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CENTRAL BANKING AND THE AVAILABILITY OF RESIDENTIAL MORTGAGE CREDIT

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In appraising some of the contributions which central banking policy can make toward expanding the availability of funds for home financing, I will focus initially on the short-run outlook for the residential mortgage market. Next I will explore some of the opportunities for structural improvements which might make the often-times uneasy relationship between the central bank and home-financing intermediaries somewhat more comfortable. Let me say immediately, however, that the following discussion must necessarily steer clear of any suggestions about prospective monetary policy or about the probable course of interest rates. Moreover, these comments must also be taken as an expression of my own personal views.

The main points covered in these remarks can be summarized briefly:

- Both residential construction and mortgage market activity may show considerable strength over the near-term. Just how much strength, of course, will depend heavily on the ability of financial intermediaries (particularly savings and loan associations) to compete for funds.

- Given the delicate balance established among commercial banks and savings institutions in the competition for funds during the last few years, I am personally convinced that the existing structure of maximum interest rates payable on time and savings deposits should be kept in place for the time being.

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*Member, Board of Governors of the Federal Reserve System. I am grateful to Mr. Bernard N. Freedman of the Board's staff for assistance in the preparation of these remarks.

- However, I am also convinced that in the longer-run it would be better to keep interest rate ceilings on a standby basis, thus permitting a wider scope for market decisions in the allocation of savings flows. In the meantime, it is desirable to press on with structural improvements which would strengthen the competitive position of home financing institutions and enhance the efficiency of residential mortgages.

- In my opinion, the above approach is much more promising than some of the recent suggestions that the Federal Reserve provide support to the mortgage market through the direct purchase of debt issues offered by Federal Government housing finance agencies.

- Nevertheless, I do recognize that the Federal Reserve, through normal market operations undertaken in the conduct of monetary policy, can help to enhance the marketability of Federal agency issues -- including those of the housing agencies.

Short-Run Outlook for Residential Mortgages

The prospects for the residential mortgage market during the next year will be influenced to a considerable extent by several developments not directly related to housing. Undoubtedly, if the negotiations seeking an end to the Vietnam War are successful, the outlook for housing and mortgage financing -- along with many other important sectors of the economy -- will be altered greatly. Since there is no way to assess this possibility, it must remain as a principal source of uncertainty. In the same vein (and partly reflecting the domestic impact of the Vietnam military effort), the outlook for inflation and the new Administration's fiscal policy -- especially the question of continuation of the 10 per cent surtax after mid-1969 -- can only be recognized at this point as important considerations to be kept in mind. Because of these uncertainties -- plus the continuing deficit in our balance of payments -- the course of monetary policy must necessarily be less clear than one might ordinarily conclude it should be -- given the magnitude of the fiscal restraint measures adopted last June. Nevertheless, although it is an obvious point, one must note in passing that the greater the degree of relaxation in monetary restraint that can be undertaken, the stronger will be the housing and mortgage markets in the year ahead.

While judgments differ as to the details, there seems to be a rough consensus among housing economists placing housing starts in the neighborhood of 1.65 million units in 1969. This would represent an increase of 10 per cent over the 1.50 million units which may be achieved in 1968. The projection for next year seems to rest on a reasonably sound basis: During the last few years, the short-fall of actual construction compared with its long-run growth rate apparently has resulted in a backlog of unmet demand of about 400,000 residential units. Since vacancy rates this year have been the lowest recorded in more than a decade, the replenishment market should be fairly strong. The potential expansion of the regular market for shelter should also be considerable in the year ahead. Net household formation may be at least 1 million, and net demolitions of existing structures may run 500,000 or more. Therefore, the level of housing starts might be around 1.5 million units under normal conditions. Given the pressure of replenishment demand already mentioned, the projection of 1.65 million total starts for 1969 does not appear unreasonable.

In the end, however, the strength of these demand factors will have to be tested against supply conditions which can be expected to prevail as 1969 unfolds. Even in the face of relatively modest effective demand for new residential units, shortages of construction labor have continued in a number of areas across the nation. As a consequence, labor costs have risen sharply. Recently, costs of building materials have also moved higher. Upward pressures on land costs have not only continued but have actually accelerated. One would ordinarily expect these cost developments to have an adverse impact on housing demand. However, although recent survey results appear to differ on this point, there is some evidence suggesting that the continuing rapid advance in home prices (amounting to at least 5 per cent per year for single-family houses) has stimulated -- more than it has dampened -- the demand for residential units.

Turning to the mortgage market, it seems that the probability of a substantial decline in interest rates on mortgages has been discounted by the market. Consequently, it appears that the availability of funds -- much more than their cost -- will be a dominant influence on transactions in both new and existing real estate in the coming year. During the first half of this year, mortgage holdings of all lenders rose at a seasonally adjusted annual rate just over $26 billion; in the third quarter, the rate of expansion was almost the same ($25 billion). Thus, during the first three quarters of 1968, the net increase in all types of mortgages outstanding was substantially above the average recorded in the same period last year. However, compared with the gains registered in the final quarter of 1967 (when recovery from the late 1966 low was still in progress), the average quarterly rise this year has been smaller.

As the current quarter began, the mortgage market continued to show considerable strength. However, there were also scattered indications that conditions were somewhat tighter than they were during the summer following the adoption of the fiscal measures last June and the lessening of pressures in the money and capital markets. As interest rates on competing capital market instruments rose somewhat faster in October, mortgage yields in the sensitive secondary market area also turned upward again. For example, yields on FNMA's six-month forward purchase commitments of Government-underwritten home mortgages climbed steadily through October to close the month at about 7.24 per cent. Although this level was still substantially below the peak of 7.71 per cent set last June, it does represent a noticeable advance from the yield level prevailing at the end of September.

On the other hand, during the third quarter, mortgage lenders accelerated their commitments to make future loans -- partly to take advantage of high yields which many thought would not prevail much longer. Net savings inflows to thrift institutions were sustained through and after the mid-year interest crediting period. In each of the first three quarters of this year, savings accounts in these institutions rose at an annual rate of just over 6 per cent. The expansion of time and savings deposits at commercial banks was somewhat more varied, growing in each quarter, respectively, at annual rates of 7 per cent, 3.2 per cent, and 17.9 per cent. Moreover, the spread between gross yields on mortgages and competing market securities (though less than the 100 basis points in September) has kept mortgages relatively more attractive as an investment outlet than was the case early this year.

Looking to the year ahead, as I mentioned above, the extent to which savings institutions can meet the expected rise in demand for real estate mortgage loans will depend substantially on their ability to compete for funds -- especially for consumer-type savings. Aside from the impact of the factors cited above (including the course of domestic inflation and monetary policy) institutional ability to compete will also depend heavily on the structure of maximum rates of interest which can be paid on consumer-type time and savings deposits.

Interest Rate Ceilings and the Competition for Savings

While I personally accept the view that the existing interest rate ceilings should be kept in place, it is not a comfortable position for me. It will be recalled that since September, 1966, the Federal Reserve Board, the Federal Home Loan Bank Board (FHLBB), and the Federal Deposit Insurance Corporation (FDIC) have been authorized to set maximum rates of interest payable on consumer-type deposit claims. However, it might not be recalled quite so readily that the Federal Reserve and the FDIC since the 1930's had been required to establish ceiling rates on time and savings deposits in commercial banks, while the FHLBB had no authority to do the same with respect to insured S&L's. In addition to covering the latter, the 1966 legislation (which has been extended year-to-year) also broadened the basis that can be used in establishing the rate ceilings.

A principal aim of the 1966 legislation was to shift the distribution of funds flowing to financial intermediaries to provide a more favorable position for S&L's (and to a lesser degree for mutual savings banks) compared with commercial banks. A basic underlying motive, stressed when the legislation was before the Congress, was the desire to improve the availability of mortgage funds. Given the sharp changes which occurred in the distribution of savings during 1966 (partly as a result of an increase in maximum interest rates payable by commercial banks but also as a result of a steep climb in market yields), I believe the structure of rate ceilings adopted in that year was necessary. That structure, you may recall, involved a maximum of 4 per cent on commercial banks' passbook savings, 5 per cent on their consumer-type time deposits and 5-1/2 per cent on their large denomination CD's while for S&L's the maximum passbook rate was typically 4-3/4 per cent. Although a few modifications have been made in the ceilings since then, the structure of maximum rates has remained essentially unchanged for over 2 years.

Over this period, of course, market interest rates varied considerably -- declining substantially during the early part of 1967 but generally rising or easing very little since then. Under these circumstances, the existence of the interest rate ceilings and their effects on the competition for funds have been the focus of much discussion -- some of it heated -- among participants in the financial markets. From time-to-time, I am urged by commercial bankers to support an increase in the ceilings on consumer-type time and savings deposits (or better still their complete removal). Even more frequently, I hear complaints from bankers about the advantage of 75 basis points which S&L's have over banks in the maximum rates payable on passbook savings. At other times, I receive complaints from S&L officials about the competition from commercial banks because of the latter's ability to offer up to 5 per cent on consumer-type CD's -- the "Golden Passbook" being a special target of criticism. In reporting these comments, I do not intend to suggest that there is widespread unhappiness with the existing interest rate ceilings. However, I do think they are indicative of the kinds of difficulties which must be encountered when bank regulatory authorities are called upon to engage so directly in setting prices.

For this reason, as I have stated numerous times, I think it would be a serious mistake for Federal agencies to get into the habit of substituting their judgments as to a desirable interest rate structure -- on a quarter-to-quarter basis -- for those of management officials responsible for the conduct of the affairs of particular institutions. In my opinion, it would be better not to have any mandatory ceilings (as is currently the case under the temporary authority now in force). Moreover, under normal circumstances, I would favor removing the ceilings entirely -- although I would like to see a continuation of standby authority to reimpose the ceilings if a serious disequilibrium were to emerge among those institutions competing for savings flows.

In reaching this conclusion, I am not unmindful of the fact that some depositary institutions (particularly S&L's) compete in imperfect markets and thus run the risk of losing deposits (or gaining them at a slower pace) if they were to attempt a reduction in rates while their competitors continued to advertise higher rates. Given this situation, I am convinced that the rate ceilings should be kept in place for the time being.

Need For Structural Reforms

On the other hand, I also think it is highly desirable that efforts to bring about reforms in the structure and techniques of operation of depositary institutions (again especially among S&L's) should be accelerated. Consequently, I applauded the FHLBB's encouragement of S&L's to modify the structure of their liabilities by putting more stress on the sale of savings certificates -- offering higher yields on longer maturities rather than making across-the-board adjustments on regular accounts. For the same reasons, I also applauded the efforts to enact the federal charter bill in the last Congress, because this would have broadened considerably the instruments available to institutions to compete more vigorously for savings. It also would have created much wider investment opportunities. Hopefully, the S&L's (despite the benefits they derived through the amendments to the 1968 Housing Act) will not abandon their efforts to help bring about these needed reforms.

On the other hand, while I think we are well advised to stress the improvements required to strengthen the position of thrift institutions, we ought not to lose sight of the significant changes already occurring in the structure and functioning of the mortgage market. For example, the market for existing homes traditionally has been a major user of mortgage funds; the volume of transactions in this part of the market has normally run as much as 2 to 3 times greater than the volume in the market for new units. In the early years of this decade, when funds were much more ample, when interest rates and other terms were relatively easy and when opportunities for refinancing were much wider -- it was to the market for existing homes that lenders turned to keep their funds employed. During the last few years, however, there has been an increased tendency to by-pass regular lender channels as sellers of old homes have allowed buyers to assume outstanding mortgages carrying interest rates much more attractive than those currently available.

Increased reliance on assumptions of existing mortgages is only one of many indications that the market is becoming more efficient in the direct use of mortgage funds from regular lender sources. And this increased efficiency has apparently been supported by other developments as well. For example, equity participations in real estate ventures, particularly by life insurance companies but also by others, have grown in place of direct investment in mortgages. This has reflected investor awareness of the greater yield potential offered at a time of rapid appreciation in real property values mentioned earlier, compared with the yields on fixed market instruments. The trend has also reflected both the lure of the special tax advantages that still accrue from apartment and related ownership, and the possibilities opened by the expanded capital and management requirements for new ventures.

Another perhaps less obvious illustration of factors that have promoted greater efficiency in the use of direct mortgage funds from conventional sources has been the shift by FNMA to regular weekly auctions in connection with its secondary market activity. Instead of buying outright eligible Government-underwritten home-mortgages at a set price, since last May FNMA has offered, in effect, standby commitments that may or may not be taken down within 3 months, 6 months or a year at the option of the bidders. Among other benefits, this change has allowed FNMA to make a greater immediate contribution to activity with a much smaller outlay of its own resources.

Such institutional changes will inevitably have a bearing on the volume of commitments builders will be able to secure for new construction. Even so, if the availability of mortgages is to be assured in the long-run, basic improvements in traditional sources of funds -- that is, in flows to major lender groups -- will have to come. Also, the differential in favor of mortgages vis-a-vis bonds and other types of investments will have to be maintained, if not improved, if life insurance companies and mutual savings banks (two of the lender groups with relatively broad investment options) are to return to their traditional positions in the mortgage market. Also, as seems possible, commercial bank mortgage financing -- which has already expanded significantly in recent years -- will have to grow further. In addition, the structural adjustments in funds-flows resulting from the removal of the statutory ceiling on Federal Government-underwritten home mortgages last May and the raising of usury ceiling limits for conventional mortgages in certain states -- particularly in the Northeast where such ceilings had been especially low -- will have to be preserved.

The Federal Reserve and the Mortgage Market

As I have said, steps such as these discussed above -- designed to bring about greater stability in the flow of funds into mortgages -- should be applauded by all of us. In my opinion, efforts in that direction are far more promising than are proposals that the Federal Reserve support the mortgage market directly. Such a proposal was debated and rejected, although narrowly, by the Senate last summer. This was in an amendment adopted by the Senate Banking and Currency Committee to S.3133, a bill to extend the temporary authority for establishing ceilings on rates payable by banks and thrift institutions to attract savings -- which was discussed above. The amendment would have authorized the Federal Reserve System to purchase, directly from the agencies involved, obligations issued or guaranteed by Federal agencies. And it would have directed the Federal Reserve to make such purchases "when alternative means cannot effectively be employed, to permit financial institutions to continue to supply reasonable amounts of funds to the mortgage market during periods of monetary stringency and rapidly rising interest rates."

This proposal was opposed by the Administration and by the Federal Reserve. Speaking for the Board of Governors, Chairman Martin testified in opposition to the proposal before the House Banking and Currency Committee on June 27. The basic objections to the proposition were expressed in one paragraph in that testimony:

"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. There are, of course, legitimate grounds for concern about the mortgage market, just as there are many other areas in which Federal support programs may be called for. But thus far the Congress very wisely has refrained from attempting to finance such programs through creation of money by the central bank. At a time when confidence in our ability to manage our financial affairs responsibly is being severely tested, we simply cannot afford to create the impression that we are about to embark on a new support program to be financed in such a fashion."

If this support operation were directed at assuring something approaching a normal flow of funds into mortgages, the amounts involved could be massive, perhaps as much as $9 billion at annual rates. System purchases of FHLBank and FNMA issues in such magnitudes would, of course, mean that we would have to make offsetting sales of Treasury bills, to avoid an inflationary increase in bank reserves. And such sales would push Treasury bill rates higher, at a time when (by hypothesis) interest rates were already rising rapidly. The Federal Reserve would then face, as Chairman Martin pointed out, "the difficult choice of abandoning the effort to support the mortgage market, or continuing it notwithstanding its inflationary impact, or attempting to make offsetting sales of Treasury obligations at the risk of disrupting the market for Treasury securities."

Large-scale sales of Treasury bills by the System would pose another problem, too, for thrift institutions and the mortgage market. As interest rates rose under the pressure of such sales, savings could be diverted from depositary institutions directly to the market, thus reducing the supply of funds available for the principal mortgage lenders. And yields on mortgages would decline relative to other investments, so that lenders who were free to do so would tend to shift out of mortgages.

The end result, then, would be a massive substitution of Federal Reserve funds for private funds in the mortgage market, which would benefit neither lenders nor borrowers in that market.

Let me add that the Federal Reserve recognizes an obligation to assist thrift institutions in emergency conditions, as a lender of last resort. Standby procedures to accomplish this purpose were authorized by the Board in 1966, and the System study of the discount mechanism released last July reiterates our readiness to meet this obligation.

Moreover, since September, 1966, the Federal Reserve System has had authority from Congress to buy and sell in the open market all Federal agency issues (including those offered by FNMA and FHLBanks) which are direct obligations of, or fully guaranteed as to principal and interest, by the agency. System transactions have taken the form of repurchase agreements. The gross volume of such agreements has been over $1.7 billion since late 1966, and housing agency issues have accounted for more than one-half of the total.

Currently there are roughly $21 billion of outstanding obligations issued by the Federal Home Loan Banks, the Federal National Mortgage Association, the Federal Land Banks, the Federal Intermediate Credit Banks, the Banks for Cooperatives and the Tennessee Valley Authority. Housing agency issues represent almost one-half of the total Federal agency debt outstanding. Over the last decade the volume of debt issued by all agencies has more than quadrupled. Roughly two-thirds of the total presently outstanding consist of short-term issues maturing within one year, and only about 10 per cent is composed of long-term issues due after five years.

Agency issues are generally fairly close substitutes for U. S. Government debt; the same investor groups that hold regular Treasury debt are typically holders of agency debt as well. Yields on agency debt ordinarily vary in about the same pattern as those on Treasury debt of the same maturity. While the levels of yields on agency debt are generally somewhat above those on Treasury issues, they are below yields on private securities of comparable maturity. As general credit conditions change from ease to tightness, yield spreads between Treasury and agency debt tend to widen, reflecting the somewhat greater liquidity and marketability of Treasury issues.

Also, spreads vary depending on the relative size of changes in new debt offerings in the two markets. For example, in the first half of 1966 when general credit conditions were tightening, the volume of new agency debt was being expanded at an unprecedented pace, largely as a result of expanded FNMA and Federal Home Loan Bank issues. At the same time, the Federal Government was meeting a sizable part of its new money requirements through a new program of sales of Federal participation certificates in lieu of straight Treasury debt. Spreads between yields on Treasury and agency debt under the circumstances widened to as much as

75 basis points. In periods of relatively easy money, however, the spread on short-term issues ranges from 10 to 25 basis points, moving to the high end of the range and above as credit conditions tighten.

The persistent tendency for yields on agency debt to maintain a spread above those on Treasury issues is partly a reflection of differences in default risk. But in addition -- although the secondary market for agency issues has developed substantially in recent years -- Treasury issues are still generally assumed to have greater marketability. This is particularly true of Treasury bills, but even Treasury coupon issues are viewed as more tradable, particularly among longer maturities. This is so partly because individual agency issues are of substantially smaller size than individual Treasury issues, which makes it more difficult for dealers to trade them. It should be noted, however, that trading activity among short-term agency issues is generally as large as that for Treasury coupon issues of similar maturity. Also short-term debt of the six separate agencies is relatively homogeneous, and typically trades at roughly commensurate yield levels.

As I noted above, some Federal Reserve System transactions during the last two years have been conducted through repurchase agreements involving agency issues. These transactions have tended to strengthen the agency market by encouraging dealer willingness to hold securities in position as they intermediate between buyers and sellers. Since nearly one-half of this debt outstanding consists of housing agency issues, strengthening of the agency market also contributes marginally to an improved market for home mortgages.