For release on delivery
Friday, September 30, 1966
1 P.M. EDT (approximately)

RECENT MONETARY DEVELOPMENTS

Remarks of

SHERMAN J. MAISEL

Member
Board of Governors
of the
Federal Reserve System

at the

Governor's Conference
on
Corporate Pension Fund Investments

Los Angeles, California

September 30, 1966

I am most pleased to be with you today. Governor Brown's imagination and initiative in calling this Conference open possibilities for significant economic gains. This Conference expresses the interest that the people of California--the most rapidly growing State--have in pension funds--the fastest growing group of major financial institutions. It joins an area with vast potential demands for funds to a group with an ever-increasing supply. A better match of the supply and demand for credit should give increased benefits to all. If, as we can hope, this Conference succeeds in increasing your yields while lowering the costs of mortgages for California borrowers, it will have accomplished a great deal.

The probabilities for such mutual gain appear high. Our economy is booming. The prospects that our over-rapid expansion can be moderated and that growth can be re-established on a sustainable prosperous upward path seem excellent. A backlog of mortgage demand is accumulating. This will give a special fillip to a need which had already presented every indication of steady growth into the future. An increasing demand with a continuing expansion in incomes should form the bases for very successful mortgage investment opportunities.

Recent Economic Developments

This past year has witnessed several major changes in the economy. The extent and rapidity of movements, particularly in money and financial markets, have surprised most observers. The sharpness of financial shifts at times engendered a feeling of uncertainty and apprehension that seemed far removed from the actual movements of production. While financial markets were churning, the primary economic forces of output and employment moved rapidly and steadily forward. Some of the variations in the financial sector clearly were related to the economy's need for credit. A greater proportion, however, seemed to reflect rapid shifts in expectations, a variety of psychological shocks, and perhaps a fair amount of hoarding of financial resources.

Sharp divergences between the financial facade and the underlying economic structure are not, of course, at all unusual. Psychological shifts influence financial markets much more rapidly than they change those for goods and services. Anxiety arises because observers remember times when production slumps have followed financial ones. They forget the many times when this has not occurred. In the recent period, many feared that changes in the money markets would cut deeply into production. At the same time, nearly an equal number feared the opposite--that the impact of the credit changes would be so slight as to have virtually no effect.

The arguments over how much impact psychological forces can exert on real ones have waxed hot and heavy for many years. As a result, many have concluded that decisions to spend may be influenced somewhat by psychological factors. On the other hand, all experience indicates that if there is a continued strong real demand, the financial world will eventually adjust to the true underlying situation.

Uncertainty has also existed because only slowly have our fiscal needs and policies been firmed up. The specter of recent periods when our country seemed stalled as a result of near deadlock in the fiscal sphere still hovers in our minds. This has increased concern over the present. Since I am a confirmed optimist, I have never felt strong doubts about the future. I have remained convinced that when the size of our Vietnam commitment and the amount of excess demand were known, the Administration would propose, and Congress and the people would actively support, the proper fiscal action. The first steps in this direction have now been taken. When a total fiscal package is worked out, I am certain it, too, will receive the active backing of almost all.

Output and Employment

The large financial shifts have dominated the news. More basic movements of the economy have been relatively neglected. However, because these underlying forces are the most important for long-term investment decisions, they are worth reviewing. The record is clear. From 1960 through the middle of 1965, the economy expanded rapidly and steadily. The high growth rate was supported partly by the normal long-term growth in productivity and the labor force but also by the gradual re-employment of the substantial amount of unused resources which existed at the end of the 1950's.

This year, as use of these resources approached the full-employment mark, some retardation in the economy's expansion rate would have been required to settle down to a long-term growth path which could be sustained. For example, in order to maintain the excellent record of non-inflation with continued improvements in employment, the rate of growth of total demand probably would have required a cutback of a half or one percentage point from the 6.8 per cent rate of 1962 through 1965.

But in fact this gentle slowing in the pace of demand growth did not occur. Instead economic activity was pushed to an even faster pace by two powerful stimuli. One, of course, was the escalation of Vietnam expenditures. Almost as great and perhaps related, was a sharp expansion in business spending.

These two increased spending forces with their normal multipliers (induced consumer spending from the recipients of added income) were large enough to push the rate of increase in demand 60 or more per cent above its normal growth trend. In other words, in place of a non-inflationary growth of 4 to 4.5 per cent in real output and 5.5 to 6.5 per cent in current dollars, these stimuli, Vietnam and business spending, might have caused money demand to grow this year by 10 per cent or more if no offsetting action had occurred. Actually, such a rate of expansion did occur between last October and March.

Clearly, such a surge in demand set off important price reactions. When the economy's resources are almost fully employed, added pressures above the normal growth rate can only be satisfied at increased prices.

Faced by rising demands, the Government acted along several paths. Some tax increases were initiated. The expansion of non-war expenditures was slowed down. The President urged businesses to phase their investments over a longer period. The Federal Reserve moved to hold the rate of growth in money and credit to that needed for a non-inflationary expansion.

While we lack the facts and the skill to calculate the exact impacts of these various policy actions, rough estimates indicate that through their influences on consumption, housing, and other expenditure streams, the excess growth in demand was cut about in half. The excess which remained has given us undesired and unfortunate effects in the form of too rapid increases in prices. The hoped-for stabilization did not occur. War costs rose above their initial estimates. Business did not decrease its rate of expansion. A series of supply problems raised prices of agricultural and other sensitive materials.

Other Reactions

Obviously, this stark statement of what happened to the basic aggregates of the economy gives no indication of the churning that has occurred in one or two major industries as well as in financial markets. It glosses over the undesirable impacts felt by many individuals and firms. These are extremely important and must not be neglected. At the same time, the aggregates do show why I at least find it hard to agree with those who are pessimistic with respect to the economy's future.

Those who forecast a serious setback either in demand and production or in the financial markets seem to base their pessimism on a partial analysis or a misreading of history. Many people forget that most business cycle analysis leaves out periods with large war expenditures. The reason is obvious. Large-scale shifts in demand of the public sector tend to overwhelm typical fluctuations in private expenditures.

While, as a share of our total economy, Vietnam expenditures are comparatively small, this minimum relation is not the relevant comparison. More significantly they are large when measured in terms of the narrow margin existing at the start of this period between normal full employment and inflationary demand. While no one has a good estimate of Vietnam expenditures, it appears that in this year the total effect of this increased spending will be equal to at least a third or more of the potential addition to supply. Given the fact that normal demand was already increasing at a rate equal to or greater than available supply, these higher war expenditures have played a highly critical role in determining economic events.

As the economy moves from a normal to too rapid an increase in demand, the usual economic signposts are reversed. Traditional indicators do not have the same significance as in a normal period. Factors decreasing demand are welcomed rather than feared.

If we are fortunate enough to see an end to Vietnam, the economic situation will again change drastically. We could go full speed ahead to meet significant public and private needs delayed by current events. The greater are unfulfilled demands, the easier will the transition be. This is a major reason why the investment tax credit and similar policies aimed at increasing demand do a double disservice if not suspended in periods such as the present. Any postponement of expenditures from a period of too-strong to one of too-weak demand is twice helpful. It serves to hold down pressures now while it will aid in bringing about stability later.

I think people in the financial sphere have similarly been unduly pessimistic. While history need not repeat, most past financial crises have occurred in periods when money and credit were being contracted. The Federal Reserve has tried to make it clear in all its statements that its policies are those of expansion not of contraction. The fact that a war must be supplied in addition to normal civilian demands means that real output must expand at its full potential and that the expansion must be financed.

The Federal Reserve has repeatedly pointed out that, while its policy is to moderate an excessive growth in credit, a continued expansion is to be expected and welcomed. The System would, I believe, be making a serious error if it became so concerned with the need to moderate growth that it failed to furnish the necessary supply of money and credit needed for the economy to follow its full-employment expansion path.

The Current Mortgage Market

Against this background of recent economic and financial events, let us consider more fully developments in the mortgage market. Here, too, vast differences exist between the present and the expected future trend. Right now funds for new mortgage commitments are extremely scarce. Financing stringencies have slowed building production. If the shortage continues and mortgage investment fails to expand, many families will experience a fall in their standards of housing and of living.

The sudden development of a shortage in mortgage funds is not mysterious. It follows well-understood economic rules. This year has witnessed a prime example of the institutional impact of shifting money markets on the flow of mortgage funds. In my writings over the past ten years, I have described this phenomenon and discussed the reasons for it at length.

In essence, we know that each financial market adjusts uniquely and often irregularly to shifts in credit's rate of expansion. The flow of funds varies among institutions. They in turn alter their commitment policies with respect to mortgages. A situation develops roughly similar to that experienced in the old game of "crack-the-whip." A small pressure at one end gradually increases as it moves through the line. An impact, minor at the start, can be drastic at the end of the line. In the contemporary environment, the mortgage market marks the end of the financial line.

This short-run curtailment of mortgages' expansion rate contrasts sharply with most of the postwar experience and with all expectations for the next five to ten years. Mortgages have steadily increased their percentage of total and private debt. Their share of the assets of all financial institutions has also expanded rapidly.

Given the thrust of an expanding adult population and the need for upgrading housing requirements, this increasing importance of mortgages is almost certain to continue. Even without a build-up from present events, a sharp acceleration in the demand for housing and mortgage funds was about to occur. Now future needs look still larger. Based both on the current shortage as well as on favorable long-run prospects, it would behoove each investment officer to examine this market very carefully in order not to miss a favorable opportunity for future high yields.

Pension Funds and Mortgages

The growth rate of pension funds since 1945 has far exceeded that of all non-bank financial institutions. While their total assets are somewhat smaller than some of the older more established institutions, their annual growth rate--and therefore their impact upon investment and financial markets--is the largest. Even though this rate of growth may slow, pension funds will continue to play a major part in our total financial picture.

Examining the simultaneous growth in pension funds and mortgages, we find a strange dichotomy. While mortgages expanded to become the largest and most important asset for all financial institutions combined, this did not hold for the growing pension funds.

Insurance companies, and therefore insured pension funds, hold between 35 and 40 per cent of their assets in mortgages. This is close to the average for all financial institutions. It also about equals the average role of mortgages in the economy. In contrast, State and local pension funds invest about 11 per cent of their assets in mortgages. For private corporate non-insured funds--the topic of our meeting today--mortgages make up less than 5 per cent of total assets.[1/]

It has frequently been suggested that this small percentage invested in mortgages by the funds is bad for the economy but more importantly for the funds' own beneficiaries.

Financial markets have shifted rapidly. Future movements, while different, will probably not be simpler. In this developing situation, groups with the direct responsibility for the investment of large volumes of long-term funds will require far greater imagination and more sophistication in judging relative risks, costs, and yields than has been true thus far. Because they have skilled management as well as because of their increasing importance, pension funds of all

1/ For more detailed analysis of pension fund investments, cf. "Pension Fund Investments," Business Conditions, Federal Reserve Bank of Chicago (September 1966), pp. 6-20.

types but particularly corporate funds must assume a growing responsibility to match their growing size. These funds exert a significant impact on the direction of credit flows as well as upon related movements in production and productivity.

The Investment Policy of Pension Funds

The arguments for an increased attention to the mortgage market from pension funds are basically familiar. Some are based upon the constantly increasing demand for mortgages and their high yields. Some are based upon questions raised with respect to the current heavy investment of these funds in common stocks.

Various dangers inherent in this situation have been frequently pointed out. A problem arises over the question of control or lack of control over management by large holders of equities. Funds have traditionally avoided participating in management decisions. Can this policy be continued with the growing importance of pension funds?

A broader question has been raised about the effect on the economy of the high proportion of fund purchases of common stocks. Newly issued bonds or mortgages provide the money for new investment--the lifeblood of our economy. In contrast common stocks are almost invariably purchased in a second-hand market. Money is transferred but the share of the credit which ends up in real investment or expansion of firms tends to be much smaller than for other uses of funds.

The experience of pension funds with stock investment has been favorable. On paper, capital gains have been large. But paper values can decline with a falling market, while obligations remain unchanged. A still more important question has not been examined at all carefully. How much of the success on paper of funds has been primarily a self-validating prediction by those making the decisions? How much of the rise in the price of stocks owned by institutions can be attributed to the fact that these institutions have directed a large portion of their net inflow of funds to purchases of a limited number of stocks? Have these purchases been significant enough at the margin so that they dominate the price trends? If so, to a certain extent, pension fund portfolio managers have been lifting themselves by their own bootstraps. This is a process which might react against their future equilibrium.

Mortgages as an Investment

Perhaps more important than possible disadvantages of current investment policies are the major direct advantages which pension funds might gain from larger purchases of mortgages.

One of these--since it is non-financial--probably gets neglected in a vast majority of cases. Fund trustees tend to evaluate management's records in terms of the last five basis points of yield. It is, however, occasionally useful to examine other benefits which particular investment policies may offer the funds' beneficiaries.

If there is a prospect of cheaper and better living or of more jobs and income for a fund's beneficiaries, this should be considered in the over-all investment strategy of any fund.

As an example, under current and similar conditions in the past when builders and home purchasers are severely cramped for credit, pension funds investing in mortgages or taking standby commitments can have a major influence on employment prospects in particular areas of both industry and the nation. In many cases, as is recognized by some union pension funds, the funds' own beneficiaries will profit directly through more jobs and higher income.

A pension fund investing only a moderately increased portion of its assets in mortgages may help by making more credit available and thereby limiting the cost to prospective home buyers in specific local areas. In such cases, it is also possible to make certain that the funds' beneficiaries profit directly by making the credit available to them individually. In other cases it may be preferable to make the impact more diffused and indirect. Clearly a recognition of these prospective advantages was among the reasons this Conference was called today.

More important perhaps is the evidence that because they are failing to invest in mortgages through a lack of skills and know-how in an admittedly very difficult investment area, many funds may be getting less than an optimum yield. By the usual yardsticks of yield in relation to cost and risk, mortgages may well merit a larger proportion of the investment portfolio of corporate pension funds than they have been receiving.

In the whole period since 1948, the effective yield on mortgages has been high. Many studies indicate that returns to mortgage holdings are among the highest for any asset group. For example, FHA insured mortgage yields, which are generally below those for conventional mortgages, have on the average had a gross yield more than 100 basis points greater than the returns received from offerings of prime corporate bonds. While this spread is reduced on a net basis because of the higher servicing costs of mortgages and because of a necessary allowance for poorer marketability and some risk of default, the relationship which has generally prevailed seems to provide a generous allowance for these differences.

In recent years the spread has narrowed as more money flowed into savings and loans, still even on FHA calculations the spread in favor of mortgages has tended to remain above 100 basis points. Many people believe that an additional 20 basis points should be added to these FHA calculations to get a more accurate estimate. Furthermore, the FHA comparisons are on a national basis. Margins in the West have been appreciably more favorable.

Risk in mortgage ownership has tended to be far less even for non-insured loans than the conventional wisdom born of the 1930's might have suggested. The upward thrust of incomes and property values has decreased risks. Also, of course, mortgages have been vastly improved through provisions for regular amortization (which provides a regular source of liquidity where required) plus the availability of various types of guarantees or insurance to lenders. Foreclosure experience even in recent years has on balance been minimal and losses on the average slight.

The mortgage market does still suffer from a number of imperfections. To become an active participant has required more special expertise than most pension funds have been willing to develop. Originating and servicing mortgages can be both inconvenient and expensive. On the other hand, the cost and inconvenience of originating and servicing have tended to decline as a more highly developed and efficient correspondent system has evolved.

I have purposely kept my remarks general and related them primarily to economic conditions and trends. The speakers that follow will take up the specific problems and questions that must be faced in developing a mortgage investment program. I have, I hope, however, made clear my belief that if pension funds do expand their limited participation in mortgages, both the funds and the economy can reap gains. This was the reason I was happy to accept Governor Brown's invitation to participate in this Conference.