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MONETARY POLICY, SAVINGS FLOWS, AND THE
AVAILABILITY OF HOUSING FINANCE

Remarks

By

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of the
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When I accepted the invitation extended to me last winter to speak at this Annual Meeting of the Michigan Savings and Loan League, I indicated that I would focus on some aspect of monetary policy as it relates to housing finance. At that time, I obviously could not have anticipated that the interrelations between the two would be so central to our mutual concerns when the date for this Meeting actually arrived!

Of course, given the fundamental importance of credit availability for the housing market, I am certain that there is always a meaningful dialogue to be carried on between those of us who help to formulate and execute monetary policy and the members of your industry who supply such a large proportion of the funds needed to meet the nation's demand for housing. But the decision made earlier this month by the Federal Reserve Board and other Federal supervisory agencies to raise or remove the interest rate ceilings on savings and consumer-type

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I am grateful to several members of the Board's staff for assistance in the preparation of these remarks. Messrs. James Kichline and Michael Prell helped to trace recent developments in savings flows at depository institutions. Mr. Bernard Freedman provided assistance in the assessment of trends and prospects in homebuilding, and Mr. Robert Fisher did the same thing with respect to the mortgage market. Mr. Kichline also helped with the appraisal of the financial outlook in the months immediately ahead.

However, while I am grateful to the staff for its support, the analysis presented and conclusions reached are my own and should not be attributed to the Board's staff. Nor should they be attributed to my colleagues on the Board.

time deposits has clearly sparked a vigorous discussion of some of the vital issues that are close to thrift institutions and others concerned with housing finance. So, I decided that in these remarks, I would attempt to examine several of these issues from the vantage point of a Member of the Federal Reserve Board. Let me acknowledge, however, that because we have responsibility for the conduct of monetary and credit policy with the objective of enhancing the economic welfare of the country as a whole, our perspective may not be precisely the same as that held by participants in a particular industry.

Before turning to the body of these remarks, it might be helpful to summarize several of the main points:

- The Federal Reserve has followed a policy of substantial monetary restraint in 1973. However, by June the need for additional measures to check the excessive expansion of the monetary aggregates had become increasingly evident. Otherwise--far from serving to help dampen the persistently strong inflationary pressures in the U.S. economy--monetary policy could have become an instrument of further inflation.
- In pursuit of this goal, the Federal Reserve has employed all of its traditional tools of monetary control: it has supplied fewer reserves through open market operations; it raised reserve requirements, and it advanced the discount rate to the highest level posted since the early 1920's.
- As is generally known, the discount rate lagged behind rising market rates through late 1972 and in early 1973. This differential created an incentive for a number of the largest member banks to borrow heavily through the discount window to help meet the strong credit demand of the private sector--especially the demand originating with business firms.

- Many of the largest corporations in the country in turn were induced to borrow from commercial banks partly because the relatively low prime lending rate prevailing at the latter in the face of sharply rising yields in the money market. Until April of this year, policies followed by the Committee on Interest and Dividends limited the ability of the commercial banks to pass on to business borrowers the higher cost of money which the banks themselves were facing. As a result, a substantial proportion of corporate demand for short-term funds was shifted from the commercial paper market to the banks.
- Homebuilding was a major source of economic strength during the early months of 1973. However, by mid-year, the pace of housing activity was dampened appreciably by the lessened availability of mortgage finance at thrift institutions. The latter experience itself was the result of the severe competition for savings reflected in the sharply rising level of interest rates on market instruments.
- To moderate the adverse impact of these developments on savings intermediaries (and through them on the supply of mortgage funds), the ceilings on interest rates payable on consumer-type deposits were raised earlier this month.

In the final section of these remarks, some of the principal elements in the financial outlook over the next several months are discussed. I realize, of course, that the continuing uncertainties affecting the dollar in the foreign exchange markets--as well as the uncertainties on the domestic political front--will have a bearing on financial developments in the United States. These can only be noted here to indicate my awareness of their presence.

Strategy and Implementation of Monetary Policy

During the first half of 1973, monetary policy sought to restrain the large demands for funds registered in the money and capital markets as part of the national effort to check inflation. In pursuit of this goal, the Federal Reserve System employed all of its traditional tools of monetary policy: fewer reserves were supplied through open market operations; the discount rate was raised six times, and member bank reserve requirements were increased. Moreover, the System resorted extensively to moral suasion, and interest rate ceilings on time deposits were relaxed on two occasions. The interplay of strong credit demands and a restrictive monetary policy contributed to a significant firming in financial markets. This firming was reflected in a sharp increase in short-term interest rates, and--as the year progressed--in a general tightening in lending practices at commercial banks. At nonbank thrift institutions, a slowdown in deposit growth during the spring and early summer reportedly also prompted a tightening of mortgage commitment policies.

Behavior of Bank Reserves: In the first six months of this year, total reserves of member banks expanded at a seasonally adjusted annual rate of 7.3 per cent. However, the volume of reserves supplied by the Federal Reserve expanded less rapidly (at an annual rate of 4.8 per cent). Consequently, the pressure on bank reserves arising from the strong demands for bank credit led to

a significant rise in the federal funds rate. In the first quarter, the rate banks pay for reserve funds borrowed overnight from other banks rose more than 175 basis points to a level of 7.09 per cent in March. Pressure on bank reserve positions increased even further in the second quarter, and the federal funds rate exceeded 9 per cent in early July, more than 300 basis points above the level prevailing at the end of last December.

On May 16, a marginal reserve requirement of 3 per cent was imposed on large denomination (\$100,000 and over) certificates of deposit (CD's) issued by Federal Reserve member banks. This move raised to 8 per cent the reserves required against increases in the amount of CD's outstanding after mid-May. Subsequently, the Board asked nonmember banks and agencies and branches of foreign banks in this country to subscribe voluntarily to the same requirement. Late in June, reserve requirements were raised by 1/2 per cent on member banks' net demand deposits in excess of \$2 million, effective in mid-July.

Accompanying the rapid credit expansion, reserves available to support private non-bank deposits (RPD's) rose at a seasonally adjusted annual rate of 11.3 per cent in the first half of this year. However, with private member bank demand deposits growing more slowly, most of this increase went to support the sharp expansion in outstanding CD's. Total reserves grew at a much slower rate reflecting a sizable decline

in Federal Government and interbank deposits. Nevertheless, as the month of June progressed, it became clear that the overall availability of bank reserves was expanding at a rate in excess of that which was consistent with a policy of monetary restraint. For example, in June nonborrowed reserves rose at an annual rate of 24 per cent and RPD's at an annual rate of 16 per cent. As these trends emerged more clearly, the Board concluded that reserve requirements should be raised, and the step was taken at the end of June.

Behavior of the Money Supply: During the first six months of 1973, the money supply turned in a mixed performance. The rate of growth slowed appreciably in the first quarter, but a sharp acceleration occurred in the last three months--especially during June. In the January-March period, the narrowly defined money stock (M_1 , privately-owned demand deposits and currency in the hands of the public) rose at a 1.7 per cent annual rate. This was in noticeable contrast to the relatively rapid 8.6 per cent growth rate in the final quarter of 1972.

Several factors may have accounted for the slower pace of expansion in M_1 , during the first quarter. It is possible that the demand for money was dampened by the cumulative impact of rising interest rates. Moreover, deepening concern over inflation may have led some consumers to substitute goods for cash. Aside from these general influences, a number of special factors may have helped to

hold down the rate of growth in M_1 . For instance, it appears that State and local governments (who received a sizable amount of revenue-sharing funds last December) reduced their checking accounts and shifted the funds into time deposits. The evidence also suggests that corporations borrowed less than usual to pay income taxes in mid-March and instead drew down their demand balances. Finally, the disturbances in the foreign exchange market in February and March could have resulted in the movement abroad of a minor amount of funds withdrawn from demand deposits.

The first quarter of the year also saw a considerable slackening from the strong rates of growth in the broadly defined measures of the money stock. One of these, M_2 (defined as M_1 plus time deposits at commercial banks other than large CD's), rose at an annual rate of 5.7 per cent during the January-March months. Over the same period, M_3 (defined as M_2 plus deposits at thrift institutions) expanded at an annual rate of 8.6 per cent. To some extent, these slower rates of expansion reflected the tapering off of growth in M_1 . Beyond this, however, a further decline occurred in February in the inflow of consumer-type time and savings deposits at commercial banks as well as thrift institutions. This slower inflow, in turn, was a reflection of the fact that consumer-type time deposits became progressively less able to attract investors as yields on competing market assets rose appreciably.

In the second quarter, the expansion of M_1 accelerated sharply to an annual rate of 10.4 per cent. In June alone, the rise was 12.9 per cent at an annual rate. Apparently, the rapid growth in GNP and increasing inflationary expectations resulted in a substantially larger transactions demand for money by consumers and businesses. In addition, special factors such as unusually large personal income tax refunds in April and May perhaps contributed to the faster second quarter pace. For the first six months together, M_1 increased at about a 6.1 per cent annual rate. This was appreciably below the 8.5 per cent pace in the second half of 1972. Yet, as the second quarter drew to a close, the growth of the money supply was ballooning again. If allowed to continue unchecked, the quickening pace of monetary expansion would further strengthen inflationary expectations and undermine the effort to restore reasonable price stability by the use of wage and price controls. To forestall that prospect, monetary policy became much more restrictive toward the end of June.

As interest rates on competing market assets rose further in the second quarter, inflows of savings and consumer type time deposits slowed. Consequently, both M_2 and M_3 expanded at rates below that recorded for M_1 . In fact, the prospect for substantial outflows of such deposits was the main factor which persuaded the Federal Reserve

Board of the need to lift interest rate ceilings on such deposits earlier this month. This action is discussed further below.

With deposit inflows slowing, banks bid aggressively for funds to finance rising credit demands through sales of large negotiable CD's. As a result, in the first six months of 1973, CD's increased by close to \$19 billion--compared to \$10 billion for the entire year 1972. A significant proportion of the increases occurred in the first quarter when the inflows of demand and time deposits were weakest. In the second quarter, banks found it increasingly costly to attract CD funds, and net sales were somewhat less than in the preceding three months. By March, rates offered by most large banks on CD's with maturities of 90 days or more were at ceiling levels--which were below rates available on competing money market instruments. Consequently, bank sales became more concentrated in short-term issues. On May 16, the Board suspended interest rate ceilings on all large denomination CD's, and rates on longer-term instruments rose sharply. The increase in marginal reserve requirements on CD's late in the second quarter made additional use of these funds even more expensive to banks.

Behavior of Bank Credit: During the first half of this year, bank credit expanded at an annual rate of 14.3 per cent. This sharp increase was dominated by an expansion in business loans--basically

a reflection of an increased cyclical need for working capital. In addition, especially in the first quarter, the relatively low commercial bank prime lending rate resulted in sizable substitutions of bank credit for more costly commercial paper borrowing by corporations. Other loan categories (including real estate and consumer loans) were unusually strong throughout the first six months of the year--in association with the large rise in consumption spending and continuing high levels of homebuilding activity.

In the first quarter alone, commercial banks' total loans and investments rose at roughly an 18.5 per cent annual rate. This was almost 1-1/4 times the growth rate recorded in 1972. During the January-March period, banks reduced their holdings of U.S. Government securities, but these cutbacks were more than offset by the upsurge in business borrowing. These businesses, in turn, were borrowing heavily to finance inventory investment and to meet working capital requirements. In addition, as discussed further below, the restraint on the banks' ability to increase their prime lending rate made it difficult for them to discourage borrowing by large corporations. As a result, a substantial number of these businesses relied more on commercial banks and less on the commercial paper market to obtain funds.

The drawdown of U.S. credit lines by foreign commercial banks also gave a substantial boost to bank credit expansion during the first quarter. Changing foreign exchange rates and the differentials between

U.S. interest rates and yields available in the Euro-dollar market apparently provided an incentive for these foreign banks to borrow here and to use the funds abroad. As a consequence, loans to foreign banks climbed by about \$2 billion in February and March. Although some repayment of these loans had gotten underway by late March, the volume outstanding remained exceptionally large. On the domestic scene, bank lending directly to consumers rose substantially in the first quarter. The banks also expanded their lending to finance companies--which in turn channeled the funds primarily to households. Other nonbank financial institutions (especially mortgage bankers and real estate investment trusts) also borrowed heavily at banks.

During the second quarter, the rate of growth of bank credit slackened somewhat--registering an annual rate of expansion of 9.8 per cent compared with 18.4 per cent in the first three months of the year. Banks expanded moderately their holdings of both U.S. Government and other securities. Among types of loans, the slackening in the pace of growth was most noticeable in the case of business loans--which expanded at an annual rate of 20.3 per cent in second quarter vs. 39.1 per cent in the first three months. The banks' real estate loans rose at an annual rate of 16 per cent in both quarters. The growth of consumer loans slackened somewhat--receding to an annual rate of 14.2 per cent in the March-June period compared with 17.6 per cent in the first quarter.

The behavior of business loans in the last month is especially noteworthy. In June, bank loans to business firms rose at a 14 per cent annual rate. This rate suggests that business demand for funds is still strong, but it seems to have moderated considerably compared with the exceptionally high rates of growth which occurred earlier this year. Undoubtedly, part of this slowing can be attributed to the increases in the banks' prime lending rates as they responded to the rising costs and lessened availability of funds. Furthermore, borrowing by corporations to make quarterly income tax payments seems to have been somewhat below the volume borrowed in previous years. Apparently corporations relied on a sizable run-off of CD's to meet a significant part of their needs. It also seems that a number of businesses turned to the commercial paper market in June to raise a relatively greater proportion of the funds they required--spurred to some extent by the rapidly rising prime lending rates at commercial banks.

Discount Rate Policy and Member Bank Borrowing: As mentioned above, the Federal Reserve Banks' discount rate was raised six times during the first half of this year. On January 12, the rate was raised to 5 per cent from 4-1/2 per cent (where it had been since December 10, 1971). Through mid-May, the rate was moved up three more times to 6 per cent. On each of these occasions, the Board emphasized that the actions were taken to bring the discount rate more into line

with market rates--although the latter remained well above the former. However, in early June, the discount rate was increased to 6-1/2 per cent, and the Board stressed that the action was designed partly as an anti-inflation move. Finally, at the end of last month, the discount rate was again raised by 1/2 per cent to 7 per cent. On that occasion, the Board's desire that the measure be seen as a further anti-inflation move was made quite explicit, and it was combined with a 1/2 per cent increase in reserve requirements on demand deposits.

As money market interest rates rose, the gap between such rates and the discount rate became progressively larger. This strengthened the incentive of member banks to borrow from Federal Reserve Banks. Such borrowing rose sharply in the first quarter to an average of \$1.5 billion--compared with an average of \$740 million in the last three months of 1972. The average level of borrowing has risen steadily since then--to \$1.8 billion in the second quarter and to \$2.0 billion in the first two weeks of July. Viewed in a longer perspective, the year-to-year change in the level of member bank borrowing is even more striking. For example, in 1972, weekly average borrowing ranged from a low of \$12 million to a high of \$1,223 million; this year the range has been from a low of \$688 million to a high of \$2,401 million.

Moreover, borrowing has been heavily concentrated among the largest member banks. The 46 money market banks (which report daily to the Federal Reserve on their federal funds transactions) typically

accounted for one-quarter to one-third of total member bank borrowing during the first 6-1/2 months of this year. In contrast, during the period of severe monetary restraint in 1969, their share of total borrowing averaged only one-sixth, and it rose to only one-fifth in 1970.

An even closer look at the statistics on borrowing from the Federal Reserve Banks demonstrates clearly that member banks have lost much of their traditional reluctance to borrow.^{1/} Instead, they seem quite willing to include borrowing at the Federal Reserve discount window along with CD's, Euro-dollars, and other sources in planning their portfolio strategy. In choosing among the various alternatives, they seem to be influenced far more by differences in the cost of money than was typically thought to be the case. Undoubtedly, the vast majority of member banks do remain reluctant to borrow from Federal Reserve Banks; and when they do borrow, they normally make few trips to the window and for fairly short periods of time. But among the very large banks, the frequency of borrowing has increased, and its timing suggests strongly that these banks are motivated substantially by differences between the discount rate and the cost of funds in the money market.

^{1/} See Andrew F. Brimmer, "Member Bank Borrowing, Portfolio Strategy, and the Management of Federal Reserve Discount Policy," Western Economic Journal, Vol. X, No. 3, September, 1972, pp. 243-297.

For this reason, I have become convinced in recent years that the Federal Reserve discount rate should be kept much more closely aligned with market rates. This was recommended in 1968 by a Federal Reserve committee which made a comprehensive study of the discount mechanism. Initially I had reservations about that proposal. However, as I have watched the changing posture of member banks with respect to borrowing from Reserve Banks, I have become increasingly convinced that the Federal Reserve System--particularly the Board of Governors--needs to revise its attitude toward the discount rate. I believe the rate should be managed in a much more flexible manner, and it should be kept in much better alignment with money market yields.

Interest Rates: Competing Policy Objectives

As I noted above, short-term interest rates have continued to climb steeply through 1973. This uptrend is the by-product of strong demands for short-term credit and a more restrictive monetary policy. On the other hand, some short-term interest rates have risen less rapidly than one would have expected--and are still at levels below those which might have been implied by the vigor of economic activity and the growing scarcity of resources. To some extent, these divergencies

may reflect the efforts of the Administration's Committee on Interest and Dividends (CID)^{3/} to moderate increases in administered interest rates to increases in costs that resulted primarily from pressures in the money and capital markets.

Monthly average rates on three-month Treasury bills rose over 200 basis points from December, 1972, to June, 1973. During the same period, commercial paper rates increased by about 250 basis points; the federal funds rate advanced over 300 basis points, and commercial banks' prime lending rate moved from the 5.00-5.25 per cent range at the beginning of the year to 7-3/4 at the end of June. Following the increase in the discount rate to 7 per cent effective July 2, all of these rates rose sharply. For example, by mid-month, rates on 3-6 month Treasury bills had climbed by some 65 basis points to the neighborhood of 7.89 per cent. The rise in private short-term rates generally exceeded the advances in bill rates. In mid-July, the highest rates being quoted in the 3-month maturity range on prime bankers' acceptances and large CD's at New York City banks (9-1/4) and on prime commercial paper (9 per cent) were 80-90 basis points above the levels

^{3/} A great deal of confusion has developed between the role of the CID and the responsibilities of the Federal Reserve Board. It is true that Dr. Arthur F. Burns is Chairman of both. But, in fact, the two entities are quite separate and distinct. The CID is a unit of the Administration's Cost of Living Council which administers the wage and price control program. The Federal Reserve Board (no Member of which besides the Chairman serves on the CID) remains an independent agency charged by Congress with the responsibility to conduct monetary policy so that it can make its maximum contribution toward the achievement of economic stability.

prevailing two weeks earlier. Moreover, reports were heard that even higher rates had to be paid to do a substantial volume of business. Commercial banks' prime lending rates had also moved to 8-1/2 per cent. Thus, by mid-July, short-term interest rates had generally risen almost to--and in a few instances above--the record levels set in late 1969 and early 1970. But, given the persistence of inflationary pressures and the strong competition for funds, the uptrend of interest rates was consistent with a policy of monetary restraint designed to help check inflation.

But while interest rates were generally advancing, some rates lagged appreciably behind. This was true, at times, not only of consumer and mortgage rates--traditionally lagging rates--but also of rates commercial banks charged their corporate and small business customers. In response to requests by the Committee on Interest and Dividends, during the first quarter of this year, banks limited increases in the structure of rates to the rise in their own cost of funds. Apparently the CID was apprehensive that the Administration's Economic Stabilization Program might be undermined if administered interest rates--which the Committee stated to be its sole concern--moved upward rapidly on a broad front. The Committee stressed that it was at no time concerned with open market rates.

Opinions differed sharply over the approach of the CID to the behavior of interest rates. But independently of where one's own views might rest in this controversy, the effects of the policy on the demand for bank credit can be seen clearly. As the banks' prime rate lagged behind interest rates in the commercial paper market early in 1973, many corporate borrowers found it advantageous to switch to bank credit as a means of meeting their working capital needs. As a result, dealer placed paper contracted by \$3.8 billion during the January-April period of this year. The amount of such paper outstanding rose by \$1.1 billion in the same period of 1972 and by \$1.7 billion in 1971. In contrast, business loans at large commercial banks rose by \$11.6 billion during the January-April months of this year--whereas the increase in the same months of 1972 was \$677 million, and in 1971 a decline of \$481 million was recorded. Thus, the relatively low prime lending rate at commercial banks led to the substitution of bank credit for a sizable amount of borrowing which corporations otherwise would have done in the money market.

In April of this year, the CID issued guidelines which permitted a two-tier prime rate to emerge. Under this arrangement, the prime rate that banks charge large corporate borrowers could be aligned more closely with rates on other money market instruments, while the rates charged small businesses were expected to remain fairly stable. Banks moved quickly to take advantage of this greater flexibility, and lending

rates to large borrowers were raised substantially. Partly in response to the rising cost of bank credit, business loans at large banks rose by only \$884 million in May vs. an average of \$2.9 billion in the preceding four months. The increase in June was much larger (\$2.1 billion), but the May-June average of \$1.5 billion was well below that recorded in earlier months. Also in May, the volume of dealer-placed commercial paper rose by \$222 million, and June brought another gain of \$180 million. So, by mid-year, as commercial banks raised their prime lending rate progressively, an increasing number of corporate borrowers were induced to look to nonbank sources of funds to meet their demands for funds to finance working capital and inventory investment.

Housing Demand and the Supply of Funds

The significant role which the housing sector has played in economic expansion during the last few years is widely known and need not be recounted here. However, it might be helpful to summarize the highlights of recent (and prospective) developments relating to the demand for and supply of housing. As mentioned above, the increasingly adverse impact of rising market interest rates on the availability of mortgage funds was one of the major factors influencing the decision of the Federal Reserve Board and other Federal bank regulatory agencies to lift interest rate ceilings on consumer-type savings earlier this month.

Trends in Residential Construction: Real outlays for private residential construction have drifted downward since March. Underlying the decline has been a noticeable decrease in private housing starts from the near-record pace of activity during the winter months. Nevertheless, the average level of starts in the first quarter of this year (at a seasonally adjusted annual rate of 2.40 million units) was second only to the peak recorded in the same period last year. Moreover, starts in the second quarter averaged 2.22 million units--still one of the highest averages on record. On the other hand, on the basis of preliminary figures for June, it appears that the sharply higher level of starts reported for May (2.42 million) was not sustained. At 2.12 million units, the level of housing starts last month apparently receded to that recorded in April (which was also 2.12 million).

In the meantime, an unusually large volume of housing units is still under construction. This suggests that homebuilding activity through the remainder of 1973 and into 1974 will remain at a fairly high level--thereby affording an increasingly stringent test of the absorptive capacity of the real estate market. These newly-completed units, carrying rather liberal mortgage financing terms arranged sometime earlier, will add to downward pressures on new housing starts financed under relatively less favorable terms.

Supply of Mortgage Funds: Through last month, the slackening of deposit inflows at thrift institutions (caused mainly by the rise in market interest rates) apparently had a growing adverse impact on the availability of new mortgage funds. At savings and loan associations (S&L's) in particular (the largest single source of housing finance), the growth of share capital appears to have slowed to a seasonally adjusted annual rate of 9-1/2 per cent in the second quarter, compared with 16 per cent in the January-March months. If this were the case, the April-June quarter would be the first one since the same period of 1970 in which share capital has failed to grow at a rate significantly in excess of 10 per cent. Under these circumstances, the total of S&L mortgage loans in process and outstanding commitments for future mortgage loans was down by 7 per cent through the month of May from record high levels. For example, outstanding commitments and loans in process peaked at \$21.5 billion (seasonally adjusted) in February; by May the level had declined to \$20.1 billion--a relatively sharp decline for these items but--nevertheless--to a level still above that for any time prior to this year.

But as the spring continued to unfold, the cumulative effect of reduced net savings inflows to the S&L's and savings banks during June and through early July apparently continued to induce further cutbacks in the volume of new residential mortgage commitments, particularly in view of the large backlog of outstanding commitments. Consequently, under these circumstances, S&L's have been borrowing heavily from the Federal Home Loan Banks (FHLB). To date this year, they have borrowed a net of \$3.5 billion--\$700 million of which was raised during the 3 weeks ending in mid-July. By then, outstanding advances had reached more than \$11 billion.

The willingness of the FHLB system to support S&L's in their lending efforts has been an important source of partial protection for the housing market in 1973 in the face of sharply rising interest rates. Of course, reliance by S&L's on higher cost FHLB advances is no real substitute for regular deposit inflows as a means of sustaining the flow of funds into housing. But such advances do enable S&L's to adjust their residential mortgage lending in an orderly manner as the pull of market interest rates dampens savings inflows.

Just how important FHLB advances have been to S&L's can be seen by a comparison of this year's experience with that registered in 1966 and 1969-70. In 1966, the FHLB Board responded in limited fashion to the restricted flow of funds to its member institutions. At that time, its policy on advances was initially influenced by concern with the loan portfolio quality and dividend rate policies of the S&L's. Furthermore, the FHLB System's ability to raise funds for advances was subject to some

uncertainty in the market environment it faced and because of a Government program of restricting agency borrowing. As a consequence, advances outstanding rose less than \$1 billion during 1966, and net mortgage debt formation by S&L's fell three-fifths from the 1965 level. Housing starts also fell sharply in the course of the year.

The experience in 1969-1970 differed markedly from that in the 1966 period of credit restraint. The FHLB System responded aggressively to the credit squeeze in order to assure the availability of mortgage funds. Advances outstanding rose by \$4 billion during 1969 and by another \$1.3 billion in 1970--despite the upsurge of deposits in the second half of the latter year. The greater availability of FHLB advances in 1969 helped S&L's to maintain a steadier flow of mortgage loans than in 1966, and hence aided in cushioning the decline in housing starts in 1969. Thus, the FHLB's actions in the 1969-1970 episode, rather than those in 1966, better reflect its current perception of its role in support of the savings and loan industry and the nation's housing objectives.

Trends in Mortgage Interest Rates: Even before ceilings on savings deposits were raised earlier this month, interest rates on residential mortgages had already risen appreciably. In late June, conventional first mortgages on new homes carried contract interest rates which averaged 8.05 per cent. This represented an increase of 50 basis points from the most recent low registered in March, 1972, and it was the highest monthly average since late 1970. Even so, the June level was roughly 55 basis points below the peak attained in the Summer of 1970.

The average rate of interest on existing-home mortgages was also 8.10 per cent in June. In a number of states (located primarily in the East and South) that still have fairly low usuary ceilings, yields required by lenders had already reached the legal limits by last month.

The gradual uptrend in costs of residential mortgage financing that began early in 1973 has apparently accelerated in July. To some extent, this represents a reaction to the increase in ceilings on consumer-type savings effected earlier this month. Moreover, contract interest rates on FHA and VA mortgages were raised by 75 basis points in early July, although no new commitments can be made under these programs until the Congress reinstates the insurance authority that expired at the end of June. Rates on new commitments for conventional home mortgages apparently were averaging 10 to 15 basis points in excess of 8 per cent as of mid-July, thereby intensifying structural problems associated with usury ceilings that have become increasingly restrictive again.

In the secondary mortgage market, the uptrend in yields also has accelerated, partly stimulated by the announced upward adjustment in FHA/VA mortgage rates. In the mid-July FNMA auction of forward commitments to purchase Government underwritten home mortgages, the average yield climbed to 8.38 per cent, the highest level in more than 2-1/2 years.

Interest Rate Ceilings and Savings Flows

The decision made earlier this month by the Federal bank regulatory agencies to raise interest rate ceilings on consumer-type time and savings deposits was received with mixed feelings on the part of many depository institutions. In fact, among some officials in these institutions, there have been explicit criticism of the increase in rate ceilings. Perhaps to some extent this has reflected a misunderstanding of the role and effect of such ceilings when viewed from the national-- as opposed to the industry--level.

After an unusually high rate of growth in January of 1973, deposit flows to nonbank thrift institutions began to slow in succeeding months. The seasonally adjusted annual rate of expansion in these deposits was 13.6 per cent during the first three months of the year, but it is estimated to have moderated to about 8-1/2 per cent in the second quarter. The personal savings rate during the first half of this year was only marginally lower than in 1972, and savings flows may have been buttressed in April and May by income tax refunds. But deposit inflows slowed under the impact of the sustained and sharp rise in yields on alternative investment instruments. At savings and loan associations, the reduced expansion in savings accounts came at a time of an exceptionally high volume of mortgage takedowns. This generated a substantial increase in borrowing from the Federal Home Loan Banks, some reduction in liquidity positions, and a reported tightening of mortgage commitment policy.

I can understand why spokesmen for S&L's and other depository institutions urged that interest rate ceilings (particularly those on passbook savings) not be increased. It is true that interest rate ceilings can and have protected the thrift institutions from competition of commercial banks that could prove undesirable for mortgage credit supplies. But, at the same time, it is necessary to realize that ceilings on depository claims cannot protect depository institutions as a group from the increased relative attractiveness of yields on market securities.

At both S&L's and mutual savings banks, the inflow of funds in May and June seems to have exceeded the volume which many observers anticipated--given the already high and still rising level of market yields. During the first quarter, deposits at mutual savings banks expanded at an 8.1 per cent seasonally adjusted annual rate, and at S&L's the rate of increase was 16 per cent. So their combined growth rate was about 13-1/2 per cent. In April, the annual rate of deposit growth eased off to 5 per cent at mutual savings banks and to 7 per cent at S&L's--for a combined growth rate of 6-1/2 per cent. However, in May a rebound occurred. At mutual savings banks, the rate of expansion climbed to 6.1 per cent, and at S&L's the rise was even more marked at 10.7 per cent. Taken together, the two sets of institutions recorded an annual rate of increase 9.3 per cent in May. Moreover, the uptrend in deposit growth appears to have continued during the early weeks of June. For the month as a whole, inflows may have risen at an annual rate of 8 per cent at mutual savings banks and at an 11 per cent rate at S&L's. If so, these figures would suggest a combined annual rate of expansion of 10 per cent.

Yet, when the trend of inflows within the month of June is examined more closely, it becomes quite evident that the substantial increases in market interest rates had placed these thrift institutions on the brink of disintermediation. Commercial banks also were faced with a significant reduction in the rate of increase in deposit inflows. The pattern and magnitude of inflows at the three types of institutions can be traced in the following statistics:

Net Deposit Inflows at Insured Savings and Loan Associations^{1/}
(Millions of Dollars)

| <u>Month</u> | <u>1972</u> | <u>1973</u> |
|--------------|-------------|-------------|
| January | 3,117 | 3,117 |
| February | 2,700 | 1,795 |
| March | 2,532 | 1,628 |
| April | 1,668 | 724 |
| May | 2,107 | 1,741p |
| June | 1,626 | 700e |

^{1/} Net of interest crediting.
p - preliminary. e - estimated.

Deposit Inflows During the Reinvestment Period at the Seventeen
Largest New York City Mutual Savings Banks
(Millions of Dollars)

| <u>Year</u> | <u>Last Three Grace Days of June</u> | | <u>First Five Business Days of July^{1/}</u> |
|-------------|--------------------------------------|--|--|
| | <u>Net</u> | <u>Net Adjusted for Passbook Loans</u> | |
| 1969 | -326.3 | -170.6 | -108.0 |
| 1970 | -242.7 | -118.9 | - 28.5 |
| 1971 | -112.3 | - 69.8 | 1.4 |
| 1972 | -147.2 | - 67.7 | 38.0 |
| 1973 | -118.0 | - 86.8 | - 88.6 |

^{1/} Net deposit flows, adjusted for repayment of passbook loans made earlier to save earned but unpaid interest.

Consumer-Type Time and Savings Deposits at
Weekly Reporting Commercial Banks
(Change in Millions of Dollars)

| <u>Time Period</u> | <u>Passbook Savings</u> | <u>Consumer-Type Time Deposits</u> |
|------------------------|-------------------------|------------------------------------|
| May 31 - June 28, 1972 | 220 | 761 |
| May 30 - June 27, 1973 | 22 | 568 |

The message transmitted by these figures is inescapable: in the face of sharply rising short-term market interest rates, all of the principal depository institutions faced an increasingly real prospect of serious attrition in the inflow of funds. It appears that S&L's--after allowing for interest credited--experienced a substantially slower net inflow in June. At mutual savings banks in New York City, outflows during the June grace period were the largest since 1970; in early July of this year, they also had a large net outflow in contrast to net inflows in the previous two years. The increase in passbook savings at large commercial banks in the month of June this year was only one-tenth the size of that recorded in 1972; inflows of consumer-type time deposits also fell off by one-quarter.

So, in the absence of a change in interest rate ceilings during the present period of monetary restraint, savings inflows most probably would have deteriorated much more sharply. As a consequence, institutions undoubtedly would have cut back on new mortgage commitments, raised mortgage rates, tightened nonprice terms, and S&L's would have borrowed much more heavily from the Federal Home Loan Banks than is now in prospect. Moreover, those institutions able and willing to compete for funds through offering higher deposit rates could not have done so. Along with these inefficiencies,

small savers--those of moderate income and minimal financial sophistication--would have been more severely and inequitably penalized by being paid much less than the return that their savings could earn if employed in other channels.

I realize, of course, that a chief problem in the regulation of interest rate ceilings at depository institutions concerns the interest paying capacity of S&L's, where longer-term assets provide a slower cyclical change in cash flow and gross earnings than is experienced at commercial banks or mutual savings banks. Since early 1970, when interest rate ceilings were last adjusted upward, S&L earnings have improved sharply with the addition of higher-yielding mortgages to S&L portfolios. For example, in 1970, the cost of funds to S&L's averaged 5.30 per cent; their average interest return on mortgages was 6.56 per cent--giving them an earnings spread of 126 basis points. By 1972, the cost of money had risen to 5.38 per cent; the average return on mortgages had risen by substantially more to 7.05 per cent. So the margin had widened to 167 basis points--nearly as high as it was in 1965.

On the basis of this evidence, I conclude that the S&L industry--if not all associations--is in a position to compete for funds by offering higher rates to depositors. By so doing they can pay a return to savers closer to the economic value of their deposits.

It is still too early to tell in a definitive way how S&L's and other depository institutions have responded to the greater flexibility afforded them to set their own offering interest rates on savings. However, on the basis of information from informal soundings and other sources, it

appears that a sizable number of commercial banks have moved up to the new 5 per cent ceiling on passbook accounts, and they also have raised rates on savings certificates of under 4-year maturities. A much smaller number of banks have posted rates on the new 4-year \$1,000 minimum denomination consumer certificates. Where they have done so, nominal rates have generally centered at 7 or 7-1/2 per cent. Fragmentary information suggests that many S&L's have generally adopted the new 5-1/4 per cent passbook rate. However, in some areas, it seems that they have perhaps been slower than commercial banks in raising their rates on certificates.

On balance, as I mentioned above, I believe the decision of the Federal Reserve Board and other regulatory authorities to raise the ceilings on the maximum interest rates payable on consumer savings was well-founded. As thrift institutions adjust their offering rates, the pull of market yields on the flow of funds to them--and on into the housing sector--will be moderated compared to the more adverse impact they would have otherwise suffered.

Concluding Observations: Elements in the Financial Outlook

Before concluding these remarks, we ought to pause briefly to see what inferences for the financial outlook we can draw from the foregoing review of recent developments in money and capital markets. But I must confess at the outset that there are severe limitations on the extent to which I am able to scan the horizon to chart the probable course of interest rates and credit flows. Of course, one of these constraints arises from my own limited ability (along with most other economists!) to forecast economic developments with any substantial degree of accuracy--particularly in times such as this. But beyond this difficulty, as a Member of the Federal Reserve Board, I am faced with another serious handicap. By long-standing tradition (which I fully support), Members of the Board refrain from speaking publicly about the probable future course of monetary and credit policies. Since I share in the formulation and implementation of such policies, any attempt on my part to forecast the future path of interest rates would necessarily involve telegraphing my own views and preferences with regard to the appropriateness of prospective decisions.

Within these limitations, however, several elements which will undoubtedly influence financial developments in the months ahead can be cited. First among these, of course, is the impact of Phase IV of the Administration's wage and price controls program on the rate of inflation. I have no special basis on which to evaluate the effects of the effort on price pressures or to form a judgment about its

probable effects on the public's deeply-rooted inflationary expectations. But to the extent that the strengthened program does help to check the upward tendency of wages and prices, it might also help to dampen the public's demand for money and credit.

In a similar vein, the continuing uncertainties affecting the dollar in the foreign exchange markets--as well as the uncertainties on the domestic political front--will also influence financial developments in the United States. These can only be noted here to indicate my awareness of their presence.

It seems quite probable that the exceptionally strong demands for goods and services that have been evident so far in 1973 will abate somewhat as the year progresses. Just how rapidly this abatement might be expected to emerge cannot be predicted with precision. Yet, it appears that a number of strategically placed manufacturing industries are working at or close to capacity, and this factor can be expected to restrain somewhat the rate of growth of real output. On the demand side, consumer expenditures (especially outlays for durable goods) are clearly expanding much more slowly than they were earlier in the year. As indicated above, homebuilding--which was a major source of strength during the first quarter--has already eased off somewhat, and the level of activity is expected to decline through the rest of the year. The demand for output generated by the business sector (particularly in the form of spending for fixed investment) will probably lessen somewhat as well in the months ahead. It also seems unlikely that

spending by the Federal Government will give a noticeable boost to the economy. So, when the principal economic sectors are viewed in the aggregate, the unfolding evidence suggests that the overall pace of economic activity is likely to slacken through the second half of 1973.

With respect to financial developments, the money and capital markets are still adjusting to the recent monetary policy moves to restrict further the availability of money and credit. Both short- and long-term interest rates are still responding to those actions, and it may require somewhat more time for the process to be completed. On the other hand, in view of the continued high level of economic activity (as measured by the rate of growth of nominal GNP), credit demands appear likely to remain quite heavy for some time. Under these circumstances, commercial banks and other financial institutions can be expected to tighten further their lending policies and to make more of the difficult portfolio adjustments--such as liquidating municipal securities--that are required if monetary policy is to be effective in restraining excess demand.

In the case of business firms, funds generated through internal cash flow may lessen appreciably as profits shrink. Since their need for funds to finance working capital and inventory investment will continue to expand, businesses will have to turn increasingly to external sources.

Undoubtedly they will rely heavily on credit provided by commercial banks. To respond to such needs, banks themselves may find it necessary to attract a sizable amount of deposits through the sale of high-yielding CD's and by borrowing from non-deposit sources. Moreover, bank liquidity--which has already shrunk well below the high levels prevailing a year ago--can be expected to decline further. Banks will undoubtedly attempt to pass on to business borrowers as large a proportion as they can of the increased cost of money which they must themselves assume. Other lending terms may be tightened still more, and customers will probably find it increasingly difficult to obtain accommodations for some of their projects.

In response to the reduced availability of credit at banks, many corporate borrowers can be expected to rely much more heavily on the commercial paper market to meet their credit needs. Corporations may also become more interested in floating long-term issues in the capital market as pressures in the short-term market remain strong. So far, however, industrial enterprises apparently have shown little inclination to tap the long end of the market for an appreciable amount of funds. On the basis of the experience in previous periods of monetary restraint, State and local governments may encounter somewhat greater difficulties in marketing long-term obligations. Some of these might arise because of statutory interest rate limitations. Other borrowers may choose to postpone projects--especially if the funds are to be raised through sales of long-term revenue bonds which frequently contain restrictive call-protection features.

As far as the Federal Government is concerned, there may be little need for direct borrowing over the months immediately ahead. On the other hand, Federal agencies may bring to the market a sizable volume of debt issues. Among these, offerings by the FHLB Banks may be especially large--since these institutions are committed to a policy of providing substantial support to S&L's in the face of declining savings inflows. Nevertheless, it appears that further cutbacks in new commitments for home mortgages are clearly on the way, and additional upward pressure on conventional mortgage interest rates seems to be in store.

I know that the picture which emerges from the foregoing scanning of the financial horizon is far from comforting. If it materializes, a number of borrowers may be disappointed in their quest for funds to meet all of their needs. Still others will have to bear interest rate costs that they find particularly burdensome. However, all of us should recognize that these consequences are inherent in the use of a restrictive monetary policy as a leading instrument in the fight against inflation. At the same time, of course, the greater the contribution to the overall stabilization effort that is made by fiscal policy and Phase IV of the wage and price controls program the smaller is the burden which monetary policy has to carry. But, in the final analysis, my own responsibilities--along with my colleagues at the Board--center in the area of monetary policy. The task before

-36-

us at this juncture seems clear and unmistakable: given the tenacity of the continuing inflation in the United States, we ought to be prepared to stick with the policy of monetary restraint as long as it is required.

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