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"Monetary Policy, the Economy, and Housing"

An Address by

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at the

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The timing of this conference of housing leadership is particularly appropriate in view of the wave of innovation in the ways the public gains financing access for shelter. Rip Van Homebuyer, awakening from a 20-year hibernation, would find his thesaurus of no help in searching for understanding of ARMs, CMOs, MMDAs, TIMs, the secondary markets, stockholders in thrifts, negative net worth institutions, and someone calling himself a discount stock-broker in a savings bank lobby. Should he seek elucidation from a passing Congressman, old Rip would be informed that what matters is not the plethora of services offered, but the public policy questions of deregulation, holding company powers, the suspension of mortgage revenue bonds, determination of the bank/thrift regulatory structure, a rather vague definition of something called an industrial policy sounding rather anti-housing, and a warning that bank write-offs of huge credits to less developed countries could slow down the growth of domestic credit.

Recent retrospectives on John Maynard Keynes, of course, have not led to similar reconsiderations of his academic rival of 50 years ago, Joe Schumpeter, whose concepts of "creative destruction" at work in capitalism are so applicable to today's housing financial institutions and services, as the old is discarded and adjustments are made to new ways and means.

There is, of course, some continuity. Your industry led the recovery and its turn into expansion. Beginning in the fourth quarter of 1982, growth in the residential investment, expressed at annual rates, was 53%, 58%, 79%, and 30%, through third quarter 1983. One fundamental is unchanged, however. Housing remains vulnerable to fluctuations in the cost and availability of credit despite the wave of financial innovations. Closer ties with money and capital markets provide deep flows of funds under some market conditions but transmit to housing instability from those markets in other conditions. Monetary policy quickly affects rates on builder bonds, costs of funds to the partially deregulated institutions, and yields on mortgages, participations, and mortgage-backed securities--seemingly in microseconds. Segments of the thrift industries swing from conditions of minimal profitability to operating losses resulting from fairly modest upswings in market rates. One hundred or 150 basis points makes a significant difference at the margin.

I assure you that these and other consequences of changes in the implementation of monetary policy are considered most seriously at the Federal Reserve. In this regard, the intelligence conveyed to us in our quarterly meetings with our Thrift Institutions Advisory Council is most useful.

Of course, housing is not the only interest-sensitive sector. Each period of firming in long-term rates results in a sharp curtailment in corporate bond issuance. The financing costs associated with carrying inventory is one factor in the very low levels of goods on the shelf relative to sales at this stage in the economic expansion. A year ago many doubted that the recovery could develop into a normal rate of economic expansion in the face of interest rates at today's levels, but your industry and business in general have proved them wrong. Growth in this quarter may turn out to range between 6% and 7% in real terms--a 7% quarter would give us nine months of growth in line with the more successful postwar recoveries.

The indicators show further robust and increasingly broadened expansion as we mark the first anniversary of the current recovery. Housing may be stabilizing at good levels, business equipment investment is strong, inventory rebuilding is in the offing, employment gains have confounded the pessimists, defense spending continues to be a stimulative force, and even state governmental finances have taken a turn for the better.

Of course, the Federal Reserve's responsibilities encompass both sustaining economic growth and contributing to the containment of inflation, as well as promoting a stable pattern of international transactions. Producer and consumer prices are exhibiting increases far below recent levels. Wage and salary adjustments are more closely in line with gratifying gains in productivity. The surge of imports, competing with American goods, aids in containing inflation but figures in the enormous trade deficits. Corporate cash flow continues to provide the means for the initial rebuilding stages of the corporate balance sheet restructuring and of rebuilding productive capacity, extending the period prior to the inevitable and rather fully discussed crowding out of private credit demands by federal deficit financing and federal agency financing.

Growth in the monetary and credit aggregates has stabilized somewhat, as public demand for various innovative savings and transactions accounts has apparently been satisfied for the moment. The strength and sustainability of the recovery/expansion has encouraged some apparent "unwinding" of highly spendable balances. Interest paid on market instruments is not so far above yields on the nontransactions components of M2, and that measure would appear to remain well within its target range. The even broader measure, M3, still reflects the "deregulated" financial industry's management of its liabilities, but its relatively rapid accumulation does not place it outside its 1983 target range.

The "monitoring" aggregates of M1 and domestic credit are exhibiting similarly benign behavior. Credit growth, of course, is dominated by the massive federal financing, but weak private demand early in the expansion contributes to a total increment which is not alarming, given the preliminary status of this rather new measurement. The narrow money aggregate, despite its outsized growth earlier in the year, is beginning to show signs of a return to a more predictable and stable relationship to economic activity.

Close scrutiny of the narrowly defined measurement of money has, however, had an unfortunate effect of increasing the short-term volatility of market interest rates. Some observers in the financial markets gauge the intent of monetary policy not so much on our stated growth ranges and long-term performance with respect to the monetary objectives, but by the minutia of Federal Reserve implementation reflected in the weekly "French farce" following the movements of M1.

Over the last few months, market participants have progressed through the full circuit of market expectations--from fears of excessive M1 money growth leading to an overheated economy, to a belief by some today that the Federal Reserve is unduly damping the growth in M-1 and slowing the expansion. This full swing in the pendulum of public opinion has occurred as the M-1 "monitor" has moved to and remained within its 1983 target range--a phenomenon indicating that market commenters are relying too much on the weekly swings of a single indicator that is reliable only as a monitoring range, and that has assumed only a minor role in determining current monetary policy direction.

For your industry and others to enjoy the benefits of lasting economic growth, our policy actions must be based on the long-range criteria of supporting sustainable GNP growth and stable prices. The monetary and credit aggregates are only the operational means to those ends. Further, you are aware that to attempt to target the longer range objectives (GNP, for example) from week-to-week or between FOMC meetings would involve us in responding to a multitude of factors and forces outside our control-- federal financing being only one.

The wave of innovations in the structure of market institutions and instruments over the last 12 months has significantly altered many of the historical relationships between monetary aggregates and nominal as well as real economic variables. Thus the Federal Reserve has pragmatically relied on a flexible approach to our operations, using multiple targets. Isn't this very close to the approach taken in your organization in recent years?

One further comment regarding the implementation of monetary policy as it affects mortgage and housing markets. We have entered a period of increased interest rate volatility in recent years. This can be partly attributed to, in the very short run, the Federal Reserve's switch to a reserves-based operating procedure in late 1979. However, rates have also become more volatile in a cyclical context (though less so in the very recent past). There are probably two main factors at work here. The first is interest rate deregulation. The absence of non-price rationing effects, such as those associated with Regulation

Q in previous periods of monetary restraint, makes it likely that interest rate swings must be somewhat greater to achieve the same market impact when there is substantial resistance to departures of the economy from a particular growth path. Secondly, we have learned to expect the unexpected: the shocks that the economy has received in recent years and will receive in the future. Because of this education, and to the extent to which inflationary expectations have become entrenched in economic decision making, the degree of monetary restraint necessary to turn back inflation has been greater than would have otherwise been the case.

You are aware that the relationships between the monetary aggregates, the credit aggregate, and other extensive economic variables continues to evolve. In this environment, and confronted with the continued, unfinished attempts to reconcile fiscal policy goals, it behooves those of us committed to housing to continue the series of capital market innovations which are serving us well today. Thus legislative initiatives to re-regulate should be resisted, and measures to widen and deepen access to capital markets should be pursued.

Many of us at this conference have participated in the successful efforts to encourage development and growth of markets for mortgage-related securities guaranteed by federal agencies and federally sponsored enterprises. By the middle of this year, pass-throughs guaranteed by the Government National Mortgage Association, the Federal Home Loan Mortgage Corporation, and the Federal National Mortgage Association totaled $211 billion--equivalent to a sixth of all residential mortgage debt outstanding. By contrast, development of markets for fully private mortgage pass-through securities--that is, securities without federal sponsorship issued against pools of conventional loans--has been quite modest. While a fair number of banks, thrift institutions, mortgage companies, insurance companies, and so-called conduit organizations have issued private pass-throughs, available estimates suggest that the total amount outstanding is less than $10 billion.

The very success of public policy in the utilization of market processes to further homeownership and residential financing provides the platform from which private initiatives can and should now be launched. Thirteen years ago I came before this conference to advocate the establishment of a secondary market facility for conventional mortgage loans. With your help, Freddie Mac, the Federal Home Loan Mortgage Corporation, was established and has had some success. Freddie Mac has demonstrated the feasibility of the conventional mortgage-backed security, but I predicted in 1970 that the private market eventually could take over some of its functions. I believe the time has now arrived to further that transfer, while at the same time recognizing continuing roles for both Fannie Mae and Freddie Mac.

In my judgment, it would be sound public policy to change laws and regulations, where appropriate, to encourage a broadening of the secondary mortgage market through more extensive involvement of the private sector. The President's Commission on Housing identified a host of legal and regulatory impediments to development of the private mortgage-backed security in its 1982 report. Senate bill 1822 would enable a financial institution to pool mortgages and transfer them to a trustee who would administer the pool for the benefit of investors. Issuers would be permitted to market different classes of securities and to engage in pool management without double taxation of trust income. Admittedly there are important questions to be resolved, such as whether if the portion of cash flow paid to investors representing the recovery of market discounts on pooled mortgages should be taxed at federal capital gains rates versus ordinary income tax rates. The question of limiting issuers to financially strong institutions is another.

The present Trusts for Investment in Mortgages (TIMs) initiative is one I can enthusiastically support as an effort to create an investment device that can provide private mortgage security issuers some or all of the tax advantages critical to their success in pass-through securities markets. The establishment of these trust devices should create a strong and flexible tool that can be actively used and expanded upon by the private sector. To that end any legislative action should include provisions specifically permitting the issuance of different classes of securities against a mortgage pool and allowing some degree of management of assets by the trustee.

Along those same lines, we must remain cognizant of the opportunities provided by the introduction of the TIMs device both for market expansion and innovation as well as for the strengthening of our traditional mortgage lenders. TIMs could become a valuable secondary market instrument for the variable-rate mortgage in addition to its envisioned role as a servicer of the needs of fixed-rate mortgage originators.

At present the expansion proceeds apace, buoyed by strong fundamental factors, in spite of present and future federal megadeficits, high interest rates, so far surmounting a "wall of worry"--to use a Wall Street phrase. There is a widespread, shared objective expressed in the comment "let us become competitive again." Monetary policy is gauged to support the extension of growth typical of post-World War II cycles, but without the degree of inflation which in recent recoveries have eroded cost controls and productivity. If these objectives are obtained in whole or in part, the resulting need and demand for housing and housing's services could well return to levels which will tax the resources and the management of the industry.