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MONETARY POLICY, CREDIT FLOWS, AND THE OUTLOOK FOR HOUSING

Remarks By

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I am delighted to have been invited to address the Annual Meeting of the Seattle Industrial Council. For me, this trip to the Pacific Northwest is something of a homecoming: last month marked the 23rd year of my arrival in Bremerton--just a few miles from here--as a boy of 17, fresh from the flat delta lands of northern Louisiana. Here in the Puget Sound Country, I grew to manhood and acquired my first introduction to the world of industry and finance, particularly during the 4-1/2 years which I spent at the University of Washington. But next month will also mark the 15th year since I left the Northwest to continue graduate work in economics at one of the eastern universities. For years, I planned to return to Seattle to live. However, one-after-another "short-term" commitments postponed the decision, and my appointment to the Federal Reserve Board in March 1966, for a 14-year term makes the prospect of returning even less promising. So, I am glad that I could at least come back for a visit.

The invitation to share this day with you also asked that I review the main contours of monetary policy in 1967--with particular reference to the implications of credit flows for construction and residential financing. I welcome this assignment. In attempting to carry it out, I shall focus on the main objectives of monetary policy and the broad pattern of credit flows and homebuilding activity in the first half of 1967. I shall also try to sketch the general implications of these flows for mortgage financing and the housing industry during the rest of this year. Finally, I will have a few comments on the critical importance for housing of the President's 10 per cent surtax proposal currently before the Congress.

Objectives of Monetary Policy

It will be recalled that monetary policy adopted a posture of ease last fall--once excessive pressures on resources and prices began to moderate. Since then, the principal objectives have included the restoration of financial liquidity and a more general availability of credit to help the economy through a period of inventory adjustment. At the same time, monetary policy has also been conducted with the aim of making whatever contribution it could toward achieving further improvement in our balance of payments. In carrying out these objectives, the Federal Reserve has taken a number of steps to expand member banks' reserves to support the growth of credit and to re-align the structure of interest rates:

- In March, the Board of Governors reduced reserve requirements on member banks' passbook savings deposits and on the first $5 million of time deposits. As a result, $850 million of reserves were released. Approximately $500 million of this amount went to country banks, which tend to use a somewhat larger share of their resources for real estate lending than do reserve city banks.

- Through open market operations primarily in U. S. Government securities, the Federal Reserve expanded nonborrowed reserves of member banks by an annual rate of nearly 13 per cent from the end of last November through June of this year. Such reserves had declined moderately (on a seasonably adjusted basis) during the summer and fall of last year. As more reserves were supplied this spring, member banks cut back borrowing from the System to the lowest level since the fall of 1962.

- In making these reserves available, the Federal Reserve made a net expansion of $2.4 billion in its holdings of Treasury securities during the first six months of 1967. Of this amount, $776 million was provided through the acquisition of coupon issues, of which two-fifths had maturities over five years. These transactions in coupon issues were undertaken in recognition of the heavy pressures from securities flotations in long-term markets and shifting expectations about the future course of interest rates.

- In recognition of the sharp decline of short-term market yields during the first three months of this year, the discount rate was reduced in early April from 4-1/2 to 4 percent.

The over-all results of these actions can be seen in a number of financial measures: total credit extended by member banks rose by $14 billion in the first half of this year, compared with $9 billion a year earlier.

The growth of member bank time deposits has been striking--up about $12 billion in the first half vs. $7 billion in the same period of 1966. Private demand deposits rose by $5 billion in the January-June months this year--against $2 billion last year. Since last December, the money supply has climbed almost 5 per cent, compared with less than 2 per cent in the first seven months of 1966.

However, despite this liberal provision of bank credit, financial markets have remained under considerable pressure since late winter, as many business firms, consumers, lending institutions, and governmental units attempted to replenish liquidity lost under the monetary restraint required through most of 1966--when an acceleration in Vietnam military activities was superimposed on an extended boom in capital investment. The quest for liquidity has also stemmed from expectations of a strong revival in general economic activity, on the one hand, and the certainty of a large Federal deficit for fiscal 1969 on the other. Moreover, market recognition that revenue demands by the Treasury generally are concentrated in the first half of a new fiscal year has only served to accentuate these pressures in recent months.

Government Finance

So far this year, despite a continuing rise in revenues, state and local governments have made record demands on the capital markets. In the first quarter of this year, these borrowers marketed a record $4.1 billion (gross) of new bond issues, and they sold an additional $3.5 billion in the second quarter.

In contrast, total Federal Government financing was smaller in the first half of 1967 than in the first half of 1966 and resulted in an estimated increase of $0.3 billion in outstanding securities, compared with an increase of $4.7 billion in the first six months of 1966. The first half of the calendar year is traditionally a period of debt redemption by the Treasury, and estimated net redemptions of direct Treasury obligations through June was in the neighborhood of $3.0 billion--$2 billion more than in the same period a year earlier. At the same time, net agency debt outstanding dropped by over $500 million in the January-June period, as against a net rise of $3.5 billion a year earlier. This reflected two factors, both intimately related to much needed improvement in mortgage market conditions. First the Federal National Mortgage Association increased its outstanding indebtedness at a much slower rate in the first half of this year, as its mortgage purchases from private holders declined. Also, the Federal Home Loan Bank reduced their own outstanding debt by $2.3 billion, as against a net increase in market borrowing of $1.1 billion in the same period of 1966. Sales to the public of participations in Federal loans rose moderately in the first half of the year, for a total of $2.9 billion, compared with $2.2 billion in the first half of 1966. An additional $900 million of participation certificates were sold directly to the U. S. Government trust funds during the first half of 1967.

Business Finance

Despite the general slowdown in the economy, business firms raised a substantial volume of funds during the first half of 1967. While the need for funds for inventory investment and for new plant and equipment declined since the start of the year, internally generated funds (retained earnings plus capital consumption allowances) also fell. As a result, corporations have continued to rely heavily on outside sources of financing. In addition, corporate needs for funds were augmented during the first half of the year by acceleration of tax remittances to the Treasury. The speedup in collection of social security contributions, withheld income taxes and excise taxes in the first quarter drew off an estimated $650 million in business working capital, and the continued acceleration of the corporate income tax payments schedule added an estimated $4.3 billion to business tax remittances in April and June.

Unlike 1966, businesses so far this year have tended to prefer to obtain funds directly from the capital markets rather than from the banking system. Through the first half of 1967, bank loans to business grew at a slower rate than the 14 per cent gain recorded in 1966, reflecting corporate restructuring of debt in the wake of very heavy borrowing from the banks in 1966, further attrition in liquidity positions (which has been going on for some time) and anticipations of greater financial stringency after mid-year.

According to the SEC, market borrowing for repayment of bank debt rose to 28.6 per cent of a new bond financing in the first quarter of 1967, from 21.6 per cent in the same period of 1966, and preliminary data suggested an even higher proportion during the second quarter of 1967. The shift to capital market financing was facilitated in the early part of the year by the decline in market rates that followed the move to monetary ease in late 1966. This made borrowing through the issue of capital market instruments relatively attractive, since bank lending rates dropped less during this period. But the need to steady--if not improve longer-term liquidity positio[n] particularly on the part of the large corporations--was also a significant factor.

In the first half of this year alone, gross new public and private issues of corporate bonds reached an estimated $10.6 billion. This compared with $8.4 billion in the same period last year; this was a record amount for any half-year. Also, during the first half of 1967--as during the last half of 1966--the amount of new bonds publicly offered substantially exceeded the amount of new bonds privately placed with insurance companies and other institutional investors. (The last half-year period characterized by this development was the first six months of 1962.)

In addition to raising a record volume of funds in the long-term capital markets, corporations have also resorted increasingly to the commercial paper market for funds. Issues of commercial paper by non-financial corporations had risen sharply during the second half of 1966, as business firms attempted to find a source of funds alternative to commercial banks. And so far this year, this trend has accelerated somewhat further, reflecting, in part, lower costs relative to those available at commercial banks.

Consumer Finance

Consumer spending continued to grow through the first half of 1967, but at a slower rate than disposable personal income. As a result, personal savings rose above 7.0 per cent of disposable income, a full percentage point above the average savings ratio in the 1953-66 period. Total spending on durable goods absorbed a lower proportion of income in the first quarter of the year than in 1966, and the growth of consumer credit--which is normally used to finance a major part of such expenditures--slowed. However, if the recent pickup in automobile sales is maintained and supplies during the second half are not curtailed by a protracted strike, growth in consumer credit should accelerate once more.

Revival of Savings Flows and Mortgage Finance

The thrift institutions (mutual savings banks and particularly savings and loan associations which are traditionally the major suppliers of home mortgage loans) have experienced sharply increased savings flows so far in 1967. These large net inflows reflect not only the rise in consumer savings but also the reduced rates on competitive savings instruments, such as short-term marketable securities. During the first six months of 1967, S & L's recorded a $5.9 billion net inflow of funds, in sharp contrast with the $2.1 billion inflow recorded during the first half of 1966. Similarly, mutual savings banks have also experienced striking--in fact, record, inflows of funds thus far in 1967.

In fact, as had been expected, a substantial portion of the enlarged savings flows to the thrift institutions did not move directly into the mortgage market in the early part of the year. This reflected, in part, a limited supply of immediately available mortgages and lender needs to replenish liquidity positions which had been substantially depleted during 1966 when net inflows had dropped sharply below expectations at a time when lending institutions still had a large volume of commitments outstanding. Altogether, in the first half of this year, S & L's repaid more than $2.5 billion of their borrowings from the Federal Home Loan Banks as against a net increase in borrowing of $800 million during the same period last year. In addition, all thrift institutions have appreciably rebuilt their liquidity through the purchase of short-term securities, and mutual savings banks have purchased a large amount of long-term corporate securities. Even so, during the first half of this year, these institutions expanded their mortgage holdings on a seasonally adjusted basis at a rate more than twice that recorded during the last half of 1966, and commitment volume rose to levels at least somewhat above a year earlier when commitments had just begun to decline.

Interest Rates and Yields

With the sharp rise in the volume of new issues and with clear expectatio of even heavier demands on capital markets during the second half of 1967, long-term corporate bond yields during the second quarter of this year reversed the decline which began in the fourth quarter of 1966 and approached--and in come cases exceeded--the postwar highs recorded late last summer. Recently, yields on some outstanding long-term Government bonds have returned to the peaks recorded in late 1966, reaching the highest levels in forty years. With yields remaining substantially above the 4-1/4 per cent ceiling on interest rates for Government bonds with maturities exceeding five years, Treasury financing operations have had to be confined to short- and intermediate-term issues.

Reflecting these developments, secondary market yields on FHA-insured thirty-year mortgages (which had declined during December and the first four months of 1967) turned upward again in May and June. At 6.51 per cent, such yields in June were still some 30 basis points below the high reached last November, but they were over 100 basis points above the plateau which had prevailed from the spring of 1963 through the summer of 1965. Moreover, price declines associated with the increase in yields required by lenders on such mortgages brought discounts to an average of 4.4 per cent, still substantially under the 6.8 per cent reached last November--but appreciably higher than the 2.5 per cent recorded as recently as last April. Contract rates on conventional first mortgages also increased in May and June, by 10 basis points altogether in the case of loans on new homes, though by somewhat less for loans on existing homes, according to the Federal Housing Administration.

Unlike earlier years, the spread between mortgage and bond yields has narrowed considerably in 1967, and this has produced a situation in which yields are now much more responsive to changing money market conditions than was once the case. In both May and June, the increase in secondary market yields on FHA-insured mortgages, the most sensitive of the mortgage yield series, was less than the rise in returns of new issues of high-grade corporate bonds. As a result the yield spread which in May had already been unusually small, narrowed even further--to only 72 basis points.

The Pattern of Housing Starts in 1967

Through the first half of the year, housing starts improved at least somewhat ahead of most expectations, considering the sharp break in activity which had reduced starts to a seasonally adjusted annual rate below a million units in the fourth quarter of the year--a twenty-year low. The need for builders and potential buyers alike to recognize and adjust to the prospect of increased availability of mortgage funds and the time inevitably required by builders to regain some of the momentum lost during 1966 also were draw-backs. Under these circumstances, while recovery is still incomplete, the upturn to a 1.2 rate in the first quarter so soon after money markets began to ease and, more important, a further improvement in the rate in the second quarter, when normal seasonal factors rise very sharply, has to rank as a considerable achievement. Moreover, in July housing starts rose sharply to an annual rate close to 1.4 million units.

Given the momentum already achieved, the improved level of commitments from S & L's as well as the mutual savings banks, and the record rate of net savings inflows, a sustained further increase in the rate of housing starts would normally be expected over the remainder of the year. The extent of that increase and the course it will describe going into 1968, however, must depend on a number of further developments. These include not only apparent continuing high demands by corporations and state and local governments on the capital market, but also the expected new market pressures from Federal borrowing, which may exceed $15 billion. Moreover, expansion in consumer demand for durable goods may compete increasingly with savings flows.

In this situation, however, a number of countervailing factors may help to sustain the flow of mortgage funds. As noted earlier, the liquidity positions of lender groups, including the Federal Home Loan Banks, have been substantially improved. Also, corporate liquidity requirements at least, have been partly met. Sizable adjustments have been made in the comp for savings, particularly in favor of S & L's.

Need for a Better Mix of Fiscal and Monetary Policy

In the end, however, major hope must rest on the possibility of a substantially better mix between fiscal and monetary policy than that which prevailed in 1966 as a means of helping to keep Government deficit financing and other demands of an expanding economy within bounds. The improvement of the policy mix, as events proved so decisively last year, would materially alter expectations for housing not just for the remainder of this year but for 1968 as well--because arrangements for construction loans and permanent financing, for land development and construction arrangements all take considerable time.

For this reason, among others, I strongly support the President's recommendation for a 10 per cent surtax that is now before Congress.

Obviously, one cannot predict what impact an increase in taxes will have on interest rates and financial markets. The actual outcome, in the final analysis, will depend on the magnitude of the increase, its timing, and the over-all pressure of demands on available resources in the economy as a whole over the period ahead. However, there is little question that an increase in taxes will be a moderating factor on demands by the business and consumer sectors, and it will clearly moderate Treasury requirements for credit. And this will permit far greater flexibility to monetary policy than was the case during most of 1966. This flexibility would enhance the availability of mortgage funds for home markets. As a result, the momentum already regained by builders and lenders would be less likely to be broken again, further improvement in starts could continue and the possibility of developing shortages would be tempered considerably.

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