

# Business Conditions

**1968 May**



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# Trends in banking and finance

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## Term loans—big business for big banks

How far commercial banking practice has departed from the old idea of short-term self-liquidating loans is demonstrated by information now available on the amount of “term” loans outstanding at banks.<sup>1</sup>

Reports from about 150 of the nation’s largest banks indicate that more than 45 percent of their outstanding commercial and industrial loans were made under agreements that provide the borrower with credit for more than a year—up to seven or eight years in many cases. Such loans account for almost two-thirds of the net increase in business loans of these banks since a year ago.

The trend toward longer loan maturities has been underway since the mid-1950s. But the recent upsurge in term loans coupled with moderate net growth in total business loans,

suggests that corporations have been seeking firm credit commitments from their banks, possibly in anticipation of tighter credit.

### What are “term” loans?

Several types of borrowing arrangements are called term loans, their common characteristic being a contractual agreement that the bank will supply credit for longer than a year. The type of arrangement (ordinary term loans, revolving credits, and standby credits) usually reflects the purpose of borrowing and the timing of the customer’s financing needs. Such arrangements are made only for “qualified” customers—those with well established relations with the bank and with financial conditions and prospects that meet rigid standards.

An ordinary term loan is a business loan with an original maturity of more than one year. It may be repayable in a lump sum or in periodic instalments—a serial term loan. (Loans collateralized by real estate are ex-

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<sup>1</sup>A new statistical series on commercial and industrial term loans at the large banks in major cities. The series, which reports loans by industry, is available from the Board of Governors of the Federal Reserve System as a supplement to its weekly H.12 release. Data begin on January 25, 1967.

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**BUSINESS CONDITIONS** is published monthly by the Federal Reserve Bank of Chicago. Dorothy M. Nichols was primarily responsible for the article “Trends in banking and finance,” George W. Cloos for “Steel bargaining: a source of economic instability,” and Lynn A. Stiles for “Homebuilding—at the precipice again?”

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cluded from the definition used here.) The terms of the loan agreement are tailored to the specific needs of the borrower and vary greatly. Repayment schedules can range from monthly to annually, and the amounts to be repaid can vary over the life of the loan.

Revolving credit agreements normally allow the borrower access to a specified amount of credit for up to two or three years. Individual notes written under such agreements are short-term—often with 90-day maturities. But the notes can be renewed at maturity, and the borrower can pay down and reborrow to suit his needs for the duration of the agreement. Thus, the credit used is in effect long term, even though the outstanding amount often varies with seasonal needs.

Standby credit is another arrangement that allows the borrower to draw funds from time to time up to a maximum amount until the expiration date. There is no provision, however, for paying down and reborrowing as there is with revolving credit. Under either arrangement, the borrower normally pays a small commitment fee on the unused portion of credit and may never take down the entire amount available to him.

A variation that appears to have gained popularity in recent years is a revolving or standby credit that can be converted into a term loan after a certain length of time. Under this arrangement, the borrower can be assured of credit for seven or eight years. The arrangement is appropriate where a borrower needs flexible bank financing during initial stages of plant construction and expects to arrange for permanent financing from another source but wants protection from the need to do so under adverse circumstances.

Both ordinary term loan and revolving credit agreements usually specify definite conditions regarding the use of the funds and standards of performance in the maintenance

of the borrower's business and financial position. In a sense, the bank and its customer become working partners in the accomplishment of specific corporate objectives.

As long as he complies with the conditions of the agreement, the borrower is assured of bank financing up to the limits stated. For this privilege, he pays interest on the outstanding balance and often a commitment fee on the unused credit—usually  $\frac{1}{4}$  percent. He may also be required to maintain a compensating balance.

The bank, in turn, assumes the risks involved in making a commitment to supply a certain amount of funds as required by the customer. Sufficient funds to meet loan demands when they arise may be difficult or costly to obtain. To minimize this risk, the bank may maintain fairly high liquidity, thereby reducing current income without any assurance that the customer will actually use the funds. Moreover, while his contract with the bank usually provides the customer some protection against rising interest rates, the bank normally comes under great pressure to renegotiate the contract if rates fall.

### **Why term loans?**

Term lending on a large scale by commercial banks is a fairly recent development. Traditionally, prudent commercial bankers were expected to hold assets with short maturities in keeping with their liabilities—mainly demand deposits. Long-term credit needs were served largely by capital markets.

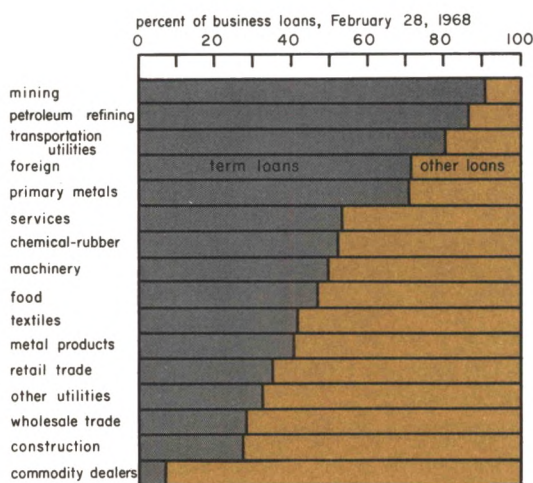
Banks began to venture into the intermediate credit area in the 1930s, when funds were plentiful and the need for such credit was widespread. Longer maturities were encouraged both by experience with Reconstruction Finance Corporation loans and a shift in emphasis of supervisory authorities from liquidity to soundness of assets. In re-



cent years, it has been recognized that both the increased ability of banks to manage their liabilities and the cash flows resulting from serial repayment schedules provide substantial liquidity—more perhaps than when most business loans were 90-day notes that might have to be renewed several times. At the same time, intermediate-term bank credit has considerable appeal to many businesses as a flexible means of financing.

Term loans are well suited to financing of capital expenditures that can be recouped from the borrower's earnings and depreciation allowances in five to eight years. Also, credits with one to two-year maturities can be used to provide interim financing in the early stages of plant construction or equipment purchases that will eventually be funded through security issues. Or, term loans may be preferred over sales of securities at times when capital market rates are believed high.

### Term loans predominate in capital-intensive industries\*



Another factor affecting the demand for term loans and revolving credit is business expectations regarding the future availability of bank loans. When monetary policy is restrictive, or is expected to become restrictive, some companies that normally borrow under established lines of credit prefer more formal credit agreements with their banks and are willing to pay a fee for a firm commitment.

### Who borrows?

Typically, term loans have been extended primarily to large companies in extractive industries and transportation utilities, such as railroads, airlines, and trucking concerns, where operating units are large and financing needs are not purely seasonal. The funds are often used to finance equipment purchases.

Term loans are most important in New York and Chicago, where many of the largest business companies do their banking. Of all banks reporting term loans, those in the New York Federal Reserve District accounted for 54 percent of the term loans reported at the end of February, compared with 38 percent of total commercial and industrial loans. As a proportion of the commercial and industrial loans in each district, term loans ranged from 61 percent in the New York district to 20 percent in the San Francisco district. Slightly more than half the business loans on the books of the 15 large reporting banks in the Chicago district were term loans, but ratios for individual banks in the district ranged from 10 to 65 percent.

Differences in the importance of term loans at large banks in the Seventh District partly reflect the industrial mix of the banks' business customers. Term loans are made most often to large companies in industries with large capital expenditures. Of outstanding credits at large Seventh District banks to companies engaged in mining or petroleum

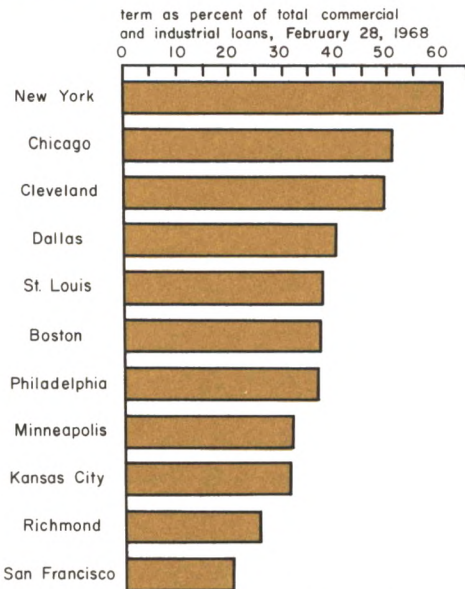
refining, almost 90 percent had more than one-year maturities. The ratio was about 80 percent for transportation utilities and 70 percent for producers of primary metals.

But the willingness of banks to extend term loans may be influenced by the amount of funds they have employed in other long-term earning assets. Thus on the West Coast, where, in contrast to New York, banks have very large investments in mortgages, business term loans are relatively small.

### How much "insurance"?

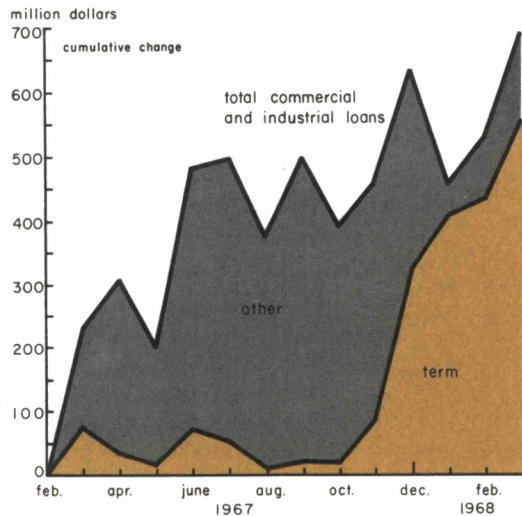
Outstanding commercial and industrial loans to domestic borrowers at reporting banks expanded \$4 billion over the year ended in late February. Of that, nearly \$2.8

### The importance of term loans varies greatly among Federal Reserve Districts



Note: Includes only banks for which term loan figures are available.

### A rapid shift into term loans has taken place since last fall\*



\*Reported by 15 large Seventh District banks.

billion was in term loans. There was only modest expansion in term loans before December. But since then, term loans have risen sharply while short-term loans have declined. At Seventh District banks, term loans accounted for more than 80 percent of the net gain in total business loans.

Both the industrial distribution of the expansion in term loans and its timing suggest a considerable substitution of term loans for short-term borrowings. Many loan officers have said corporate borrowers want "insurance" that they can obtain bank credit as needed under tightened credit conditions and are willing to pay the commitment fee as a "premium."

Much of the recent growth, especially for Seventh District banks, can be attributed to borrowings by companies engaged in metal manufacturing. A fourth of the increase at

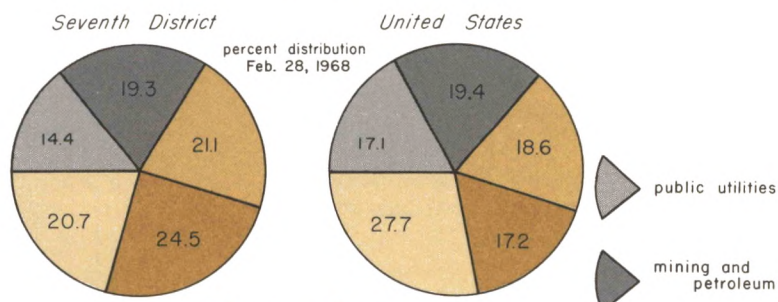


district banks went to producers of primary metals, who a year ago accounted for only 2 percent of the outstanding term loans. Borrowings of these companies, which include steel companies, probably reflects the financing needed to carry stocks built up to meet customer demands in case of a strike this fall. Mining companies, which are normally the largest term-loan borrowers, account for almost none of the expansion in the period ended in late February.

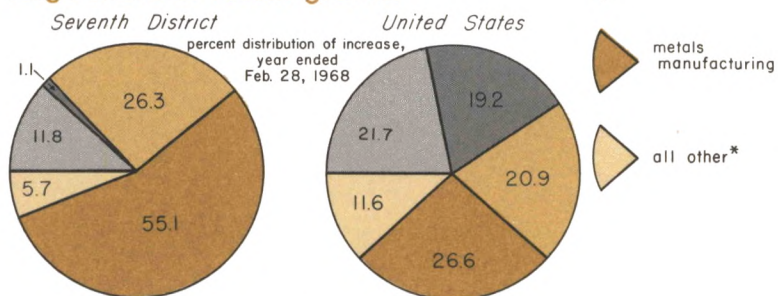
Part of the recent upsurge in term loans undoubtedly represents the financing of long-term capital needs. With yields on high-grade corporate securities well above 6 percent, businesses eligible to borrow at the prime rate—which was 6 percent until mid-April—found bank credit attractive. However, much of the funds currently taken down under long-term loan agreements is apparently of the revolving credit type.

Clearly, the recent shift to term loans cannot be related to any particular type of business expenditure. A number of factors have combined to enhance the appeal of these loans to borrowers in the current financial environment. But in the long run, the growth

### Outstanding term loans are concentrated among a few industrial groups . . .



### . . . with metals manufacturers accounting for an unusually large share of recent growth



\*"All other" includes retail and wholesale trade, services, construction, and unclassified. Foreign term loans which declined in the year ended February 28, 1968, are included in outstandings but excluded from growth distributions.

of term loans as a proportion of bank assets must also be attributed to their appeal to the lending banks. The comparatively high yields on these loans, coupled with increased confidence that a significant degree of liquidity can be provided through the management of bank liabilities, help explain this trend.

Many smaller businesses borrow under serial term-loan contracts. The evidence suggests, however, that this type of accommodation is provided mainly to large well-established companies with the demonstrated ability to make repayments out of earnings.

# Steel bargaining: a source of economic instability

For the first time since 1965, continued economic growth is threatened by the possibility of a work stoppage that could idle more than four-fifths of the nation's steel capacity. Because the availability and price of steel affect nearly every economic activity, periodic labor-management negotiations in the industry attract widespread interest.

The industry shipped 84 million tons of steel products last year—a total exceeded only in 1955 and the years from 1964 through 1966. Shipments this year are expected to exceed 90 million tons and, if a lengthy strike can be avoided, maybe surpass the 1965 record of 93 million.

Industrywide bargaining between major steel producers and the United Steelworkers began during World War II in response to urgings of the federal government. This practice has continued in the postwar period. Bargaining was usually an annual affair until 1956 when the first three-year contract was negotiated.

Representatives of the largest companies—including United States Steel (20 million tons of shipments in 1967), Bethlehem (13 million), Republic (6 million), National (6 million), Armco (5 million), Jones & Laughlin (5 million), Inland (5 million), and Youngstown (4 million)—and three smaller companies are participating in negotiations as a “coordinating committee group.”

The group accounts for more than 80 percent of domestic steel output. A similar proportion of the industry's capacity will be idled if a strike is called when the current contract

expires August 1. The current contract could be extended by mutual agreement, as was done in 1965. But this is not likely unless the bargainers are close to a settlement.

Most of the other steel companies are not organized by the United Steelworkers, have different contract termination dates, or are relatively small producers that would probably be allowed to operate during a strike, as they were in 1959, with the understanding that they would ratify agreements the union reached with larger companies.

Negotiations began in mid-April, and advance planning had started months earlier. Agreements are necessary on so-called “economic” issues (wages, pensions, life and health insurance, vacations, and cost-of-living adjustments) and on “noneconomic” issues (seniority and grievance procedures, and various “local conditions and practices,” including issues relating to safety, in-plant transportation, washrooms, cafeterias, meal-time allowances, work schedules, and crew sizes). These noneconomic issues obviously involve costs and benefits to labor and management, as do wages.

If agreements are reached without a strike, the country will have avoided a disruptive development that would become increasingly serious, depending on the length of the walk-out. Important considerations are involved from the standpoint of price inflation, lost production, and operating efficiency. Also, insofar as imports are encouraged and exports discouraged, the nation's balance of payments may be affected adversely. These factors are



also affected to an extent by the mere threat of a strike. As in 1962, 1963, and 1965, most steel producers are operating at practical capacity as customers accumulate inventories as a hedge against a possible work stoppage.

### The postwar strikes

Major steel strikes were a chronic affliction of the postwar U. S. economy until the 1960s. Walkouts of a month or more hit five times between 1946 and 1959. The walkout in 1952 lasted two months, and the one in 1959 lasted almost four months. The first postwar strike directly involved 450,000 workers engaged in the production of iron and steel, the mining and processing of iron ore, and in transportation (mainly shipping on the Great Lakes). The other four strikes involved 500,000 or more such workers. Many supervisory and white-collar workers remained at work during the strikes, either because they were not union members or because they belonged to other unions. All types of employment in the steel industry currently total about 630,000—far more than in any other industry producing materials.

The federal government has tried to pre-

vent or at least shorten steel strikes when negotiations appeared to have reached, or approached, an impasse. Secretaries of Labor and even Presidents and Vice Presidents of the United States have intervened or tried to intervene to bring negotiations to an agreement.

After a strike began in 1952, during the Korean War, President Truman ordered the steel plants seized and operated under government orders. The order was overruled by the Supreme Court and a new strike was called.

In 1959, after a steel strike had lasted almost three months and production had been curtailed or threatened to be curtailed in most steel using industries, President Eisenhower took steps to obtain an 80-day injunction under the Taft-Hartley Act. Legal procedures delayed the effective date of the court order almost a month. In January 1960, before the injunction period ended, pressures from the government and the public helped force a strike settlement. President Kennedy in 1962 and President Johnson in 1965 took active interest in negotiations, and Secretaries of Labor Goldberg and Wirtz worked closely with the bargaining groups.

In years when there have been steel strikes, they have accounted for a large part of all man-days lost directly through work stoppages caused by labor disputes. Strike induced work stoppages were widespread last year. Although no steelworkers were involved, strikes caused more than 40 million idle man-days—15 million more than in 1966 and the most since 1959.

Time lost because of strikes in industries other than steel was relatively small in 1956 and 1959—well below the 1947-67 average

### Postwar steel strikes

Year	Start	End <sup>1</sup>	Number of days	Number of workers
1946	Jan. 21	Feb. 17	28	450,000
1949	Oct. 1	Nov. 11	42	500,000
1952	June 2†	July 26	59	560,000
1956	July 1	Aug. 5	36	500,000
1959	July 15	Nov. 7*	116	520,000

<sup>1</sup>In most strikes some plants resumed work earlier than others.

†In 1952 the strike actually began on April 29, but workers returned to their jobs after May 2 when the federal government "seized" the steel plants. The Supreme Court ruled against the seizure, and the strike was resumed June 2.

\*Work was resumed when the President obtained an 80-day injunction under the Taft-Hartley Act.



**Man-days idle in work stoppages**

	Total	Steel industry (million man-days)	Other
1946	116	13	103
1949	51	22	29
1952	59	33	26
1956	33	18	15
1959	69	60	9

of 24 million man-days. But all major steel strikes have been accompanied and followed by secondary layoffs and shortened work-weeks in coal mining, transportation, manufacturing, and construction. These effects have been most noticeable in the auto industry, but they have also been important in the machinery and equipment industries, fabricated metal products industries, and in heavy construction.

Such reverberations were, of course, most serious in the case of the 116-day strike in 1959. Because of well publicized and adamantly held opposing stands taken by management and labor in 1959, steel users anticipated the strike. For more than three months before work stopped, steel was produced at an annual rate of about 135 million ingot tons—compared with a total of 93 million for the year. Millions of tons of steel were added to inventories. These excess stocks would have enabled most steel users to maintain production through a strike of one or two months, but not four.

Secondary layoffs rose sharply in October 1959 as steel supplies were depleted. Some plants with adequate inventories of steel were forced to reduce operations because suppliers' production of necessary components was reduced. The Department of Labor estimated that secondary layoffs idled 560,000 workers by mid-November—more than the number

that had been on strike. In Flint, an area heavily dependent on auto production, 26 percent of the labor force was laid off. The proportion was greater than 4 percent in Chicago, Detroit, and Milwaukee. Government agencies reported the strike was hampering output of defense products. Secondary layoffs would have skyrocketed even further if the strike had continued a few more weeks.

Losses of output in steel using industries have typically reached a peak after the steel plants reopened. It usually takes a month or more for normal conditions to be restored as operations gradually increase and pipelines to users are refilled.

Estimates of the total impact of strikes, in steel or other industries, can never be exact or conclusive. Some output of goods containing steel may be merely postponed. On the other hand, there are tertiary effects on the output of the goods and services that might have been bought with the income lost by strikers and workers hit by secondary layoffs. And these effects cannot be even roughly estimated.

It is also possible that these disturbances combine with other maladjustments in the economy to produce a general business decline. Recessions began in 1953, 1957, and 1960, after surges in activity following the settlement of steel strikes. However, the part played by steel strikes during those periods is too much interwoven with other influences to allow easy generalization.

Strikes and preparations for strikes reduce efficiency and raise costs for a number of reasons. Extremely high rates of operation involve the use of overtime and obsolete facilities that are typically less productive than normal work schedules and first-line equipment. Costs of carrying excess inventories have been estimated at 15 percent a year. And some types of goods, including

steel, deteriorate if held too long, especially in makeshift storage facilities. Less efficient means of transport may be pressed into use. Perhaps most important, shutdown and start-up costs can be expensive in many industries, especially when labor forces cannot be re-assembled expeditiously.

### The inventory buildups

Although steel strikes have been avoided since 1959, the possibility of a walkout affected orders and output in 1962, 1963, 1965, and now 1968. Customers have been well aware of contract terminations (or, as in 1963, reopening dates) and have taken steps to protect themselves by ordering additional supplies. Manufacturers' steel inventories normally range between 30 and 60-day supplies. When a strike threatens, most steel users try to build additional reserves for another 30 days or more.

Because factors other than strike hedging affect steel demand—for example, actual and expected changes in usage and expectations of price changes—the exact month such buildups begin often cannot be pinpointed. Moreover, when the buildup is underway in earnest, the proportion of shipments intended for reserve supplies cannot be determined exactly. Nevertheless, some approximation of the impact of these inventory buildups and subsequent liquidations can be made.

Since late 1961, the Department of Commerce has tabulated data on inventories of steel held by manufacturers, steel service centers, and the steel mills themselves. Changes in the tonnage of finished steel held by manufacturers is shown in the accompanying table.

Inventory changes in manufacturing plants, steel service centers, steel mills, and in the construction and extractive industries have had substantial influence on steel output.

**10** When steel inventories are rising a million

tons a month—as they typically do during a buildup—there is an increment to total business inventories of about \$2 to \$3 billion on an annual-rate basis. To this must be added a sizable but unknown increment to inventories of finished and semifinished goods made of steel.

Inventory fluctuations have played a major part in business fluctuations since World War II. Both the slowdown in the economy in the second half of 1962 and the excessively rapid rise in activity after mid-1965 were unquestionably influenced by inventory changes related to labor negotiations in steel. One reason for doubting the continuation of the current rate of upswing in activity is the virtual certainty of a substantial liquidation in steel inventories later this year and a sharp drop in steel output, even if negotiations are concluded without a strike.

### Steel prices and wages

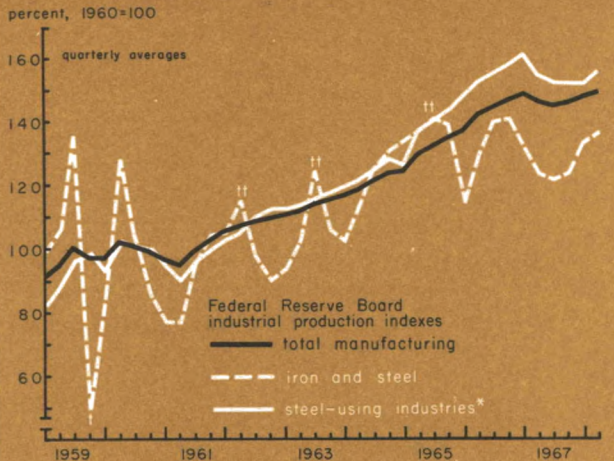
Until 1959 prices of finished steel had risen substantially every year since World War II. Except for 1949 and 1952, the average price of all industrial goods also rose, prices commonly going up after the effective dates of wage increases. It appeared to many observers that the general wage-price spiral, together with periodic work stoppages in the steel industry, had become built into the economy. But the experience of subsequent years has been quite different.

### Manufacturers' inventories of steel

	Before buildup	Peak (million tons)	After liquidation
1962	8.8(Nov. '61)	12.2(Apr. '62)	8.4(Dec. '62)
1963	8.4(Dec. '62)	11.9(July '63)	9.3(Dec. '63)
1965	11.2(Dec. '64)	17.2(Aug. '65)	10.8(Apr. '66)
1968	9.1(Dec. '67)	?	?



## Steel output increases sharply in face of strike threat



\*Includes fabricated metal products, machinery, and motor vehicles.  
 †1959 steel strike.  
 ‡Inventory buildup during labor negotiations.

First, steel strikes have been avoided. Second, starting in late 1958 and continuing until mid-1965, the average of all wholesale prices of industrial (nonfarm) products was remarkably stable at 101 percent of the 1957-59 average. Steel prices played a part in providing this stability. At the end of 1964, finished steel prices averaged no more than in late 1958. The intervening years had seen many moderate selective price adjustments—up and down—in contrast to “across-the-board” increases in 1958 and before.

Clearly, the economy in general and the steel industry in particular entered a different, more competitive environment in the late 1950s. In the case of steel, competition increased from foreign sources and from alternative materials, especially cement and aluminum. These developments, with more

ample domestic capacity relative to the requirements for steel, worked toward greater price stability. At the same time, upward cost pressures were reduced as new equipment and improved processes helped stabilize labor cost per unit of output in steel and in the manufacturing industries in general.

Starting in 1965, with the Vietnam war superimposed on a vigorous domestic economy, prices of steel and most other manufactured products began creeping up again. At the end of 1967, both steel prices and average prices of all industrial goods were 107 percent of the 1957-59 base period.

Cost stabilization in 1958-64 reflected increases in worker compensation being about in line with increased productivity — higher output per man-hour. The labor-

management agreement negotiated in the steel industry in March 1962 called for a three-year “package” of higher wages and other benefits of about 2.5 percent, less than the 3 percent-a-year secular rise in productivity estimated for the entire economy and suggested by the Administration as a guidepost for noninflationary wage increases. The agreement of September 1965 was valued at almost 4 percent and widely taken to represent a breach in the guidepost concept.

This year, talks are taking place against a pattern of contract settlements in other key industries (autos, farm and construction machinery, and copper) valued at 6 percent or more a year. Projections of annual gains in output per man-hour still range close to 3.5 percent for the economy as a whole.

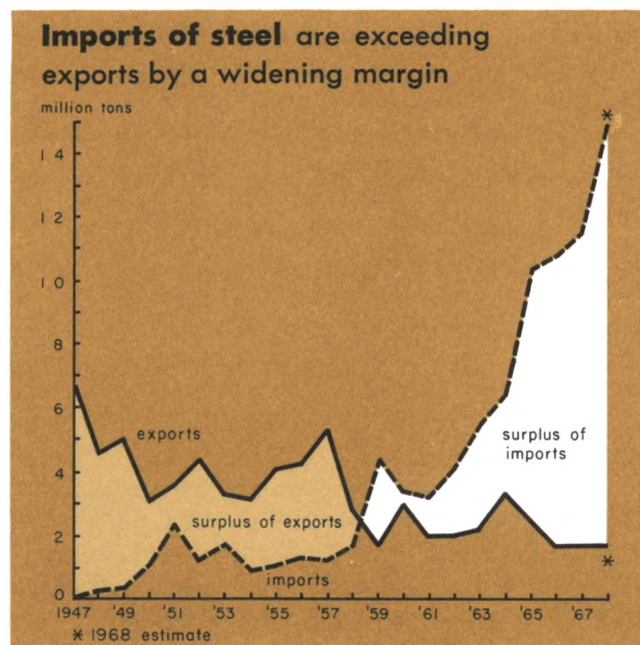
Increases in worker compensation well in



excess of probable gains in productivity cannot simply be laid on the doorstep of Big Labor and Big Industry using monopolistic powers to raise wages and prices in isolation from market forces. The super-prosperity that has characterized the U. S. economy in most of the period since mid-1965 has brought the entire cost structure of industry under pressure, especially labor costs.

### Strikes and steel imports

Steel strikes and inventory buildups resulting from threats of strikes have encouraged foreign penetration of the U. S. steel market. This country was a net exporter of steel from the end of World War II through 1958. In 1959, largely because of the long strike, imports of steel exceeded exports. On a tonnage basis, imports have continued to exceed exports ever since. The gap has widened substantially since 1964.



As they learned to meet the quality and service standards required by U. S. customers, foreign producers of steel have gradually broadened their markets here. Where imports were once confined largely to low-priced products, such as reinforcing bars and barbed wire, they now span the whole spectrum of steel products.

Although price remains the main consideration of most buyers of foreign steel—which often sells \$20 to \$30 less per ton than the domestic product—demand for foreign steel has tended to jump in years when U. S. output was curtailed or threatened by strikes.

Imports of steel last year amounted to 11.5 million tons, compared with exports of only 1.7 million. Imports were worth \$1.4 billion, compared with exports of \$600 million, for net imports of about \$800 million. As late as 1958, steel had contributed \$400 million net to the trade surplus. This year, steel imports

are expected to rise to about 15 million tons, partly because of the strike threat. This will amount to at least 14 percent of total domestic supplies. In case of a long strike, the proportion could be much higher and the trend could continue into 1969.

### Toward stabilization

The 1960s have not seen the breakdowns of collective bargaining in steel that brought the strikes of the 1940s and 1950s and severe shocks to the entire economy. But the inventory fluctuations that have preceded settlements in the steel industry have had some of the same disruptive effects—on smaller but still significant scales—on industrial efficiency and the balance of payments.



Instability is one of the costs a free economy must pay for the exercise of basic rights, including the right of collective bargaining. An agreement between management and labor will be reached in the end, but the longer the participants test each other's will, the more serious the consequences.

In some countries, changes in wages and

prices in major industries are matters of government decree. One of the dangers inherent in extended labor-management disputes here is the possibility that public sentiment may swing in favor of government intervention, thus narrowing the area of private decision making now exercised within the discipline of free market forces.

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## Homebuilding— at the precipice again?

Last year saw a sharp recovery in homebuilding. By the fourth quarter, residential construction had regained the level from which the steep decline began in the second quarter of 1966. Just as the contraction had been touched off by an abrupt curtailment in the availability of mortgage funds, revival came after the stringency eased.

### **Reflux of savings since late 1966**

A pronounced recovery in savings inflows into mortgage lending institutions began in late 1966. The improved inflow accompanied a downturn in interest rates that carried on into early 1967, following official action in September 1966 to restrain interest-rate rivalry among commercial banks, savings and loan associations, and mutual savings banks.

Much of the growth in savings funds at these institutions was earmarked from its onset, however, to rebuild liquidity eroded in the credit squeeze of 1966. Because of this, as well as the slow tempo of financing typical

of the first months of a year and the time needed for builders to reactivate their plans, the acquisition of new mortgages was delayed. But by mid-1967, lenders had made substantial headway in rebuilding holdings of cash and marketable obligations and in retiring indebtedness; their loan commitments had returned to the high level of early 1966. The upshot was a sizable flow of funds into mortgages throughout the second half. The volume has remained high—the seasonally adjusted annual rate of housing starts holding close to 1.5 million units.

With a strong upsurge in market interest rates underway since early summer, some hesitancy developed late last year. The spectre of a loss of savings over the year-end interest and dividend crediting date was apparently a factor inspiring caution in savings institutions' assumption of mortgage lending commitments. The closing weeks of 1967 saw a decline in the rate of savings net inflows, but even this and the low savings

gains in the first quarter of this year added up to results that were above expectations. To this—perhaps as much as to anything else—were due the scattered reductions in rates noted fleetingly in the first quarter, as well as softening in other terms on mortgages.

Early reports on the volume of savings over the end-of-March dividend and interest credit and April income-tax dates indicate withdrawals greater than a year ago, although much smaller than in the first stage of the credit squeeze two years ago. Results were apparently much as lenders had expected. The numerous increases in mortgage interest rates posted in April appear to have reflected the growing strength of loan demand more than any abrupt shrinkage in fund availability.

Two factors are cited as explanations of savers' seeming indifference until recently to the yield advantage market instruments have offered over savings accounts. One is that many customers of banks and savings and loan associations have switched their holdings from passbook accounts to higher yielding certificates of deposit, which must be held specified periods for the interest to be earned. The other is that the heavy volume of withdrawals in 1966 apparently included a big outflow of "hot money"—funds especially sensitive to interest yields—that did not return later to the financial intermediaries.

### **The second half and beyond**

Prospects for the rest of the year (and beyond) are unusually hard to evaluate. The state of the mortgage market and the pace of homebuilding will depend on a number of imponderables, all of which are interrelated:

- *Vietnam*. Will there be a further build-up? Or, a phasing out?

- *The tax surcharge*. Will it be adopted? If so, when? And for how much?

- *Federal nondefense spending*. Will it be

as projected? Less? Or more?

- *Private spending*. How much vigor?

- *Monetary policy*. What will it be?

What eventuates in Vietnam will have a lot to do with chances for the tax surcharge and the level of federal spending for other than defense purposes. And what happens to federal income and outgo, taken along with the performance of the rest of the economy, will continue to influence the course of monetary action.

The greater the increase in private and public spending, the greater will be the pressure on productive resources and the greater the need for restraining action in the interest of price stability. Restraint can be exercised by raising taxes (or cutting public spending) or by restricting monetary growth.

Fiscal restraint bears down directly on spending. A tax hike tends to discourage private spending. A reduction in federal outlays slows the advance in aggregate spending by diminishing the share from the public sector.

Monetary policy registers its initial effects largely on interest rates and the capacity of banks and other lenders to extend credit. Because of the importance of credit in financing the construction and sale of houses—and, consequently, the central role played by interest rates—the task cut out for monetary policy takes on special significance to the housing and mortgage markets when restraining action is needed.

The new upsurge in interest rates that began in the first half of 1967 reflects the impact of vigorously growing credit demand on a slower growing supply of credit. It is not surprising that some spokesmen for homebuilding and mortgage financing have thrown their support behind the proposed tax surcharge as a backstop to monetary restraint. High and rising interest rates have been viewed as a problem not only because they



discourage mortgage borrowing but also because they pose a threat to the continued inflow of savings to the financial intermediaries supplying mortgage funds.

On net, any reduction in outlays for Vietnam—or slowdown in their advance—that may accompany de-escalation would seem due to be offset in part by stepped up expenditures for poverty and urban-related programs, resulting in federal spending in the aggregate remaining strongly expansionary. Without corrective action on the tax front, sustained high levels of government spending would entail substantial Treasury demands for credit and resulting pressure on interest rates.

High interest rates as such may be less likely to interfere with homebuilding in 1968 than they apparently were in 1966. From trade sources come reports that mortgage borrowers have become accustomed to the level of contract interest rates prevailing for the last two years or so. Acceptance of high interest rates doubtlessly reflects the continued advance in personal income, the up-trend in prices and building costs, and the increasing stringency in the housing supply.

Vacancy rates have been unusually low lately. Vacancies in homeowner units have been at a “frictional” minimum since 1965, and slack in rental units has been dwindling rapidly since late 1966. The decline in vacancies was especially rapid in 1967, an aftermath of the sharp drop in residential construction during 1966-67. It is estimated that if housing starts had not dropped as they did but had held at the 1.5 million annual rate prevailing before the dip and after recovery, 400,000 to 500,000 more units would have been built. This represents a substantial shortfall in the inflow of new units into the supply of houses and apartments.

In addition, the rate of family formation is up appreciably over only a few years ago, and

the rise is expected to continue until the late 1970s as the many young people born since the war reach marriageable age. While the draft and prolonged schooling have postponed many marriages, prospects are for a growing number of households to constitute a plus for homebuilding for several years.

There remains the overhanging threat of substantial net outflows of savings funds from savings institutions as long as market securities yield more than the institutions’ pass-book and certificate accounts. Any renewal of savings drains affecting life insurance companies—as by another upsurge in loans to policyholders—would probably have only a limited impact on owner-occupied housing. Home financing by insurance companies has been at a low level since 1966. Corporate securities and mortgages on income properties—including apartments, which now account for about a third of all housing starts—have offered more alluring returns than home mortgage loans.

For the last year or so, acquisition of home mortgages bearing relatively high contract interest rates has undoubtedly increased the average yields of mortgage portfolios, thereby placing many lenders in a position to match (at least to a small extent) further advances in market rates. Taken along with the retirement of debt and the buildup in liquidity that savings intermediaries have achieved since late 1966, the advance in asset yields suggests that high market interest rates may pose a less serious threat to housing and the mortgage market today than comparison with early 1966 at first implies.

### **Housing in a climate of restraint**

In a time when the growth of money and credit has to be restrained to support economic stabilization, interest rates can be expected to advance. The increase is no more



than the means by which a *relatively* limited supply of funds is rationed among potential users. Rising rates mean that something has to give. The normal working of market forces can usually be expected to result in a pattern of credit allocation according to the relative urgency underlying each of a variety of credit needs.

Housing and mortgage finance feel the effects along with other users of credit—corporate borrowers, consumers, and governments. This is not the whole story, however. Several institutional features peculiar to the housing and mortgage markets appear to accentuate the impact of tight money and credit on this sector.

Usury laws offer a leading example. In some cases, the upper limits on interest rates set by usury laws designed to protect the public from avaricious lenders have rationed borrowers out of the market by preventing the payment of rates attractive to lenders.

Ten eastern and southeastern states had laws at the end of 1967 setting 6 percent as the highest contract rate an individual mortgage borrower could be charged. In all but two of these states, however, efforts have been underway this year to liberalize usury limits. Virginia has already raised its ceiling, and an increase is pending in Maryland. Action still remains to be taken in the other eight states, which include New York, New Jersey, and Pennsylvania.

In the Seventh District, a 7-percent usury limit applies in Illinois, Iowa, and Michigan. The ceilings are 8 percent in Indiana and 12 percent in Wisconsin. So far, these rate limits have caused no apparent difficulty in the Midwest, but if a 6-percent ceiling has obstructed the flow of funds into mortgages in the East,

where interest rates are generally lower than elsewhere in the country, appreciable further tightening in credit markets could make the 7-percent limit a hindrance to mortgage financing in the Midwest.

Limitations on the rates on FHA and VA mortgage loans provide another example. To the extent that mortgage lenders are averse to extending loans that must be discounted to produce attractive “effective” interest yields, the supply of funds available for mortgages underwritten by the government simply contracts. Moreover, discounts may be a major deterrent to some borrowers, boosting out-of-pocket payments beyond their reach.

A further factor is the prevalence of the long-term fixed rate typical of residential mortgage loans. The dominance in lenders’ loan portfolios of comparatively low-yield mortgages dating from periods of easy credit and low interest rates often handicaps efforts to offer suppliers of capital attractive returns in times of higher interest rates.

These considerations point up the significance of often arbitrary statutory and regulatory provisions—and practices of lending institutions—that might be modified in the interest of greater stability in residential construction and mortgage finance. But, as long as there are such rigidities in the housing and mortgage markets and in their regulatory environment, pronounced upward movements in interest rates are likely to bear severely on these sectors. In the current setting, adoption of the proposed tax surcharge, which would reduce dependence on monetary restraint, could relieve pressure on interest rates and thereby lessen the exposure of housing and mortgage finance to the side effects of institutional rigidities.