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Statement by

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before the

Subcommittee on Priorities and Economy in Government

of the

Joint Economic Committee

December 7, 1972

I appreciate this opportunity to discuss with you measures for moderating cyclical swings in the availability of credit for housing. In a report submitted last March, the Federal Reserve Board set forth recommendations to accomplish that objective. Before reviewing those recommendations, it may be useful to comment on recent developments in the markets for housing and mortgage credit, and to assess prospects for the year ahead.

The flow of savings into the thrift institutions that specialize in mortgage lending has shown extraordinary strength for more than two years. Commercial banks and other financial institutions have also been abundantly supplied with funds for lending. As generally happens in times of ample credit availability, housing credit and construction have expanded rapidly. In fact, residential mortgage loans have grown at an unprecedented rate. Growth in the first three quarters of this year was at an annual rate of \$46 billion, compared with \$36 billion in 1971 and less than \$20 billion in most other years.

Savings and loan associations and mutual savings banks accounted for about two-thirds of the expansion in residential mortgage loans in 1971 and 1972. Life insurance companies have continued to reduce their investment in mortgages on 1- to 4-family dwellings. On the other hand, commercial banks have been able this year to

accommodate business and related loan demands and at the same time expand their portfolios of residential mortgage loans at a record annual rate of \$10 billion.

Homebuilding began to respond vigorously to easier credit conditions during the second half of 1970, and thereby provided a much needed stimulus to general economic activity. This year housing starts will probably reach a new peak of more than 2.3 million units, not counting mobile home shipments, which should exceed 550,000 units.

Interest rates on home-mortgage loans are now only a little higher than they were earlier this year, and the rise has been associated in part with more liberal non-rate terms on conventional loans and larger loan amounts. In October rates for conventional loans on new homes averaged about 7.60 per cent, up 10 to 15 basis points from their recent low last Spring, but still somewhat below their August 1971 level and some 90 basis points below their peak in the summer of 1970.

Further expansion in overall business activity in 1973 might put upward pressure on short-term interest rates. There is, however, no imminent threat of a substantial diversion of savings flows from mortgage-oriented thrift institutions into market securities. In recent years, these institutions have managed to

increase appreciably the proportion of their liabilities taking the form of longer-term deposit certificates with attractive yields. Moreover, minimum denominations of Treasury bills and various agency issues have been raised, and this too should help to moderate deposit withdrawals. Deposits should thus continue to grow at a good rate, even if the recent phenomenal pace is not sustained. And supplementary support can be expected from FNMA, the Federal Home Loan Banks, and related sources when and as needed.

Since backlogs of demand have been filled and vacancy rates are now rising in some areas, production of housing in 1973 may be below this year's record level. But with funds for mortgage credit continuing in relative abundance, the pace of residential construction should continue ahead of that required to meet the national housing goal established by the Congress in 1968.

Encouraging as these developments are, we should not lose sight of the need to make the mortgage market less vulnerable to the storms by which it has been buffeted periodically in the past. On a sunny Autumn day, the prudent commuter gets out his snow tires. Chances are he will need them some time during the winter, and it is best to get them on before the snow falls. It is comforting to know that this committee is mindful of the need to help others prepare for winter weather.

Past experience indicates that at certain stages of the business cycle, forces develop that diminish the availability of funds for home loans. Mortgage credit for housing is typically in short supply when the demand for credit from other sectors rises rapidly. In a briskly expanding economy, business demands for credit from banks and the public market normally increase to finance additions to plant, equipment, and inventories. Interest rates then tend to rise, and the supply of credit available for other borrowers is squeezed. The shortage of credit may be intensified if the aggregate demand for goods and services threatens to exceed the nation's productive capacity. For in that event monetary policies designed to restrain demand and to curb inflation will further restrict the available supply of credit to borrowers.

The difficulties experienced by the housing industry stem in significant measure from the fact that homebuyers depend heavily for credit on institutions that are in a poor position to compete for funds when market rates of interest rise sharply. Their deposit inflows then shrink, and so does their ability to sustain the flow of mortgage credit. Legislative and regulatory limits on mortgage interest rates also constrict the flow of funds to housing in periods of general credit restraint.

Other classes of borrowers, particularly business firms, are less affected by general credit restraint. Established business enterprises not only enjoy preferred status as customers of commercial banks; they often also have access to alternative sources of credit in money and capital markets. Thus in periods when the aggregate demand for goods and services becomes exuberant, the share of new loan funds absorbed by business tends to rise, while that for housing falls.

While it may not be possible or even desirable to eliminate cyclical fluctuations in the supply of credit for housing, the feast-to-famine swings that we have experienced in the past have clearly been excessive. In its report to the Congress submitted last March, the Board made several recommendations for smoothing out these cyclical variations in the supply of housing credit and hence in housing construction. I will summarize the reasoning behind these recommendations briefly.

First, the Board believes that the main thrust of new initiatives should strike directly at the sources of fluctuation in housing credit. Accordingly, the Board recommends removal of a number of legislative and regulatory constraints that at times discourage investment in mortgages. Interest-rate ceilings on FHA and VA loans, intended as protection for homebuyers, have meant in

practice that this form of financing periodically dries up, or becomes available only if the seller is willing to pay several "points" as a loan fee. Recognizing this fact, the Congress has allowed greater flexibility in these ceilings by authorizing their adjustment by administrative action. Even so, the ceiling rates often lag behind market developments. If Congress abolished the ceilings, or tied them directly to market interest rates, it would encourage the States to take similar action with regard to usury laws, which have also served to block the flow of funds into mortgages.

Other changes in Federal legislation would be helpful. The Federal Reserve Act should be amended to permit the Federal Reserve Banks to lend to member banks on the basis of sound mortgage collateral at the regular discount rate. The statutory restrictions on real estate loans by national banks should be eliminated so that mortgage lending by these banks may be governed mainly by considerations of safety and soundness, tested by examinations, as other types of loans are. When that is done, the Comptroller of the Currency should however be authorized to establish safeguards through such regulations as may seem necessary from time to time. Removal of the geographical restrictions on conventional mortgage loans of Federal savings and loan associations

would help free funds for investment where the need is greatest. As in the case of FHA and VA rate ceilings, such actions at the Federal level could lead to similar liberalization of State laws.

Steps should also be taken to strengthen the ability of depositary institutions to attract and hold consumer savings when yields are rising on market securities. The thrift institutions that specialize in mortgage lending are particularly vulnerable at such times because of the disparity between their assets, which consist of long-term loans with fixed yields, and their liabilities, which are short-term. When market rates rise, savings tend to be diverted from thrift institutions into market securities because the institutions are unable to raise their rates to meet the competition. And when deposit inflows shrink, the supply of mortgage credit also declines.

The sharp swings in deposit inflows and in loan activity at these institutions could be moderated somewhat by lengthening the average maturity of their deposits. Some progress has been made, and is being made, in this direction but more could be done, perhaps by adjusting deposit rate ceilings to allow greater incentives for savers to invest for longer periods.

Some benefits would also accrue from shortening the average life of the earning assets of thrift institutions, although any sizable move in this direction should come only after careful consideration of the potential impact on the supply of mortgage credit in the long run. Some benefits can probably be gained by encouraging the specialized mortgage lenders to put a modest portion of their earning assets into consumer loans. Then their earnings would respond better to changes in market interest rates, and they would be in a somewhat better position to adjust the rates they pay on deposits so as to maintain savings inflows.

Another step well worth considering would be to enable all depositary institutions to offer mortgages with variable interest rates and attendant safeguards, side by side with the traditional fixed-rate mortgage. Since the variable-rate mortgage would result in more flexible average earnings rates, the institutions could compete more effectively for deposits. Steadier deposit inflows, in turn, would mean greater stability in the availability of mortgage credit during business cycles. Moreover, this greater stability could be achieved without affecting adversely the long-run supply of mortgage funds.

Along with these benefits would come some costs. The risk of interest rate fluctuations would be a complicating factor in the planning of homebuyers who chose a variable-rate mortgage. But this difficulty could be kept within reasonable bounds by putting limits on the amount that the rate could vary, and by providing that the monthly payment would normally remain fixed, with rate changes affecting only the term to maturity. To protect borrowers and facilitate rational choice, the lenders should be required to make full disclosure about variable-rate and fixed-rate mortgages. And needless to say, the contract should provide for adjustments both ways--to reflect reductions as well as increases in interest rates.

It would probably take ten years or more for variable-rate mortgages to become a substantial element in the portfolios of depository institutions. But they have the potential, in time, of playing a key role in smoothing out flows of funds into home loans, and their encouragement therefore deserves serious consideration.

For the immediate future, the best hope for greater stability in housing lies in continued progress in controlling inflation, and particularly in better management of our fiscal affairs so that less reliance would need to be placed on credit policy to stabilize the overall economy. By making greater use of fiscal tools, sectors

of the economy that are relatively immune to monetary policies could be made to bear their share of restraint during periods of excess demand.

Specifically, the Board recommends flexible use of the investment tax credit as a means of achieving greater stability in outlays by business firms for machinery and equipment. These expenditures are large, cyclically volatile, and relatively insensitive to monetary policy. During periods of credit restraint, expenditures for machinery and equipment have repeatedly drawn on resources that otherwise would have been available for housing.

If the investment tax credit were lowered in boom times and raised in slack periods, we would experience more stability in business demand for external financing, and therefore also in market interest rates and in the flow of funds for housing. This tax flexibility could be achieved by authorizing the President to vary the investment tax credit within prescribed limits, perhaps from zero to ten or fifteen per cent. Before a change in rate could become effective, a sixty-day waiting period should be allowed for disapproval by either House of Congress, analogous to the procedure for reorganization plans.

Among the recommendations in its report, the Board believes that first priority should be given to the proposed variable investment tax credit. Establishment of machinery for flexible use of the investment tax credit would yield benefits more quickly than can be expected from the other recommendations, and the benefits would be substantial, not only for housing but also for other sectors that are sensitive to fluctuations in credit conditions.

In closing, let me commend this Committee for drawing attention to the need to improve credit arrangements for housing. We should take advantage of the breathing spell we are now enjoying in order to prepare for problems that may develop in the future.