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PREFACE FOR M.I.T. MORTGAGE PROJECT¹

I want to congratulate Franco Modigliani for pushing this project forward despite the lack of interest shown in it by the mortgage lending institutions. What he and his associates have demonstrated is that the standard level payment mortgage which we have relied upon almost exclusively for 40 years is no longer well-suited either to the needs of the borrower or the lender. The fixed rate level payment mortgage was an invention of the great depression. As such, it reflected an expectation that prices in the future would be stable and interest rates low. It is not an instrument which is suited to the opposite conditions of inflation and high interest rates.

In my remarks, I would like to focus on some of the issues which have not received a great deal of attention in studies conducted for this project; the impact of new forms of the mortgage instrument on monetary policy, the impact on thrift institutions, and the impact on the small saver.

The impact on monetary policy will clearly be negative. The present structure for housing finance is ideally suited for the purpose of transmitting a change

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in monetary policy very rapidly to real economic activity. Housing will always be the most sensitive sector in the economy to monetary policy, whatever our institutional arrangements for generating flows of funds for mortgages; but our existing institutional arrangements greatly exaggerate the impact of monetary policy. Not only do higher interest rates reduce the demands for mortgages, but higher interest rates also dramatically reduce the supply of funds available for mortgages. The thrift institutions with a portfolio of fixed rate long-term mortgages are not in a position to compete for funds in a period of sharply rising short-term interest rates. Through this double action on both the supply and demand for mortgages, monetary policy impacts especially and with only brief lags on the housing sector.

To the extent that the graduated payment mortgage would reduce the sensitivity of the home buyer to change his interest rates and then to the extent that the variable rate or index linked mortgage improved the ability of the thirft institution to compete for funds in the short-term money market, the sensitivity of the housing sector to monetary policy would be reduced. The cost of this, of course, is that larger swings in interest rates would be required to produce a given impact on the real economy; since more of the adjustment would have to take place in sectors of the economy less sensitive to interest rates.

In my judgment, a strong case can be made for using housing as the balance wheel for our economy. A temporary cutback in new housing starts does not affect the total housing stock available to consumers to any marked degree, and the deferred demand for housing created in boom periods is invaluable when such deferred demand can be released to propel the economy out of a recession. Every recession of the post-World War II era has been led by a strong revival in housing. Furthermore, most of the resources of labor and plant capacity utilized by the housing industry can be shifted to commercial and industrial construction during boom periods.

However, the option of preserving the present system is not a real one. The Congress has made it clear that it is unwilling to accept a system under which so much of the adjustment burden must fall on the housing industry. There is widespread Congressional sentiment for a system under which the burden of monetary restraint would be borne more evenly by the various sectors of the economy.

In attempting to deal with this issue during the past decade, the Congress has established a group of financial intermediaries empowered to raise money in the open market and to funnel the funds into the housing market. This approach has met with only limited success for reasons which are familiar to all of you.

More recently the Congress has been contemplating credit allocation as a possible solution. If the actions of the federal housing intermediaries bring in automatic and opposite response, then perhaps the problem could be met by credit allocation devices. In my judgment, the limited sort of credit allocation bills submitted in the Congress thus far, such as the Reuss Bill providing for variable reserve requirements against the assets of member banks of the Federal Reserve System, would also fail. Success in credit allocation would require the administering of allocation of all types of credit from both bank and non-bank sources and, in my judgment, the cost of such a system to the society would be enormous.

It seems to me that the correct answer is to restructure the mortgage instrument in such a way that the thrift institutions will be able to supply the same degree of support to the housing industry in an inflationary, high-interest rate economy. The importance of the M.I.T. mortgage project is that it points the way to fundamental, long-term solutions for housing finance.

It has been apparent to everyone since 1966, almost a decade ago, that the thrift institutions with their assets consisting almost entirely of long-term, fixed-rate instruments and their liabilities predominantly short-term were not viable institutions in an inflationary economy.

None the less, little has been done to restructure the thrift institutions in any fundamental way during these nine years.

It is true that liabilities have been restructured out somewhat, short-term assets have risen slightly as a percentage of portfolios, the NOW Account has developed in Massachusetts and New Hampshire, and there is a nationwide push on the part of the thrift institutions to enter the payments mechanism in various ways. However, all of these changes have been marginal in significance. In general the thrift institutions were not in a much better position to meet the pressures of 1973 than they were to meet the pressures of 1966.

The answer to the problems of the thrift institutions is not to convert them into commercial banks. We have enough commercial banks. What we need are specialized housing finance institutions which are capable of functioning in an inflationary economy. To produce this capacity a restructuring of the mortgage instrument is essential.

For years the Federal Reserve Bank of Boston has been an advocate of the variable-rate mortgage. This is one building block for the future. But the M.I.T. project has convinced me that it will not be sufficient. To meet the housing needs of our large, young adult population we must move toward a graduated-payment mortgage, whether index-linked or not, which benefits the life income stream of the young adult.

The shelter of Regulation Q has delayed the adaptation of the thrift industry to its changing environment. It has been a crutch which has been just barely strong enough to prevent the necessary adaptation from taking place. The thrift institutions could not be sheltered by Regulation Q from the competition of open market financial instruments, but it has provided protection from competition by the commercial banks as well as from the more aggressive components of the thrift industry itself. In the absence of the crutch provided by Regulation Q, the thrift industry would have been compelled to move away from the fixed-rate, long-term mortgage.

The shelter of Regulation Q is eroding for two reasons: first, the market is responding by designing open market instruments for the small saver. In 1973-74, we saw two new instruments devised: the variable-rate note and the money market mutual fund. The success of these new devices, particularly the latter, assures that in the next period of tight money the competition of open market instruments is likely to be more severe than ever before.

The second reason why the shelter of Regulation Q is eroding is the rising strength of consumerism in the Congress. There is a growing awareness of the fact that the small saver has been the principal victim of Regulation Q. The rate on home mortgages has been subsidized

at the expense of artificially depressing the return available to the small saver. This is clearly a regressive arrangement, since the average small saver has a smaller income than the average seeker of a mortgage.

In the past, the interests of the small saver was never heavily represented in Congressional hearings on Regulation Q. Recent experience suggests this is changing. As an example, when the NOW Account legislation was being debated in the Congress, it was opposed by both the mutual banks and the savings and loan associations, a rather formidable combination. The fact that the NOW Account surfaced in New Hampshire and Massachusetts is attributable not only to the clout of the mutual savings banks, but to the fact that the NOW Account is a good thing for the consumer and the consumer's voice is now carrying considerable weight.