

Remarks by

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This morning I would like to discuss some aspects of the Housing Act of 1968. More specifically, I would like to discuss the feasibility of our achieving the goal stipulated in that Act -- that over the next decade, 26 million new housing units will be built, 6 million of which will be for low and moderate income families.

There are two reasons why I chose this particular topic. First, passage of this Act and the concomitant increased emphasis on housing construction is going to affect the environment in which your capital spending decisions will be made. I would be remiss if I said that this is the only, or even the most important, factor that will affect the availability of hotel and motel construction funds. I do feel safe in saying, though, that because your industry and the housing industry rely on many of the same sources of funds -- commercial banks, savings and loan associations, and life insurance companies -- changes in the demand for and supply of funds available to housing will also affect the hotel and motel industry.

I have a second reason for wanting to talk about our housing goals. I know that you are aware that high on the list of our many domestic social problems is the lack of suitable housing for a large part of our population, and that this problem must be resolved. Although considerable thought has already been given to solutions for this problem, I am of the firm belief that we still have a long way to go to ensure that our national housing goal is reached. The more this issue is discussed and deliberated, the greater are our chances of success.

I would also like to note that as a President of a Federal Reserve Bank, my primary area of interest and expertise naturally lies in

the financing aspects of housing construction. As a result, I will deliberately not address myself to the myriad other problems -- costs of construction, building and housing codes, availability of labor, etc. -- that will have to be considered if our housing goals are to be met. In the words of economists, for purposes of this talk I am going to assume them away.

I would like to address myself to three questions. First, how large a task have we set for ourselves in specifying that 26 million new housing units should be built in the next decade? Is this a feasible goal? Second, have we taken any steps toward the realization of this goal? Finally, what steps should be taken to enhance the probability of attaining our housing goals?

The answer to the first question, at least as I see it, is that the goal of 26 million new housing units is extremely ambitious, but well within the range of feasibility given our capacity to produce.

To achieve this goal, we will have to sustain a building level where 2.6 million housing units on average are produced over an extended number of years. Yet, we have never produced that many housing units in any one year. Historically, our best year was in 1950, when 1.9 million new houses were built. In more recent times, our highest total was achieved in 1968 when 1.5 million housing units were started.

This means that if traditional building methods are used, and if there is no appreciable rise in prices, we are going to have to maintain a level of building activity 70 percent greater than we had in 1968. Instead of the \$30 billion that flowed into housing in 1968, residential construction expenditures will have to rise to something on the order of \$45 to \$50

billion per year¹ by 1975. This estimate could be scaled downward to the extent that cheaper methods of building houses are found, but it is unlikely that substantial savings in homebuilding methods will be forthcoming in the next few years.

Put another way, we as a nation will have to re-examine our priorities if our housing goal is going to be met. Currently, housing accounts for around 3 percent of our total national product. Assuming that GNP rises at about a 5 percent annual rate over the next five to ten years,² to achieve our goal housing will have to rise to 5 percent of total output. We consistently spent this much or more of total output for housing during the fifteen years following World War II, and it is only since 1965 that we have substantially dropped our relative level of spending for housing. Thus, although realization of our housing goal implies that our resource commitments to housing are going to have to expand tremendously, by historical standards the increase is not insurmountable in relation to our capacity to produce.

Put in still another way, attainment of our housing goal means that our capital markets will have to undergo some restructuring. Housing will have to get a larger portion of total credit available and will have to become less susceptible to changes in credit conditions than in the past. The events of the past year and a half illustrate my point. Beginning late in 1968, the Federal Reserve, sensing the strong inflationary tendencies

¹ The Council of Economic Advisors estimates that spending on residential structures will be \$46 million in 1973 and \$49 million in 1974 and 1975. See 1970 Economic Report of the President, p. 79. This estimate is consistent with our achieving the desired level of homebuilding.

² CEA estimate as published in the 1970 Economic Report, p. 79.

in the economy, took deliberate action to retard the growth of credit. As a result, the growth in total credit outstanding in the economy has fallen considerably. Between the third quarter of 1968 and the first quarter of this year the growth of total credit declined from an annual rate of \$118 billion to \$81 billion, a fall of around 31 percent.

The effect of this cutback in credit flows, however, was not felt uniformly by the different users of credit. The flows of funds toward corporate equity and debt instruments were actually higher in the first quarter this year than they were a year and a half earlier, and their share of the inflow of total credit rose from 26.4 percent during the third quarter 1968 to 42.3 percent in the first quarter of this year.

The flow of funds into housing did not start to dry up until the beginning of 1969, but once started, housing funds dropped precipitously. During the fourth quarter of 1968, home mortgage holdings excluding those of FNMA, rose at an annual rate of \$16.0 billion, and accounted for 13.6 percent of the flow in total credit. By the first quarter of this year, mortgages held by all private holders were expanding at a seasonally adjusted annual rate of only \$6.0 billion, and accounted for only 7.4 percent of the growth in credit.

Mortgage flows of these magnitudes are certainly inadequate to ensure the attainment of our housing goal. In fact, even the money that was being channeled into mortgages before the present tight credit period will not be sufficient. My guess is that if buyers continue to finance their housing expenditures in roughly the same proportion as they do now and if home prices remain at their present levels, available mortgage funds will have to rise to between \$30 and \$35 billion per year, about twice as much as in

1968, if there is to be sufficient money for home financing.

The second question I want to ask is whether or not we are moving in the right direction? My answer to this is that we may not have at present a financial structure that is capable of allocating the necessary amount of funds to housing when competing demands are strong, but that changes have been and are being made that should reduce, if not eliminate, the existing barriers to expanded financing. Indeed, we seem to be moving much faster than I would have believed possible a few years ago.

Probably the most pleasant surprise of recent mortgage market innovations has been the way in which the Federal National Mortgage Association cushioned the housing downturn in 1969 and earlier this year. I don't think it's any exaggeration to say that the only reason housing starts in 1969 didn't fall to the crisis levels of 1966 was because of FNMA's support of the mortgage market. Everything else suggests that the 1969 housing downturn should have been as severe as that in 1966. For example, market interest rates were higher than they were in 1966, and savings inflows to thrift institutions fell considerably more.

A quick look at the numbers shows the extent to which the mortgage market was shored up by FNMA. In 1966, traditional suppliers of mortgage funds -- thrift institutions, life insurance companies, and commercial banks -- added \$15.8 billion to their mortgage portfolios. During the twelve months ending in June of this year, their mortgage holdings expanded by only \$14.0 billion, or about 11 percent less than during 1966. FNMA's expansion of its mortgage holdings, and to some extent GNMA's, however, more than offset this decline. And, as a result, the total expansion in mortgages during the twelve months ending last June was

about \$2 billion greater than it was in 1966.

Two additional recent innovations promise funding assistance to reach our housing goal. First, the tandem plan will greatly expand the total amount of money available for low income housing. Under the tandem plan, GNMA does not hold mortgages it receives -- rather, using the money that has been allocated by Congress, it buys mortgages for homes built under the various low income housing programs, and in turn sells the mortgages to FNMA at the market price. If the market price is less than par, the difference becomes GNMA's subsidy, but in the meantime GNMA has the money from the original sale to FNMA to use in buying more low income housing mortgages. The net result is that more low income housing is built for every dollar of government outlay than would otherwise be the case.

Potentially, the largest step in achieving our housing goal was taken earlier this year when GNMA introduced the mortgage-backed security. These pass-through securities, as they are called, are insured by GNMA and are designed to bring new sources of money, primarily from private and public pension funds, into the housing market. The hope is that the securities collateralized by mortgages, will permit investors to reap attractive rates of return without having to contend with the servicing problems associated with holding a mortgage portfolio.

There certainly appears to be a ready market for these securities, and there is no doubt in my mind that this innovation alone would take us a long way toward financing our housing goal if pension funds can be attracted. The total financial assets of pension funds currently exceed \$150 billion, of which less than \$10 billion is in the form of mortgages.

Moreover, the assets of these funds are growing at a rate of about 10 percent per year, so the potential is there.

Public reaction to pass-through securities seems to be favorable so far. Pension funds and other investors are purchasing these securities and mortgage bankers, in general, seem willing to experiment with various forms of pass-throughs. In the past six months, more than \$100 million in straight and modified pass-throughs have been issued and FNMA has successfully floated \$1 billion in GNMA-insured mortgage-backed bonds at rates comparable with Moody's Corporate Aaa bonds.

Because of still another mortgage market innovation, it now appears that a secondary market for conventional mortgages will finally become a reality. The Emergency Home Finance Act which was passed in late June paved the way for this program, which has long been needed and wanted by people in the industry. Among other things, the Act permitted the FHLBB and FNMA to purchase conventional mortgages. The FHLBB has responded by establishing the Federal Home Loan Mortgage Corporation which will get its initial capital from Federal Home Loan Banks and will subsequently sell its own paper and participations in the mortgages it owns. This corporation, then, will perform as a secondary market where savings and loan associations can sell conventional mortgages. Thus, S&Ls, by being able to sell conventional mortgages in a secondary market, will not be as dependent upon the extreme swings in savings inflows as they have been in the past. They will not have to close down their mortgage departments as they did in 1966 and 1969 before the FHLBB changed its policies on advances.

Because this program is so new, it is hard to judge what impact the change will have on the availability of mortgage funds. Although Preston Martin, Chairman of the Federal Home Loan Bank Board, has been quoted as saying that the new mortgage corporation will in part replace the present massive "expansion advances" that are scheduled to be repaid next year, Business Week estimates that this one innovation alone will add \$2 billion a year for more mortgages, and I have no reason to question that estimate.

At the outset of this talk, I made the comment that attainment of our housing goal means that housing spending will have to rise from the current level of \$30 billion per year to somewhere between \$45 and \$50 billion per year. The final question I want to discuss today is: Are these institutional changes in the mortgage market sufficient to ensure an adequate flow of funds into housing?

I would answer that question by stating that the necessary groundwork has been laid. Whether or not an adequate flow of funds will actually be forthcoming will depend to a great extent on what priorities we as a nation set for ourselves. It is no secret that we can mobilize the resources to meet specific goals if we are determined to do so. I think we proved that when we committed ourselves to the space program in the early 60's. It is also true, however, that we cannot do everything, and attainment of our housing goal will depend a great deal on the extent to which we commit our resources to other national goals.

And, there will be strong competition for funds in the 1970's. I am not aware of any comprehensive estimates of the costs of attempting to meet our most important investment needs, but I am sure such estimates if they existed would be extremely sobering and staggering to the imagination. For

example, controlling our pollution and environmental problems is going to require expenditures in the tens of billions of dollars by the federal government alone, which says nothing of the costs that individuals, businesses and other levels of government will have to shoulder. Urban transportation is rapidly approaching the point of being intolerable, and estimates are that our transportation capacity will have to double over the next twenty years. Urban living conditions, especially in many core cities, are deplorable, and urban renewal will require enormous sums of money just to scratch the surface of the problem.

Any one of these programs could add \$50 billion to federal government expenditures over the next ten years, and there are strong reasons for pursuing all of these goals simultaneously -- this could mean additional spending of up to \$150 billion. This means that unless there are offsets in the form of spending reductions or tax increases, the government will have to rely heavily on credit markets for the necessary additional funds. As a result, government borrowing could conceivably rise just because of these programs from \$17.3 billion at an annual rate in the first quarter of this year to around \$25 billion per year by the mid-1970's.

These are only a few of the programs that will compete for large amounts of credit. What about our needs for other types of social investment such as schools, roads and airports? What about the demands that will come from private industry's efforts to meet the needs of our burgeoning population? These demands include funds not only for new machinery but also new plants, and, yes, new hotels and motels for the increasing number of both business and tourist travelers.

So, despite the fact that housing funds are going to have strong competition from other good uses, the attainment of our housing goal depends on our ability to channel vast amounts of funds into housing. These funds can come either from the private sector or from allocations out of the public sector. In either case, however, attainment of our housing goal implies that a responsible rein be held on spending for other purposes. It is all very well to provide the institutional framework for housing to compete for the available funds, but the rates borrowers must pay are also important. If there is a shortage of current saving relative to investment of all kinds, rates will be high. The financial structure may be able to channel the funds into housing at these high interest rates, but will there be families willing and able to burden themselves with these high interest rate mortgages? If they cannot pay these higher rates, that part of the housing goal which depends on the willingness of private individuals to build and buy a certain number of housing units will not be achieved.

If private saving is not enough to keep mortgage rates at reasonable levels, the government, if it gives housing a priority status, can become a net saver and investor in homes. It can do this in at least two different ways. For one, it can reduce its spending for other programs and shift these resources toward housing. For example, the planned reduction in Viet Nam expenditures, and the resultant fiscal dividend could be shifted toward the housing sector rather than to expand other programs or to reduce taxes. Or, if the government wants to expand its other spending programs, it can still maintain a surplus by increasing taxes.

It seems to me, though, that if current saving does indeed fall below desired investment and if the government does not take the necessary

steps to bring the two into balance, our housing goals will not be met. The consequence of an excess demand for investment funds is inflationary trends, with attendant tight money policies and high interest rates. And this means that the necessary funds for housing will not be forthcoming at a reasonable price even with the new innovations that have come about in the past year or so.