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Statement by

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I appreciate the opportunity to discuss with you the problems that have developed of late in the markets for mortgage credit and housing.

Early this year, as the Committee is well aware, building permits for private housing units began to decline, and so did the number of new housing starts. With mortgage credit supplies shrinking, a significant further drop in residential building activity may lie ahead.

Recent developments in housing finance are a matter of concern to the Federal Reserve as well as to this Committee. A practical solution to the recurring problems of housing finance will be found only if the forces presently operating to depress residential construction are clearly understood. Let me therefore try to put recent events in perspective.

In the early months of 1970, activity in the residential building industry began to recover from its slump in 1969. This upturn was the beginning of a surge in housing activity that lasted three years, and proved to be the strongest home-building boom of the postwar period. In the year 1972 alone, construction got under way on 2.4 million conventional dwelling units; in addition, nearly 600,000 mobile homes were produced. Both in 1971 and 1972, the total production of new dwelling units exceeded by a substantial margin the national housing goals established by the Congress in 1968.

The booming volume of residential construction could not long be sustained by the basic demand for housing. During the year ended last March, 1.6 million new households were established in the United States. The number of new housing units produced during that year, however, was nearly twice as large. Inventories of unsold houses began to rise as early as 1971, and they are now almost twice as high, relative to sales, as they were two years ago. Vacancy rates for rental units have also crept up in many sections of the country, and they may well increase further as the completion of large apartment buildings now under construction adds to available rental units.

Besides outstripping the basic demand for housing, the boom in residential building played havoc with costs and prices. Prices of lumber, plywood, and other building materials skyrocketed, land values soared, and wages in the construction industry rose for a time at an annual rate of about 10 per cent.

Of late, construction costs have come under better control. Thanks to the vigilance of the Construction Industry Wage Stabilization Committee, increases of wage rates have moderated appreciably. Upward pressure on prices of building materials, especially lumber and plywood, has also diminished in recent months. Nevertheless, the median price of new single-family homes is now more than a third higher than in October 1969.

By late 1972, overbuilding and high prices had set the stage for a downturn in residential construction. The ensuing decline in housing starts got underway long before supplies of mortgage credit began to affect home building adversely.

One factor that contributed to overbuilding during the housing boom was the liberal supply of mortgage credit. The specialized mortgage lending institutions--that is, the savings and loan associations (S&L's) and the mutual savings banks--were well supplied with loanable funds over a prolonged period. Their total deposits, which had risen 7 per cent in 1970, increased 17 per cent in 1971 and 17 per cent again in 1972. Inflows of consumer savings deposits at commercial banks also rose rapidly, from 11 per cent in 1970 to an average of 15 per cent in 1971 and 1972.

These three classes of depository institutions together added $11 billion to their residential mortgage portfolios in 1970. As their deposit inflows moved up, their net acquisition of mortgages rose to $30 billion in 1971 and then to $43 billion in 1972. In the second quarter of this year, these institutions were still acquiring new residential mortgages at an annual rate of $48 billion.

Mortgage credit supplies during this period were so large that, despite soaring demands for mortgage credit, interest rates on mortgages actually declined between the late summer of 1970 and the spring of 1972, and then remained quite stable over the rest of 1972.

Developments in other financial markets last year, however, carried an ominous significance for housing finance. In the spring of 1972, short-term market interest rates began to rise, and their upward movement accelerated toward the close of the year. By now, as this Committee knows, interest rates on most short-term market securities have risen above the previous high peaks of late 1969 or early 1970. Long-term interest rates have also advanced, but their rise has been less pronounced.

The fundamental reasons for this rise in interest rates should, I think, be evident to any thoughtful observer. With economic expansion proceeding at a vigorous rate since late 1971, the accompanying demand for credit has been very strong. The revival of fears that inflation has become endemic served further to enhance the demand for credit. These developments account for the mounting pace of private credit demands. Between the first half of 1972 and the first half of 1973, the rate of private credit expansion increased by more than a third, or about three times as fast as the percentage increase in the gross national product.

Continuing large drains on the money and capital markets by the Federal sector added, of course, to the upward pressure on interest rates. Total borrowing by the Federal government--including the Federally-sponsored credit agencies--amounted to almost $33 billion in fiscal 1973. It is well to bear in mind that Federal deficits augment private disposable income, and thereby tend to increase private spending and borrowing. The impact of Federal deficits on interest rates therefore goes beyond the direct effects that stem from the addition of Federal borrowing to other credit demands. These deficits have contributed powerfully to the mounting pressures in financial markets since the spring of 1972.

During this period, monetary policy has tolerated the higher interest rates that resulted from the rapidly rising demands for credit. Supplies of money and credit were allowed to expand, but not by enough to satisfy each and every demand for credit at the going level of interest rates. If a more expansive monetary policy, aimed primarily at holding down interest rates, had been followed, the resulting increase in supplies of money and other liquid assets would have added enormously to the potential for inflation. Before long, as both lenders and borrowers adjusted their behavior to the quickened pace of inflation, interest rates would have risen sharply despite the outpouring of newly created money, and by now they would probably be even higher than they in fact are. Inflation and rising interest rates go together, and both lead to serious difficulties for the housing industry.

Signs of developing problems in housing finance became evident early in 1973, when the inflow of consumer savings to commercial banks began to shrink. In the second quarter of the year, savings inflows to nonbank thrift institutions also weakened, falling to an annual growth rate of 9 per cent, compared with 17 per cent in 1972. Mortgage lenders, therefore, became less energetic in committing funds for housing, and interest rates on mortgage loans began to advance.

The threat to homebuilding activity posed by such developments becomes all the more serious when residential construction is already beginning to weaken as a result of overbuilding, as was the case in early 1973. By the middle of this year, housing production thus appeared to be on the verge of yet another downswing in the feast and famine cycle that has long characterized this industry.

These recurring cycles have been of great concern to the Federal Reserve Board. You may recall that in my testimony before this Committee on February 7, 1970--my first appearance before a Congressional Committee as Chairman of the Federal Reserve Board--I indicated that the Federal

Reserve staff would undertake a thorough search for ways of moderating the short-term swings in the availability of mortgage credit. Upon completion of that study, the Federal Reserve Board submitted its report to Congress on March 3, 1972. Our most important recommendation was a proposal for a more flexible use of fiscal policy to smooth out the fluctuations in business fixed investment, so that dependence on credit restraint to achieve economic stability could be reduced. Other proposals were aimed at stabilizing the flow of funds to financial intermediaries.

While the Board's report was submitted at a time when commercial banks and other thrift institutions were enjoying strong deposit gains, it pointed out that these inflows would probably shrink when yields on market securities again rose. The Board therefore urged the Congress to take the opportunity afforded by conditions then existing in the mortgage and housing fields to strengthen the ability of our nation's depository institutions to function effectively in an environment of fluctuating interest rates.

The fundamental reason why the stream of savings into the specialized mortgage lending institutions--especially the S&L's--dries up periodically lies in the asymmetry between their assets and liabilities. Their assets consist chiefly of mortgages with a long average life, and their earnings rates are therefore rather inflexible. Their liabilities, on the other hand, consist of passbook accounts that in practice are payable on demand, or of time deposits with relatively short maturities. These forms of savings are rather close substitutes for short-term market securities, on which yields are highly variable. When yields on competing market instruments rise, a strong tendency develops to divert savings from the thrift institutions to market securities.

The Board's report set forth proposals to deal with this problem. To achieve greater flexibility in the earnings of S&L's, so that they could compete more effectively against market securities, the Board suggested that perhaps 10 per cent of their earning assets might be placed in consumer loans. More importantly, we recommended that consideration be given to enabling all depository institutions to offer mortgages with variable interest rates, subject to regulatory safeguards.

The Board hopes that its report will assist the Congress in its search for ways to deal with the problem of cyclical instability in housing finance. But the necessary ameliorative measures have not yet been adopted. As a result, the nation's housing industry may now have to bear once again a disproportionate share of the burden of policies to moderate the expansion of aggregate demand. Fiscal policy has not yet been made a flexible tool for economic stabilization. And monetary and credit policies are still serving as the primary line of defense against excess aggregate demand, although we know from experience that general monetary restraints affect housing more than other industries.

As recent experience again indicates, our depository institutions, particularly the S&L's, have great difficulty in coping with rising market interest rates. Over the past several years, the structure of deposits at the S&L's has changed substantially. Nearly all of the growth in their savings capital has come from special deposits with a fixed term to maturity. A large part of these special deposits, however, have rather short maturities. By actively encouraging growth of such accounts, it appears that the S&L's have attracted a substantial amount of interest-sensitive funds, thereby aggravating their problem of deposit instability.

The Federal Reserve has been troubled by this development for some time. During the spring of this year, some depository institutions began losing funds to market securities, on which interest rates were rising rapidly, and it seemed likely that the diversion of individual savings to market instruments would accelerate after the midyear interest-crediting period. More freedom for depository institutions to bid for funds thus became urgent. On July 5 the Federal Reserve joined with the other regulatory agencies to allow commercial banks and other thrift institutions to offer higher yields on consumer-type time and savings deposits.

The new ceilings on interest rates paid by commercial banks were again set at lower levels than for other thrift institutions. In the case of S&L's and mutual savings banks, the largest increases in ceiling rates were made for special accounts--that is, accounts other than passbook savings. This approach was adopted to enable these institutions to utilize the limited increase of their earnings in recent years to best advantage in attracting or holding on to savings customers.

At the same time, ceiling rates on consumer-type deposit certificates with maturities of four years or longer, when sold in denominations of $1,000 or more, were suspended for all depository institutions. The objective of this action was to increase the ability of these institutions to compete with market instruments, and at the same time achieve greater stability of deposits.

In taking these several steps, the Board and the other regulatory agencies kept in mind the need for greater equity for savers. Whatever advantages the housing industry and the institutions that finance it may derive from rate ceilings, these ceilings clearly discriminate against individuals who are able to accumulate only modest amounts of savings or who lack sophistication with regard to investment alternatives. In determining rate ceilings and in related actions, such as establishing minimum denominations in which Federal securities are sold, public policy must balance the needs of housing finance against equity for the small saver. One result of deposit rate ceilings and large minimum denominations of Treasury issues has been to deny small savers the opportunity of benefiting from competitive rates of return on their funds. This may help to sustain home-building, but we need to explore other, more equitable, ways of promoting that objective. Suspension of deposit rate ceilings in limited areas, subject to safeguards, is one such avenue of exploration.

The precise details of the liberalized ceiling rates that became effective on July 5 were designed with an eye to minimizing shifts of funds among depository institutions. We soon discovered, however, that savings and loan associations in a few metropolitan areas were losing funds to some commercial banks that were merchandising aggressively the new, no-ceiling four-year certificate. The Federal Reserve Board and the Federal Deposit Insurance Corporation responded promptly to this development, by limiting the amount of such deposits that a commercial or mutual savings bank may accept to 5 per cent of its total time and savings accounts. A similar restriction had previously been imposed on savings and loan associations by the Federal Home Loan Bank Board.

Other steps have also been taken recently by the regulatory agencies to achieve uniformity among competing financial institutions with regard to penalties for early withdrawal of time deposits, and to ensure that savers who may wish to switch into higher-yielding certificates of deposit understand how such penalties will affect their interest earnings.

These regulatory actions have clearly improved the ability of depository institutions to compete with market securities for the savings of individuals. The further rise of market interest rates since early July has, however, blunted this achievement. With relatively short-term Treasury securities or Federal agency issues now offering yields of 8 or 9 per cent, the purchase of such securities by individuals has been rising rapidly of late.

In July, deposit outflows amounted to about $300 million at S&L's, and to about $600 million at mutual savings banks. In August, mutual savings banks fared somewhat better. On the other hand, deposit outflows at S&L's accelerated, if we may judge from the data now available. The larger commercial banks, in their turn, reported a loss of $200 million in consumer time and savings deposits over the four weeks ended August 29, compared with an increase of $300 million in the previous five weeks.

The contrasting experience of commercial banks and S&L's since mid-year has suggested to some observers that many banks may be attracting funds from S&L's through aggressive marketing of the new certificates with a maturity of 4 years or longer. The Federal Reserve has been investigating this question carefully.

An overwhelming proportion of the banks appear to be handling prudently the no-ceiling 4-year certificates. Less than 40 per cent of all insured commercial banks were offering these certificates at the end of July, and of those that did, only about one out of twenty paid a rate in excess of 7-1/2 per cent. The rates offered by commercial banks were broadly similar to those offered by S&L's and mutual savings banks. In general, since savers would not have gained interest income by switching funds from nonbank thrift institutions to commercial banks, it appears that the bulk of the funds lost by S&L's and savings banks during July and August did not move to commercial banks, but that the money went elsewhere--probably into market securities.

This, however, is not as yet a firm conclusion. In any event, even if valid on a nation-wide basis, it may not apply to some individual communities. The Federal Reserve Board, working cooperatively with other regulatory agencies, will therefore continue to give this problem close attention and draw upon whatever new information becomes available. A few days ago the Federal Home Loan Bank Board and the Federal Deposit Insurance Corporation liberalized their regulations, so that the S&L's and mutual savings banks will be able to issue the no-ceiling 4-year certificates up to 10 per cent of their deposits.

If further regulatory actions offer promise of diminishing turbulence in the markets for consumer savings and mortgage credit, the Federal Reserve Board--and I'm sure also the other regulatory agencies--will not hesitate to adopt them.

In all candor, however, I must acknowledge that I see no easy way out of our current dilemma. Competition among the thrift institutions could be restrained by reverting entirely to the former ceilings or by imposing a modest ceiling on the new four-year certificates. But in that event the loss of funds by depository institutions to market instruments would probably increase greatly. Alternatively, ceilings could be liberalized further, so as to give the thrift institutions more freedom to compete with market securities. But many savings and loan associations are not in a position to pay appreciably higher rates, and their future would be in jeopardy if they tried to do so. In either case, the availability of mortgage credit might be affected very adversely.

It thus appears that mortgage loans will remain in relatively short supply in the months immediately ahead, particularly in states with low usury ceilings, and that the volume of residential construction will consequently suffer. There is reason to believe, however, that the contraction in housing activity that we now face will be milder than the declines of 1966 or 1969.

A number of structural changes in housing finance during recent years have reduced the dependence of the housing industry on mortgage loans from nonbank thrift institutions. For one thing, private sources of funds for mortgage credit have been broadened. Thus, the GNMA-guaranteed mortgage bonds now attract private pension funds and other investors who previously stayed out of the mortgage market; at present, some $10 billion of such bonds are outstanding. Real estate investment trusts have also been growing. In the second quarter of this year, they supplied mortgage credit at an annual rate of $4 billion. Commercial banks now furnish a larger share of residential mortgage credit -- over 20 per cent in the first half of this year, compared with about 15 per cent in the decade of the 1960's. Moreover, mortgages have generally become more attractive to private investors because of the growth of opportunities to insure conventional mortgages and the enlargement of secondary market facilities.

The capability of Federal agencies to come to the aid of housing in times of difficulty has also been bolstered. The Federal National Mortgage Association and the Federal Home

Loan Mortgage Corporation are now authorized to buy conventional mortgages as well as government-guaranteed mortgages, so that their efforts to support housing activity can be broadly based. The financial position of FNMA has become stronger in recent years, and its security issues are widely regarded as an attractive investment medium. So also are the securities issued by the Federal Home Loan Banks to obtain funds for lending to savings institutions. Advances from the Federal Home Loan Banks through August of this year already total $5-1/2 billion, and they can be increased substantially further, if that should be necessary.

The Federal Reserve, on its part, has made plans for providing emergency credit to S&L's and mutual savings banks in the unlikely event that such a need arises. We have also sought to improve the market for the securities issued by the Federal housing credit agencies. Since September 1971, when we began making outright purchases and sales of agency issues, the spread between the yields on these obligations and those of the Treasury has narrowed, particularly for the shorter maturities. Our acquisitions were not the only reason for the lower spread, but I believe they made a constructive contribution.

Of greater importance, the Federal Reserve Board this May raised from 5 to 8 per cent the reserve requirement applicable to increases in the amount of large-denomination certificates of deposit (CD's) outstanding at the larger banks. This step increased the cost to banks of the funds that they principally use to finance business loans. Last Friday, the incremental reserve requirement against CD's was raised again, this time to 11 per cent. To the extent that this new reserve requirement restrains bank lending to the business sector, it should help to relieve pressures on residential mortgage credit.

In view of the structural changes in housing finance and related developments, I believe that the housing industry is in a better position now than it was a few years ago to weather the pressures of financial restraint. But additional actions are needed to achieve an acceptable degree of stability in housing finance and construction.

For the immediate future, the single most constructive step that could be taken by the Congress would be to increase the degree of fiscal restraint on aggregate demand. I for one would support stronger efforts to cut governmental expenditures, or actions to increase taxes. Particularly appropriate would be fiscal measures that could be quickly reversed if economic activity began to weaken. Steps to increase fiscal restraint now could have dramatic effects on financial markets, with substantial benefits for the supply of mortgage credit and housing.

I would also urge the Congress to abolish altogether the present ceiling rates of interest on FHA and VA loans. True, these ceiling rates have not been a significant impediment to mortgage credit supplies this year, but that is only because HUD and the VA have acted rather promptly to keep the ceilings in line with market rates of interest. In some states, usury ceilings have dried up the supply of mortgage credit almost completely. If the Congress acted decisively on FHA and VA ceilings, State legislators would be more inclined to raise or eliminate the usury ceilings that are presently curtailing residential building in their area.

This Committee could also be of great service to the housing industry by supporting reforms to moderate short-term swings in the supply of mortgage credit and home construction. Some of the measures needed are relatively non-controversial, could be acted on quickly, and would improve the outlook for housing finance even in the short run. The

Board's earlier recommendations to remove the legal restrictions on real estate loans by national banks, and to permit the Federal Reserve to lend to member banks on any sound collateral, including mortgages, fall into this category. Other measures will need to be debated at greater length, and it is therefore all the more urgent that the Congress initiate constructive deliberation of basic reforms. The highest priority should be given to making fiscal policy a more flexible tool for economic stabilization. A promising way to accomplish this, as the Board indicated in its housing report in early 1972, would be to make the investment tax credit variable over the business cycle.

If the tax credit for business investment were lowered during economic booms and raised in periods of slack, the rate of business capital spending would be more stable, and so would interest rates and the flow of funds into housing. The Board recommends again, therefore, that the President be authorized to propose changes in the tax credit, within a range of perhaps 3 to 12 or 15 per cent, subject to Congressional approval or disapproval under special procedures to assure prompt consideration.

Better control of the Federal budget would also be of great value. The Board welcomes the efforts of the Joint Study Committee on Budget Control, the Rules Committee of the House, and the Government Operations Committee of the Senate to reform budgetary procedures by fixing firmly the expenditure total for a fiscal year and then establishing Congressional priorities within that total.

Reforms are also needed to improve the ability of depository institutions to compete for individual savings in periods of rising interest rates. The Board would urge once again the adoption of legislation to encourage a moderate amount of investment by S&L's in consumer loans, so that their earnings rates would be more flexible. A more significant contribution to this objective would come from the use by depository institutions of mortgage loans with variable interest rates to finance the purchase of homes and apartment buildings.

The thoughts I have put before this Committee today are confined to the problem of cyclical swings in housing. This is a critical current problem. That is why I have emphasized not only the desirability of changes in the structure of housing finance, but also the importance of basic reforms in fiscal policy. Once fiscal reforms are carried out, there will be less need to depend upon monetary restraint in the course of a business-cycle expansion.

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