfolio of mortgages, which is a function of loan repayments and sales as well as of loan originations and purchases.

These problems aside, there remains the question of whether the public interest would best be served over the long run by erecting a new structural barrier to the flow of credit within the money and capital markets. It may be argued that even the mortgage market as a whole might not benefit greatly, since lenders not so restricted would tend to withdraw from such investment. An alternative and more positive approach would be to encourage steps to further enhance the competitive appeal of mortgage investment within general financial markets in which credit could flow as readily as possible toward sectors where effective credit demands were most pressing.

c. Require the Federal Reserve System to purchase securities issued by the Federal Home Loan Banks and/or the Federal National Mortgage Association at times of tightness in the mortgage market, thereby providing these institutions with funds to funnel to the mortgage market.

The Board's response to suggestions along this line was incorporated in Chairman Martin's testimony in June 1968 before the House Committee on Banking and Currency (published in the Federal Reserve BULLETIN for July 1968, pages 609–16).

As Chairman Martin pointed out in his prepared statement, "Such a directive would violate a fundamental principle of sound monetary policy, in that it would attempt to use the credit-creating powers of the central bank to subsidize programs benefiting special sectors of the economy." In concluding, he noted, "As time progressed, the effects of the Federal Reserve support operation would adversely affect savings flows to aided as well as to unaided mortgage lenders. At the same time, the operation would increase costs of funds to all nonmortgage borrowers. Ultimately, there would be little or no net increase in the over-all availability of residential mortgage credit. There would be a substantial substitution of public for private funds. All this would occur at the expense of possible disruption to other financial markets if not to the formulation and implementation of general monetary policy as well."

d. Permit savings and loan associations, mutual savings banks, and other mortgage lenders to issue long-term securities to raise funds for mortgages.

Both national banks and Federal savings and loan associations now have the statutory authority to issue long-term securities, whether to raise funds for mortgages or for other types of investments, under appropriate supervisory safeguards. The ability of other mortgage lenders to act in this respect, of course, varies with the provisions of State laws and regulations. We favor the maximum possible latitude in this respect, since the mortgage instrument itself is not well suited to the needs of many bond market participants.

e. Broaden the investment and lending powers for savings and loan associations so that they have a greater liquidity reserve to "dip" into when needed to sustain their mortgage lending.

The Board suggested in its 1967 report that this question warranted further study to determine whether such broadened powers would in fact enhance the mortgage lending potential of nonbank thrift institutions at times when general interest-rate levels are rising. To the extent that genuinely liquid investments are acquired when mortgage demands are relatively slack, of course, a potential supplement would be provided to currently generated funds in times of strong mortgage demand.

f. Bring into early operation the new authority provided to the Government National Mortgage Association (GNMA) to insure mortgage-backed bonds issued by institutions seeking to raise new funds for mortgages.

In its 1967 report, the Board suggested that encouragement be given to such sales of participation certificates or other instruments against pools of residential mortgages, subject to appropriate safeguards.

g. Permit FNMA to engage in secondary market operations in conventional as well as Federally insured mortgages.

Although FNMA as a Government-sponsored corporation has recently shifted from mixed to wholly private ownership, its operations would be changed significantly if this recommendation were adopted. Thus far, FNMA's activities have been confined to dealing in mortgages which conform to public policies, as expressed in the underwriting of mortgages by the Federal Housing Administration and the Veterans Administration.

While further improvements in the secondary mortgage market would clearly be in the public interest, important technical as well as policy questions arise if FNMA is permitted to deal in conventional mortgages —presumably solely on residential properties. Such conventional mortgages, of course, lack the marketability of Government-underwritten loans based on uniform minimum standards relating to safety of principal, collateral, loan terms, and origination practices. There is serious risk, therefore, that FNMA would gradually accumulate a portfolio which is relatively illiquid and which would have to be financed in the money market at interest levels at times quite disadvantageous to flows of funds to the depositary institutions which are also active mortgage investors.

4. How has the volume of homebuilding activity been affected by

a. changes in the general level of interest rates, and/or mortgage rates, and

b. administration of the FHA-VA ceiling on mortgage rates?

5. The practice of discounting mortgages—i.e., deducting "points" in order to raise the yield—has often been found objectionable. What kind of evidence is there as to who or what is hurt by these discounts? Should discounts be forbidden?

So far during the 1960's, the volume of homebuilding has overwhelmingly reflected the availability of mortgage credit—dependent partly on relative interest returns on open market as against depositary claims—and the strength and composition of underlying demands for housing and related credit, as disposable personal incomes have risen sharply further and housing costs have accelerated. Homebuilding appears to have been affected only to a minor degree by changes in the level of mortgage interest rates, at least with regard to mortgages bearing rates that can follow the market closely.

Basic demands in the regular market have continued to be a significant factor. For example, as overbuilding accumulated between 1963 and 1965, housing starts tended downward despite the ample availability of mortgage credit at stable interest rates. The downtrend in housing starts accelerated abruptly in 1966 when the availability of mortgage credit to accommodate transaction demands was sharply curtailed. The drop in starts—which far exceeded what a normal reduction in vacancy rates would have required—resulted primarily from sharply reduced net savings inflows to savings and loan associations and mutual savings banks that specialize in lending on real estate, as outlined in the Board's 1967 report.

During 1968, when underbuilding was a factor, contract interest rates on conventional first mortgages secured by homes rose by 70 basis points—exactly as much as they did through most of 1966, and from a higher level, according to data compiled by the FHA. Yet private housing starts increased in 1968 by over 210,000 units, in contrast to a decline of more than 300,000 units in 1966. The improved performance of housing starts last year in the face of a sharp increase in mortgage interest rates appeared to reflect the continued availability of mortgage credit—albeit at high cost—to meet a strong backlog of basic demand. The housing starts performance was also aided by greater emphasis on multifamily properties, since these could be financed more flexibly than home properties.

An important way in which interest rates have played a restrictive role since early 1966 in the housing market in general has been related to the large discounts associated from time to time with FHA and VA loans that bear fixed contract interest rates which were not adjusted rapidly enough to keep abreast of going market yields. In this connection, the Board suggested in its 1967 report that greater flexibility should be provided in setting ceiling rates on these Government-underwritten loans. This would lessen uncertainty by all market participants about the magnitude of expected changes in such ceiling rates and would avoid substantial discounts which discourage lenders, builders, sellers, and buyers alike from reliance on the types of mortgages affected. Especially hard hit are lower-income families who often depend heavily on mortgages bearing high loan-to-price and long maturity terms—typical of FHA and VA loans—in order to sell existing homes as well as to buy new ones.

Discounts, of course, are the standard method by which returns on any type of instrument carrying fixed rates of interest are adjusted to currently prevailing yields in financial markets generally. The process is essential to effective clearing of markets, since it encourages lenders to allocate their resources toward sectors of the economy where credit demands are strongest. But when contract rates on mortgages can be negotiated freely—as on new conventional loans—they respond much more flexibly to general changes in interest-rate levels, provided usury ceilings are not restrictive. Hence the magnitude of discounts, if any, tends to be fairly small and does not constitute an important impediment to property buyers, sellers, builders, and lenders.

To forbid discounts on either conventional or federally underwritten residential mortgages would seriously disrupt normal market processes and inhibit credit flows to the types of loans affected in the national market as a whole. This was the reason why Congress has twice (in 1954 and 1958) abandoned unsuccessful efforts to control discounts on FHA and VA loans. The preferable and much more successful alternative, of course, is to allow contract interest rates on mortgages to follow the market closely, thereby minimizing the magnitude of the discounts that are likely to develop when market conditions are in the process of tightening. □