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Remarks by

Henry C. Wallich
Member, Board of Governors of the Federal Reserve System

at the
National Mortgage Banking Conference
of the
Mortgage Bankers Association of America

Tuesday, 11:00 a.m., April 23, 1974

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I am grateful to your chairman and to my old friend Miles Colean for providing me with an opportunity to speak to an important topic. Miles' wise counsel I have sought out from time to time ever since I first came to Washington during the 1950's. I hope to continue to benefit from it during many years to come.

As mortgage bankers, you deal with one of the elementary human needs -- shelter. Your work has contributed to the splendid achievement of the American economy that has made homeowners of six American families out of ten. None of the problems that may come up from time to time can invalidate the fundamental fact that housing in the United States has been a tremendous success story. In no major country in the world is so high a proportion of the population so well housed as in the United States.

1/I should emphasize that in these comments I speak only for myself and not for my colleagues on the Board.

Housing and housing finance have certain well-known characteristics that must be borne in mind. When you help a family to finance a home, you are helping it to purchase the most durable major good that it will ever acquire. Durability is an attractive quality. But it also may give rise to occasional difficulties that the industry is well aware of. Durability means that the new supply of housing constructed each year, in good years and in less good ones, is necessarily small relative to the existing stock. For short periods, at least, the bulk of the nation's housing needs can be met from the stock of housing already built. This is so all the more because people can control the rate of household formation and can make more intensive or less intensive use, as they wish, of the existing housing stock. Shelter is an essential need, but the purchase of a home is nevertheless highly postponable. Thus, the goal of a stable demand for housing and of stable construction activity, though we must continue to pursue it, may perhaps be achieved only very gradually.

Durability has still another implication. Housing ideally lends itself to being financed with debt. Your industry has made skillful use of this possibility. Financial technology involves no less creativity because, unlike other forms of technology, it can all be done with a sharp pencil. The amortized mortgage is one of the examples of this kind of technology to which innumerable families owe their chance of acquiring a home. Many of you will be aware that the man who perhaps did most to build the amortized mortgage into the American system of home finance, Winfield Riefler, passed away only a few days ago.

Durability brings housing into contact with one of the less admirable features of today's scene -- with inflation. In a time of rising prices, the market value of a home often rises far above its original cost. In the difficult times that savers have experienced recently, home ownership has provided shelter in a financial as well as in a physical sense. But inflation creates many problems even for the homeowner who purchased and financed earlier. It creates very serious problems indeed for the home buyer, for the housing industry, and for the mortgage banker. I would like to examine some of these problems with regard to the supply of savings and the effect on interest rates, including their term structure, which is important from the point of view of the mortgage banking industry.

It has often been said that inflation discourages saving, because people see the value of their existing savings shrink while the price of the things they plan to buy is going up. In the past, this may have been one of the cases where it is better to be ignorant, or at least suspend judgment, than to know something that isn't so. There is some evidence that historically inflation has encouraged rather than discouraged saving. Consumer surveys typically have elicited the response that a period of rising prices is a bad time to buy. That means more saving, not less. This attitude, however, in recent years seems to have shifted to one that more nearly validates the traditional notion that inflation discourages saving. At least until the middle of 1973, there seems to have been persuasive evidence that consumers had begun to buy ahead in order to beat future price increases. The high cost of energy for the time being seems to have put an end to what may or may not have been an incipient trend. But in a country like ours, where the consumer savings ratio usually is in the range of 5-8 per cent of disposable income, in contrast to about 12 per cent in Germany and about 20 per cent in Japan, even a small reduction in consumer saving can have a substantial impact on the supply of investable funds.

Inflation also affects saving adversely by the way in which it has affected corporate profits. In "normal" times, net corporate savings (excluding depreciation) have tended to account for something like 2-3 per cent of the gross national product, or an amount roughly one-half to two-thirds of personal saving. Broadly this relationship was again attained in 1973, after a prolonged period of unusually low corporate profits and net savings. But inflation plays tricks with profits. It has been estimated that, of the $125 billion pre-tax corporate profits in 1973, something like $25 billion were the result of inflation, in the form of inventory profits and under-depreciation of business plant and equipment. Corrected for this overstatement, net corporate saving was much smaller.

In practical terms this has meant that business, not in fact having the savings it thought it had, was compelled to borrow more heavily in order to finance higher priced inventory. It also had to finance equipment investment that really represented replacement rather than additions to the capital stock. This sequence of events is a form of income redistribution and is adverse to saving since corporate business is a high saver. It throws an additional burden on the capital market, with the result that less investable funds are left for housing.

Inflation cuts into the supply of saving available for housing in still another way. It pushes up the cost of government. This has increased the pressure to remove certain government or governmentally sponsored expenditures from the Federal budget. The financing of these expenditures has then been thrown upon the private capital market. It is true that many of these "de-budgeted" expenditures have been closely related to housing. But the growing practice of off-budget financing nevertheless cuts into the supply of savings that are freely available through private channels, where the housing industry would otherwise have a chance of absorbing a good part of them. In summary, through its impact on household saving, corporate saving, and government budget practices, inflation delivers a threefold punch at saving.

The supply of savings is one of the fundamental determinants of interest rates. The effects of cutting down that supply are therefore obvious. This is one of the forms in which inflation bears on interest rates. But there are others. In particular, on top of the effect on saving, one must take into account the response of borrowers and of lenders.

Everybody today is probably familiar with the simple proposition that the "real" interest rate is equal to the nominal rate, i.e., the rate quoted in the market, minus the rate of inflation. Lenders, so the story goes, will demand an inflation premium; borrowers can afford to pay more. Thus the interest rate is raised in proportion to the rate of price increases.

Like all simple economic statements, this one is an oversimplification. I would warn you against performing a calculation that deducts the inflation of the last three or six or twelve months from a market rate of interest and that then arrives at the conclusion that the real rate is negative. That calculation makes sense only with respect to the past. The depositor who has received five per cent for his money while prices have gone up by 6 per cent has indeed had a negative return. Even then it would be somewhat questionable to say that his negative return was one per cent, because the depositor pays income tax on the nominal interest. If he is in the 40 per cent tax bracket, his return during a year when the nominal interest rate was five per cent, and inflation six per cent, will have been minus three per cent.

But what people really want to know about the interest rate is its "real" value with respect to the future. The rate of inflation that must be deducted from the nominal rate then is not the inflation that has already occurred, but the inflation that the lender or borrower expects. Since we cannot read investors' minds, their expectations of future inflation are in effect unknowable. Economists try to estimate them by assuming, for instance, that people extrapolate their past experience into the future, giving greater weight to more recent than to more distant experience. In that way, an estimate of expectations can be derived and a "real" interest rate computed.

If we apply this reasoning to the long-term rate of interest, we must remember that it is also the long-term rate of price increases that is relevant. A short bout of inflation that is soon brought under control does not affect the real return on a 20-year bond as would high inflation continuing until maturity. On the basis of this theory, therefore, it would not be surprising, during a spurt of inflation, to find short-term rates high relative to long-term rates, if investors have some confidence that inflation will eventually be brought under control.

But again I must warn against taking estimates of this kind too literally. Investors may have every reason, based on their expectations of future prices, to demand an inflation premium. But they can demand all year long and never get it if they cannot make their wishes effective. Like Owen Glendower, they can "call spirits from the vasty deep, but will they come?" The market may fulfill investors' demands, if investors are able to withhold their funds and so can compel borrowers to pay up. But investors' options are not unlimited. Where can they go with their money? Into short-term assets, into the stock market, into real estate, abroad? The review of alternative outlets suggests that investors sometimes may not be able to obtain the inflation premium to which they think themselves entitled. In this case, too, the simple calculation that relates the nominal and the real interest rate via expected inflation will not add up.

Something similar can be observed on the side of the borrower. He will be prepared to pay more during an inflation. How much more, however, he will pay depends on the rate of return he can get from the use of the borrowed funds. During an inflation, real estate may appreciate, inventories may go up in value, machinery and equipment may depreciate less rapidly than at other times. But these expectations are very uncertain. Moreover, as I pointed out earlier, businessmen may miscalculate their true profits. Investors therefore can have no assurance that borrowers will offer them interest rates containing an adequate inflation premium.

Studies done in the research department of banks (including the Federal Reserve Bank of St. Louis and Morgan Guaranty Trust Company) tentatively suggest that prior to the present severe inflation the "real" interest rate had been in a range of about 3-4 per cent. According to those calculations, the excess of market rates beyond that range could be considered, very broadly speaking, as a premium for credit risk and for inflation. Nobody can be sure, of course, whether lenders regard as adequate the inflation premium that they get today. But to the extent that they do, one may perhaps draw the moderately comforting conclusion that investors do not expect inflation over the longer run to persist at rates comparable to those we have experienced in recent months. In other words, an analysis of interest rates in "real" terms suggests that investors expect that the rate of inflation will come down.

There are plausible reasons why investors should hold this view. The present almost unprecedented rate of inflation is in good part the result of events on the supply side of the economy. Poor crops, the simultaneous occurrence of national business booms, and the quadrupling of oil prices by the OPEC countries all played a role. In the course of these traumatic events we discovered that our own supply capacity, especially in the basic materials sector, is smaller than had been assumed. A recent study by Lionel Edie & Co. of real capital outlays by manufacturers shows that, after making allowance for capital expenditures aimed primarily at meeting environmental standards and for the increase in the price of capital goods, real expenditures for expansion and modernization have shown no increase since 1967.

There is good reason to think that the supply situation will come into line in many sectors. The food picture is brighter for the second half of 1974 than it was for the early months of the year. Economic activity all over the world is no longer straining the limits of capacity as hard as it did in 1973. OPEC oil prices should come down if the producers correctly analyze their own long-term interests.

Much will depend, of course, on future wage increases. The cost of living has risen dramatically, the real income of the average worker has fallen, and it would be understandable if labor should now try to make up for all this. Such an effort, however, would be largely self-defeating. The shortfalls that the economy suffered because of supply difficulties cannot be made up by higher wages and higher consumer demand. The shortfalls reflect events in the real sector of the economy that must be accepted for what they are -- a temporary slowing in our standard of living that can be overcome only by investing more and producing more in the future. If wage increases behavior during the coming months reflects an understanding of these fundamental facts, we can avoid building recent price increases into a continuing wage-price spiral. The road will then be open to a continuing reduction in the rate of inflation.

The outlook for bringing down inflation rests also on the willingness of businessmen to do their part. If I read the legislative record correctly, controls over prices are likely to expire on April 30. It would be self-defeating if businessmen were to respond to this event with massive markups. They would then set in motion forces that, by one route or another, would perpetuate inflation. They would end up by depressing the profit margins that their shortsighted pricing policy had tried to enlarge. A realistic evaluation of long-run self-interest is needed on the side of business as well as on labor.

Even the rise in the cost of imported oil, which has contributed so much to inflationary pressure, may eventually provide something on an antidote. Large balances are likely to build up in the hands of countries that for a number of years will be unable to spend them. These funds will seek outlets in ways that so far are not clearly defined. But directly or indirectly, they can contribute to the financing of investment in this country as well as elsewhere. When a large addition is made to the world's pool of investable resources, an addition that many analysts estimate in the tens of billions of dollars, the supply of investable funds will become more plentiful almost everywhere.

Appropriate public policies will be required to bring down inflation. As Chairman Burns said before the Subcommittee on International Finance of the Committee on Banking and Currency on April 4, the Federal Reserve intends to pursue a policy that will permit only moderate growth of money and credit. In the face of strong demand for bank credit, such a policy may at times lead to greater pressures in the financial markets. But in the longer run, a slowing of inflation will bring down interest rates. It is likely also to restore the relationship between short and long rates that has prevailed during most of the years since World War II and that has been of great importance for housing finance and for the mortgage banking industry.

Appropriate fiscal policies will likewise be required. In the immediate future, budgetary policy should be guided by what is visible in the economy in the present time. What we see today implies a good deal more strength than many observers seemed to anticipate a few months ago. The oil crisis had severe sectoral impacts, especially on automobile sales and on housing. It has not, however, spread out to the rest of the economy. Consumer demand has moderated only slightly, while business spending remains very strong. Meanwhile the oil embargo has been lifted and the most general forecast is for acceleration of economic activity in the second half of the year. That is the period, of course, when monetary and fiscal policy measures taken now would have their principal effect. Under these circumstances, it would be difficult to make a case for a tax cut.

For the longer run, we must recognize the fact that monetary policy cannot stabilize the economy, if it does not receive adequate cooperation from the fiscal side. This becomes all the more apparent if we consider the impact on the housing industry that more than once has resulted from the need to seek economic stability chiefly by means of monetary policy.

Fiscal policy must avoid excessive expansionism, and it must in particular become more responsive to cyclical movements in the economy. I would like to refer you to proposals made by the Federal Reserve Board for an anti-cyclical use of the investment tax credit, contained in its March 1972 report to the Congress on "Ways to Moderate Fluctuations in the Construction of Housing." While there have been some comments to the effect that changes in the investment tax credit would create excessive uncertainty for business investment, the fact is that changes in interest rates cause similar uncertainty. Business has been able to live with this uncertainty. The difference would be that the impact of a variable investment tax credit would be exclusively on business investment, while the impact of changing interest rates affects both business and the housing industry.

While offering good advice to the makers of fiscal policy, it is incumbent upon us not to overlook things that could be done closer to home. I need hardly tell you that the Federal Reserve is at all times very conscious of how its monetary policy actions influence housing from a cyclical point of view. Important structural changes in housing finance have been suggested in the Financial Institutions Act which grew out of the Hunt Commission Report. While the legislative achievements of this great endeavor so far have been unimpressive, the basic principles there expressed, aiming at greater flexibility on interest rates, greater freedom of portfolio action for thrift institutions, and greater competition all around remain valid.

Meanwhile, the thrift industry is not without opportunities to generate greater flexibility on its own. The thrift industry has been heavily dependent upon an aspect of the term structure of interest rates that historically has been less than completely reliable. The thrift industry has banked -- if that is the word to use -- rather heavily on short-term rates being lower than long-term rates. Economics tells us that there are good reasons why this relationship should prevail a good part of the time. History tells us that from the early 1930's to the middle 1960's the upward sloping yield curve was the rule with very few exceptions. But a look at earlier history, before the Great Depression, shows that the yield curve quite often was downward sloping. Economics tells us that a downward sloping curve is likely to occur from time to time, even though the opposite can probably be regarded as the more normal situation. Essentially, an upward sloping yield curve can be interpreted as risk aversion on the part of investors. They want to be paid for taking on the market risk of longer term securities. A downward sloping curve, on the other hand, may develop under circumstances of which I would like to mention only two. One is a condition in which investors expect long-term interest rates to fall; in that case, they will demand the premium for staying short instead of taking advantage of the anticipated rise in the bond market. The other possibility is a simple demand-supply phenomenon. If funds of all maturities become scarce, short-term interest rates are likely to rise more than long-term, because they reflect a less permanent commitment and therefore have greater flexibility. I would not want to speculate which of the two explanations fits the present situation better. Perhaps both are at work.

Like so many other financial problems, that of the downward sloping structure of interest rates is likely to yield to a decline in the rate of inflation. The effort to bring inflation under control, as I said before, may generate temporary pressures. But just as it seems obvious that our present interest rates are the product of inflation, so it must be regarded as obvious that a slowing of inflation, and only such a slowing, will bring us back to the rates with which we have been familiar all our lives.

Thank you very much.