

THE FED LOOKS AT HOME FINANCING

Remarks

by

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at

meeting of the  
MINNESOTA MORTGAGE BANKERS ASSOCIATION

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Summary of points made by Lyle E. Gramley in "Short-term Cycles in Housing Production: An Overview of the Problem and Possible Solutions"

Fed Staff Study - 20 individual papers dealing with means to lessen cyclical variability of housing production.

STAFF - some obvious comments  
some novel conclusions

FOCUS - a search for practical ways of reducing cyclical variability without unacceptable side-effects on economic stabilization.

Basic Conflict: Housing cycles are counter-cyclical. Damping housing cycle throws burden on other sectors.

## I. BACKGROUND

1. Early post-war period: single family (until late '50's) multi-family starts less than 200,000 p.a.

Today, multi-family account for 45% of total. Once became important, just as prone to financing cycles as single-family.

In early cyclical slumps, Government-guaranteed mortgages affected more than conventional ('55-57 and '59-60)

In '66, both affected equally; in '69-70, Government guaranteed actually rose.

2. Housing cycle not unique to U.S. Common experience despite differences in financing techniques, financial institutions, and social characteristics.

3. Significant downtrend in ratio of residential construction to GNP over last 20 years: early '50's = 5%; last half of '60's = 3½%.

- Causes:
1. age structure of population
  2. backlog of demand when depression and World War II
  3. multi-family unites, mobile homes - less cost per family
  4. secular rise in interest rates



stability will suffer unless greater stability in housing activity is accompanied by changes that force other sectors to bear a greater share of the burden." (p. 13)

## II. ROLE OF FINANCING IN CYCLICAL HOUSING SWINGS

1. Econometric studies seem to confirm common belief that financial variables are key elements in explaining short-term fluctuations in residential construction.

Most, though not all, think that financial variables act primarily on demand for housing, not supply (i.e. financing of contractors).

2. Cyclical swing in housing a problem well before disintermediation, though this has had major impact in last two cycles.

Contractions in flows in '50's reflected mainly reductions in mortgage acquisitions by diversified lenders - still important. (commercial banks, life insurance companies, and mutuals)

3. Disintermediation: partly reflects ceiling on interest rates, but more fundamentally, the inflexibility of savings institutions in periods of fluctuating interest rates.

(Between 1965 and 1969, yields on new conventional mortgages rose two percentage points; return on assets of S & L's 0.6 percentage points.)

4. New element: growing role of Federally sponsored agencies.
5. Reasons for differential impact on housing and business of credit

### RESTRAINT:

- a. Housing depends for financing largely on specialized depositary institutions, whose sources of funds are not diversified.

Business firms have many different alternatives.

Moreover, volume of new credit extended to business firms by principal diversified lenders typically rises when growth rate of their total loans and investments falls.

b. Impact of usury laws.

### III PUBLIC POLICY IMPLICATIONS

1. While agreement that present swings in housing activity too large, complete elimination of fluctuations would not be a desirable goal, even if feasible.

Reason: desirable to restrict production of highly durable goods, like housing, during periods of excess aggregate demand. (Because restraint on real resources can be achieved without undue sacrifice of current consumption, since housing is "consumed" over long period.)

2. Main institutional reforms needed: those that reduce exposure of depository institutions to interest rate fluctuations.

1. Usury ceilings ought to be abandoned. Likewise the ceiling on FHA/VA interest rates (Phase II makes this an awkward time to push this.)
- 2.

- a. Improved functioning of depository institutions essential to reduced cycles, but also to capacity of the institutions to function safely.

Although letting market forces work freely in recent past might have had disastrous effects on institutions, must remove ceilings deposit interest rates and attack underlying problems of asset and liability rigidity.

- b. Merit to view that specialized non-bank intermediaries have out-lived usefulness, and should be merged into commercial banking system. HOWEVER, effects of such a move during next decade on availability of mortgage credit might be seriously adverse.

Liability  
Structure

- c. In near future, best prospect for better balance between maturity structure of assets and liabilities lies in efforts to lengthen structure of liabilities through differentiation. differi:  
certifi  
cates  
Possibility of "bonus accounts" with penalty for early withdrawal. Or tax incentives (or subsidies) for long-term accounts. Or higher reserve requirements for institutions with short maturities.

Asset  
Structure

- d. Asset diversification
  - 1) Installment loans. General rate advantage of 100 points over mortgages, plus faster payout. Possibly 10% of assets.
  - 2) Variable rate mortgages.  
Inappropriate for public policy to encourage, or force borrowers to assume all risk of interest rate fluctuations - need compromise. Might use link to intermediate government bond (3-5 years) to avoid short and long. Probably easier to sell a fixed payment mortgage with variable maturity than variable payment - at discount from fixed rate.

No quick answer.

3. Federal Agencies

better secondary market

Originally to increase secular flow into mortgages/ ; now counter-cyclical role. (Secular flow increase has greatest hope in GNMA programs - by mid '71, \$3.9 billion in mortgage backed securities: \$1.6 billion bond type; \$2.3 billion pass-through)

Limits to role of agencies:

- a. Cause disintermediation
- b. Rising interest rates threaten financial viability of agencies.  
matched structure of assets & liabilities (FNMA) - same as S & L's.

- c. To extent successful, frustrate effectiveness of monetary policy, and thrust burden on next weakest - state and local, and small business.

CONCLUSION: d. Probably went as far in 1969 as useful to go.

(Estimate of marginal disintermediation: 50¢ per \$1.)

#### 4. Fiscal Policy

Single most important contribution to stable credit markets: a more active fiscal policy.

Conclusions:

- a. For totals - hope for improvement lies in varying tax rates rather than expenditures.
- b. For particular better to apply subsidies and taxes to expenditures other than housing, i.e. since housing counter-cyclical, attack pro-cyclical itself, so won't frustrate general counter-cyclical policy, e.g. consumer durables, taxes on investment goods (like investment tax credit, but would apply to all firms investing, not just profitable).
- c. Business investment fund  
Rather than variable tax/subsidy on investment, require contribution to fund, and permit withdrawals depending on phase of cycle. Rationale: 1) business investment outlays large and cyclically volatile, and not sensitive to general monetary policy.  
2) can't always stimulate housing; have to restrict something!

#### 5. Other possibilities considered and rejected

- a. Variable reserve requirements on assets.
- b. Mandatory purchase of mortgages by pension funds, etc.

- c. Favoring financing of new housing over existing.
- d. Restricting borrowing by businesses - as distinguished from providing incentives to invest.

#### IV LONG RUN PROSPECTS FOR HOUSING - 1980

- Assumptions:
- 1. No change in institutional arrangements.
  - 2. Cyclically neutral
  - 3. Strong housing activity: 3.7% of GNP vs 3.3% last five years.
  - 4. Strong demand for business investment  
(Nuclear power, pollution control, etc.)
  - 5. Balanced federal budget.
  - 6.  $M_1$  grows 4 1/2%

Conclusion: funds from private lenders not sufficient to permit volume of residential construction = 3.7% GNP.

- Two reasons:
- 1. non-bank financial institutions not likely to recoup share of savings characteristic of earlier periods.
  - 2. Home mortgages less attractive as emphasis on equity "piece of action" has increased.

(Could consider equity-linked home mortgages, or inflation-hedged through link to CPI - but public policy shouldn't force such links.)

Probably have to count on public institutions (like Federal Agencies) to supply about 10%.