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A LONGER RUN VIEW OF MORTGAGE MARKETS

Remarks of

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A LONGER RUN VIEW OF MORTGAGE MARKETS

The request of your President to speak today not about tomorrow or next week, but instead about the longer run trends expected to affect the mortgage and savings markets was most welcome. Since so much of our time is spent thinking and worrying over current decisions, an opportunity to take a longer look ahead is a pleasing challenge.

I must admit, too, that in many ways it is a safer task. If I predicted what was going to happen next week or next month, any errors would be obvious and remembered. Even if I am wrong on the prospects for the next 10 years, at the least, raising some of the future's problems and indicating ways in which they may be analyzed should be useful.

Let me briefly summarize the results of my crystal-balling.

- There are no obvious reasons why, over the intermediate and longer run periods, financial markets should not return to a better state of balance than presently exists. While continuation or speeding up of current imbalances, high interest rates, and a rationing out of the market of desirable borrowers certainly is a possibility, such problems will continue only if we fail to take the necessary steps to get us back on the right path.
- The key balancing force in the general economy--and particularly in financial markets--will continue to be the Government's surplus and deficit. Failure to control the Government's budget in a proper manner could be extremely costly. Now more than ever it is vital that we think in terms of a compensatory rather than merely a balanced budget. As an example, a Federal budget merely balanced for this calendar or next fiscal year in place of the large surplus needed to bring demand and supply into balance might be very expensive to the economy.

- The demands on the mortgage and housing markets for the next 10 years may prove to be a good deal lower than many of the estimates I have seen. Whether we take 1963-65, last year, or the past six months as our basis of comparison, I would expect the growth of housebuilding and mortgage financing over the next decade to be at a somewhat slower rate than that of the economy as a whole.
- Savings and loan associations and other financial institutions must become more innovative if they are to play as significant a role in the future as they have in the past. A failure to adopt new savings instruments and new types of mortgages has increased the pressure upon them from a changing environment. This has been harmful under current circumstances. If the economy fails to stabilize in the next year or two, this failure to change could cause them irreparable harm.

Continuity in Economic Affairs

Today, I could have given a very false sense of the exactness of my predictions by handing out to each of you copies of some 50 tables with more than 1000 time series which were coaxed out of the computer in preparation for my remarks.^{1/} I am not doing so because it would give a misleading impression of scientific accuracy. Instead I want to highlight the analytical concepts which are the real basis for projections.

No matter how detailed, a projection is only the end product of a vast number of assumptions. I have assumed continuity in economic developments even while recognizing that possibilities exist for radical changes. When we project recent trends as part of a unified accounting structure, we can see what types of relationship exist. Crucial parts can be picked

^{1/} These tables were prepared by John Dawson and Bernard Freedman of the Board's staff but the responsibility for the assumptions and analysis is primarily my own.

out and examined individually and more logically. We can recognize the possible areas of imbalance and change needed to relieve strains and insure orderly economic growth.

The assumptions built into my computer show a growth in the gross national product through the next 10 years of about 100 per cent. This doubling of the country's current dollar income assumes a continuation of full employment and rapid growth, but a cutback in the rate of price increases to approximately normal levels.

As I said at the start, the results also show no critical problems for the housing or mortgage markets. The assumptions underlying this result must be examined more carefully. The movements within four areas appear most important. These include:

1. The relationships between the net savings and investment of the major sectors of the economy.
2. Those between taxes and expenditures in the Federal budget.
3. Developments in the housing and mortgage markets.
4. Changes in the credit and financial markets.

Savings and Investment

Major difficulties for financial markets would arise if the desires to save and to spend moved rapidly away from each other. Shifts in the rate of personal saving and shifts in the rate of business investment and desires for liquidity have been quite common. They have caused many past economic fluctuations. Businesses may raise their investments

rapidly even as households attempt to save less. Such opposing movements tend to raise interest rates and to force a rationing of credit. The impact of such forces has frequently been reinforced when the Federal Reserve simultaneously contracted the rate at which money and bank credit could be created.

History and the logic of the underlying situation, however, make it appear unlikely that excessive levels of investment will continue very long. While short-run fluctuations in the desires to save and invest as well as the rate of credit creation have been common, the amount of variation in the ratio of these series to the gross national product in periods of full employment has not been great.

Several types of forces seem to push the rates of saving and investment toward equilibrium. When we examine the flow of funds, we note how much of investment generates its own saving. Business and households use fairly sizable internal funds to finance their own purchases. As costs of external financing rise, more internal funds are used. This is simply one example of the fact that while prices and interest rates may not be able to bring about a satisfactory balance in a short period such as a year, they become far more effective over longer periods.

Similarly businesses may for a year or two rapidly raise their investments compared to past periods and to the level of total output. However, over an intermediate period, if the level of investment stays above normal, unused capacity will bring the level of new investment down. It is true that a return toward a previous equilibrium would not be

necessary if the ratio of capital to output shifted. But it is difficult to picture the amount of capital per unit of output changing rapidly enough over the coming decade to cause a sharp increase in the ratio of investment to the GNP.

To a certain extent, similar stability exists for household savings and investment. No major shifts in personal savings have occurred. Again the logic of the markets and of price and interest rate movements is such that unless held back by institutional barriers, the type of imbalances that can persist over one- or two-year periods seem far less likely to obtain over the longer run. While the possibilities obviously exist for major changes, their occurrence appears unlikely.

It is true, of course, that we cannot expect each sector's saving to rise equally with its real investment. It is reasonable, however, to assume that with rapid growth the deficits of the business sectors will rise and similarly the excess of saving over investment for households.

In the case of the deficits and surpluses of these sectors--as well as of those in State and local investment and savings--much of the pressure toward balance comes about through the rates and flows which occur in financial markets. Again these can fluctuate widely from the norm in short periods. To assume that they won't adjust back to equilibrium over intermediate periods, however, must be to assume that the economy stops them from arriving at a balanced position by maintaining institutional roadblocks. In some ways the assumption that proper decisions will be

made to bring the flows back to equilibrium must be considered a goal of economic policy as well as a statement of factual probability.

The Compensatory Budget

The other major sector affecting savings and investment flows is the United States Government. The amount of variation in the Government's net savings (deficits and surpluses) has been very large compared with that of other sectors. In underemployment periods, government deficits have helped to bring the economy back toward normal production. In contrast, in the past three years the high deficits have been a major inflationary force. On the other hand, in periods when the Government is a net saver, it offsets some of the pressures arising from the private economy's attempts to borrow and spend more than it saves.

Compensatory government surpluses or deficits would appear to hold great promise as a means of assuring equilibrium in the total level of saving and investment both over the immediate and intermediate term future.

Few economists doubt that the Government can halt inflation. There has been less agreement over the likelihood that any administration and Congress would be willing to run a large enough surplus to do the job. The debate over whether budget policy should seek a balance (or zero deficit and surplus) or should attempt to compensate for the disequilibrium in private spending and saving decisions probably has resulted in some harm to the adoption of the best policy. Stress on a balanced budget

probably tends to lead to inertia in periods such as the present when large surpluses are required.

While it is still too early to predict because programs for the war, for other military expenditures, and for the urban crisis are so indefinite, we should not be surprised if the economy requires much larger government surpluses over the next few years than has been true in the past.

Part of this need for larger surpluses may arise because of the greater importance of borrowings by the Federally sponsored agencies such as the Home Loan Banks. While it is important to the housing market that these agencies be allowed comparatively unfettered entry to the capital markets, the increased borrowing by these agencies may be economically sound only if the official budget surplus expands at a rate equivalent to the agencies' net borrowing. If the sponsored agencies stimulate private desires and ability to spend, an equivalent amount of saving will have to be found somewhere. Alterations in names and concepts do not alter the underlying economic facts.

The Housing and Mortgage Markets

I have touched rapidly on some problems related to competing uses of funds. Now let me turn briefly to the housing and mortgage markets. What are the major forces likely to influence the demand for housing funds over the next 10 years?

Clearly, a most important factor was the determination by Congress in the Housing Act of 1968 that substantially to meet our national housing goal within the next decade would require ". . .the construction or rehabilitation of twenty-six million housing units, six million of these for low and moderate income families." The critical question is: How many housing starts should we expect if this goal is to be met? The key to this question, of course, is how many units will be met from rehabilitation and how many from non-standard construction--such as mobile homes--not reported in the housing starts statistics.

I have been caught too many times by changes in definitions and concepts to try to quantify any figures exactly. However, in the light of the little we know about housing markets, I believe the goal to be a logical one. It appears likely that this goal can be met with fewer than 20 million public and private starts (as reported in the Census Housing Starts Series) and fewer than 18 million new units requiring mortgages. I would guess that if private housing starts, as now defined, averaged 15 per cent above the rate of the past six months, the over-all goal could be met. Clearly, in an economy as dynamic as ours and growing as rapidly as it is, such an increase in production levels should not create any major difficulties.

To translate this level of starts into the amount of additional mortgage funds required, we must make additional assumptions about the average amount of construction and land spending per new dwelling unit

and also about the amount of refinancing that will occur among existing houses for rehabilitation and other purposes.

We all know that housing costs and prices have been rising faster than other prices. Therefore, it may come as something of a shock to realize that such a relationship does not hold for the average amount spent for the varying mix of new dwelling units. In fact despite considerable variation, for the past five years the average amount of construction spending per new private dwelling unit has increased at exactly the same rate as the general price index--2.6 per cent per year.

This reflects the fact that the percentage of new dwellings in multi-family structures has been rising. As one would expect with rising prices of land, labor, and materials, and with changing population needs, we have built a higher share of units in apartment structures and these traditionally have had lower unit costs. As a result of this, as well as a regional shift in the mix of new starts, residential construction expenditures have gone up less on average than the price increases for either single houses or apartments might otherwise suggest. While much of the shift to apartments may already have occurred, it would not be surprising if, as in recent years, the average amount spent for construction per new dwelling does not rise much faster than the general price level.

As a corollary, these assumptions about starts and average costs mean that the per cent of the GNP spent for housing construction should not increase appreciably compared to recent years. Housing as

a per cent of the GNP would probably remain well below the experience of the 10 years ending in the middle of this past decade.

You are all only too aware of how critical the amount of money lent on refinancing, whether at the time of a sale or to a current owner, is for mortgage demand. Because such refinancing was high, the 1963-65 period saw an unusually rapid increase in net mortgage debt compared either to the level of construction or to net additions to mortgage portfolios in other recent years. Similarly, 1966 was unusually low. In searching for a logical base for comparison purposes, I have assumed that the relationship of net mortgage financing to construction would be similar to that of 1961-62 and that of the past two years.

On this assumption, while the increase in mortgage demand would be great in the next decade it would not rise as fast as either the GNP or personal disposable income. In other words if the assumptions hold, the share of income required to finance housebuilding (with related sales of existing units) would be no higher than in the past decade. This would be true even though by the end of the decade the total amount of net mortgage lending would be 70 or 80 per cent above recent levels.

Credit and Financial Markets

Thus far we have seen that no critical problem appears on the horizon with respect to longer run investment demands either for the economy as a whole or for housing in particular. The necessary total level of savings also appears well within reach of a compensatory Federal

budget program. However, one critical question remains: Will the necessary funds flow into financial institutions and from them into the mortgage markets?

While the demand for mortgages will grow somewhat slower than the economy, there are dangers that growth in personal saving and particularly in the share of funds placed by households in financial institutions will slow up. As a result one requirement for a sufficient supply of mortgage funds is that savings and loan associations hold their present share in the general flow of financing or that there be a complete change in mortgage lending procedures and relationships.

The obvious danger in assuming that S&L's will continue to play as significant a role is that it is an unlikely outcome if prices continue to increase rapidly. When prices are rising, people are less willing to maintain funds, particularly deposits, in financial institutions. They are more likely to trade the convenience and safety of deposits for other assets which they believe will move with the price level. They examine assets more carefully in an attempt to obtain the highest real rate of return.

Such shifts have occurred in recent years as some of the traditional investors in debt instruments have transferred to the equity market. Pension, trust, and endowment funds, as well as insurance companies, have all sought more action. This has resulted in a sharp increase in the desire for and in the price of equities and in a major shift in the relative nominal yields between debts and equities.

Interestingly, however, the share of deposits in the total economy has not changed greatly. While their share in the past three years has been below the peaks in the early '60's, it has been well ahead of the level reached in the late '50's. It seems clear that deposits yield considerable real returns over and above interest paid.

Still we all must feel a great deal of uneasiness as to whether the flows of recent years are likely to remain a stable percentage of income. Clearly many investors talk and act as if they doubted such future stability. Two important forces, however, suggest the possibility of a viable balance over a period such as the one we are discussing. (a) More people who need money seek to obtain it through equities rather than debts; and (b) there is some ratio of yields that makes debts as attractive as equities.

The percentage of business long-term funds raised through equities has increased rapidly. Stocks and convertible debentures are issued more readily. More important to our current discussion, an increasing share of mortgages on income property has equity features. These actions reduce the supply of debt issues. They also decrease the burden on the traditional mortgage market.

What ratio of yields between stocks and debts would be required for stability is much harder to guess. Two obvious forces create analytical problems. Much of the desire for equities is probably based on expectations developed as a result of the movement in past market prices rather than in yields. Expectations based on predictions of high rates

of change usually are thwarted. There is a limit to rates of increase. On the other hand, problems exist on the debt side. Yields, particularly of depository institutions, lag behind current rates. What level of rates would be viable in an inflationary context is not at all clear.

Savings and Loans

I find such a lag in the adjustment of operations of savings and loan associations relative to changes in the environment and it is most worrisome. In the past, I have frequently made clear my belief that S&L's must work out ways to be more innovative. I recognize that some important changes have been made. But adaption to changing surroundings is a continuing process. The problem now is to foresee the features which may be significant in the environment of the 1970's and consciously to plan the institutional changes that will be necessary.

The basic environmental problem of savings and loans is how to get a better match between the length of their assets and liabilities. S&L's primarily remain institutions which borrow short and lend long. This is fine if: (1) short-term rates are much lower than long; (2) the economy is stable and interest rates are not fluctuating; or (3) margins are large due to lack of competition.

All three of these conditions prevailed five years ago when I last addressed this meeting. I warned then that they could not be expected to continue as favorable and that those not planning for changes were assuming large risks. Unfortunately my predictions at that time turned out to be only too true.

I see no reason now to expect that basic conditions with respect to these forces will improve. In addition, I emphasize today some additional features of the environment of the 1970's. The industry will be faced with increasingly sophisticated and equity-conscious savers. There also will be a greater variety of types of needs by potential borrowers. Unless well-designed changes occur, we may find it difficult to raise the money required to finance the homes we need after all.

I will not try this afternoon to specify the types of innovations implied by these prospective changes because I have spoken on this topic so often. On the deposit or liability side, more progress toward longer term liabilities is required. Obvious possibilities are bonds with longer terms or deposits paying higher rates on longer maturities. To some, the guarantee of high rates makes such funds appear expensive. They arrive at this judgment primarily because they neglect the cost of risks in unbalanced portfolios. They also may neglect the loss in housing welfare if the associations grow too slowly.

On the asset side, new types and forms of mortgages are required. S&L's made a tremendous innovation when they contributed the concept of the fully amortized mortgage. Now, however, we may be at a point where still other types of mortgages are needed. In the past, I have suggested the advantages to both borrowers and lenders of variable interest rates. I have also suggested that we ought to recognize that a mortgage contains both a housing and a savings contract. There are many different ways of structuring the amount owners pay in contrast to those followed in current

amortization practice. Different forms of payments would meet the needs of separate groups far better than the single type which now predominates. In the process of designing new mortgage types the returns to the borrower and lender might be split into a more equitable form.

Conclusion

I must admit that I have not been able to make up my mind whether to end this talk on an optimistic or pessimistic note. In my speech five years ago, the note was very pessimistic. Since the projections were correct, I hope that the few who were willing to speak to me after that meeting acted and profited from their willingness to listen.

Today perhaps I should be more optimistic. I think it is clear that there are no insurmountable basic long-run problems. Future demands and supply for funds appear to fall well within previous ranges. The goal of financing necessary housing construction is certainly attainable without enormous new efforts.

If financing is to take place, however, without sharp alterations in rates and periodic shortages or surpluses of funds, the Government, the Federal Reserve, the Home Loan Banks, and you as individual savings and loan managers will have to do a better job than has been accomplished in the past few years.