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The Tradition to Adapt

This is Our Housing Market

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THE TRADITION TO ADAPT*

by Karl R. Bopp

At the luncheon a year ago, President Alfred Hayes said: "Monetary policy can never be reduced to a static, inflexible set of rules in a dynamic market economy." Mr. Hayes spoke from experience. I doubt, however, that even he anticipated how dramatically his words would be borne out again. In the year that has intervened, our dynamic market economy has given birth to new and unusual problems. These problems, in turn, have called for a reappraisal of the techniques of monetary policy.

A year ago we were at a new peak in economic activity; a year ago we could take some pleasure in observing that the danger of inflation had abated; a year ago we needed only to theorize on the possible impact that interest rate differentials among the countries of the world might have on our balance of payments and our gold supply. A year ago, when this group was convening, no one could have foreseen what challenges lay immediately ahead.

Looking back, we can see now that the central bank and its policies have been taxed to the utmost. We have tried to protect our balance of payments while stimulating economic growth without inflation. The conjuncture of several events in the past year tested our ability to adapt our traditional ways of doing things to meet the new problems of the day. I think we have made headway, but many problems remain; the task is, as always, unfinished.

The economy in the past year

I should like first to discuss with you some of the domestic economic events that led up to the

complexities of the past year. As you may recall, great expectations were held for economic advance when the recession of 1957–1958 proved to be so short. The recession lasted only nine months—among the shortest recessions on record. From mid-1958 to mid-1959, there was a general upswing in all categories of buying. Gross national product rose almost one-eighth, from an annual rate of \$435 billion to \$488 billion. Toward the end of the period, however, the rapid expansion was stimulated by an inventory build-up in anticipation of the steel strike that came in the summer.

During the steel strike in the latter part of 1959, we experienced a small decrease in overall economic activity. Producers could not buy all they desired and inventories were run down. Government spending also decreased somewhat and there was weakness in consumer demand for durables. Then the steel strike was settled and we moved into 1960. The year was ripe for expansion, so everyone believed. Long-term forecasters had been painting the 1960's as a new golden age; short-term forecasters saw a sharp recovery from reductions brought about by the steel strike.

The timetable seemed assured when in the first months of 1960 the economy moved ahead vigorously. The vigor came mainly from the private sector of the economy—consumers and businessmen, appropriately enough; the Federal Government was curtailing its spending during the upturn; it was in process of shifting from a huge deficit, induced by the recession of 1957–1958, to a moderate surplus.

But the advance, it soon became apparent, was founded primarily on business spending to

* A talk given at the 58th Annual Convention, New Jersey Bankers Association, Atlantic City, May 18, 1961.

replenish inventories after the strike. Observers began to realize early in the year that the inventory build-up could not continue indefinitely. It was hoped that something else would take its place as the year went on, but nothing else did take its place. In the next few months the spark flickered and the economy began to drift. After midyear, there was an actual downturn in gross national product. This and many other indicators confirmed that we were going through our fourth postwar recession.

The dilemma of monetary policy

We felt that monetary policy could best contribute to recovery by making reserves readily available in an effort to stimulate an expanding flow of funds into investment outlets. Indeed, monetary policy was shifted from restraint to ease early in 1960 while total output was still expanding, but while it also appeared that our economy was beginning to drift and that the inflationary danger had abated. The weakening of credit demands associated with the business decline and the Federal Reserve policy of monetary ease resulted in a substantial decline in short-term rates of interest.

Meanwhile, the economies of most other industrial countries continued to expand. I hope, incidentally, that these diverse developments here and abroad will finally dispose of that once-popular myth: "If the United States' economy sneezes, the European economy will catch pneumonia." In general, other countries followed monetary policies appropriate to their domestic economies. They tightened credit which in the face of vigorous demand for credit led to higher interest rates.

The combination of rising short rates abroad and declining short rates here produced a widening spread. Short-term funds flowed from this

country to Europe in increasing volume. The continued outflow of gold served to focus attention on this problem. It thus became clear that the monetary policies appropriate for the domestic economy were having undesirable effects on our international position. Our problem became one of devising means to deal constructively with both domestic and international developments.

We started from several basic assumptions. The first was that unemployment of men, plant, and equipment is wasteful and undesirable. Affluent society or not, there is no question that in the world struggle in which we are involved we should be using our productive resources to the fullest extent possible. Our second assumption was that a free flow of trade is desirable; that the larger the flow, the better off we all will be in the long run.

We wanted, then, to contribute to domestic recovery and at the same time to strengthen our international position. The first called for greater ease in capital markets; the second could not permit greater ease in money markets. The System has often taken the position that its policy is to lean against the wind. In 1960, the wind was blowing in different directions at the same time.

Change in open market techniques

The resolution of this dilemma was contained in an announcement by the Manager of the Open Market Account on February 20, 1961. The announcement read:

The System Open Market Account is purchasing in the open market U. S. Government notes and bonds of varying maturities, some of which will exceed five years.

Price quotations and offerings are being requested of all primary dealers in U. S.

Government securities. Determination as to which offerings to purchase is being governed by the prices that appear most advantageous, i.e., the lowest price. Net amounts of all transactions for System account will be shown as usual in the condition statements issued every Thursday.

During recent years transactions for the System Account, except in correction of disorderly markets, have been made in short-term U. S. Government securities. Authority for transactions in securities of longer maturity has been granted by the Open Market Committee of the Federal Reserve System in the light of conditions that have developed in the domestic economy and in the U. S. balance of payments with other countries.

The purpose, as I have indicated, was to make reserves available to promote domestic recovery without depressing short-term rates which would aggravate our balance-of-payments difficulties. The action was in the tradition of the Federal Reserve System which is to adapt its policies and techniques to current developments.

The change in technique most emphatically does not mean that the System is once again going to peg prices and maintain an inflexible pattern of yields. We have had sufficient experience with pegs to know that they aggravate rather than mitigate the swings in the business cycle. We know also that a booming economy, with seemingly insatiable demands for credit, will force interest rates up. We observe this not only in our own history but also, and particularly during the past few years, in other industrially developed countries, notably Western Germany. We know from experience that attempts to keep rates from rising during a boom by creating sufficient reserves to keep them down result in

uncontrolled inflation with all its injustices and hazards.

Will these new techniques ultimately prove successful? The truth is that no one can be sure. Experience has little to tell us. But of this we can be certain: our evaluation will depend to a considerable extent on how much we expect. In fairness, our expectations should be tempered by the circumstances under which these new techniques were instituted.

One important circumstance was a general attitude that greeted the new methods. In many minds, the departure from "bills only" has understandably taken on the mantle of an experiment. An experiment it certainly is; there is no denying the relevance of this word. It is an experiment in the sense that we are trying out a new method in the hope that it will have a desired effect.

I should like to point out, however, that in this sense every action in life is an experiment. In banking, installment and term loans were recently, and perhaps still are, experiments. The entire Federal Reserve System was, at one time, an experiment.

The term "experiment," unfortunately, has some additional meaning. In the social sphere, though not in the physical, the very word is somewhat suspect. We speak of social or economic experimentation as tinkering with useful and still serviceable traditions. We think of that classic failure in American legislation—"the noble experiment." Webster defines experiment as a "trial made to confirm . . . something doubtful." We sometimes tend to think of an experiment as something which, if not proved immediately successful, will quickly be abandoned—and something in which the experimenters may not have much faith.

Thoughts of this nature make success more

difficult. If people believe that the new techniques will soon be abandoned, their commercial transactions in credit markets will tend to undermine Federal Reserve efforts.

Let me emphasize, then, that there were good and sufficient reasons leading to the adoption of the new techniques. We were not merely “tinkering”; we were trying to meet a new and demanding problem. The new techniques were thoroughly discussed and evaluated. I firmly believe they represent a hopeful approach. Let me say that we have consistently pursued these policies since the announcement on February 20. I might add that, as in the case of the installment and term loans, and the Federal Reserve System itself, some experiments become traditions.

There was still another adverse circumstance surrounding the adoption of the new methods. About the same time as the announcement in late February, there began to appear some signs that the recession was reaching bottom. Since then, signs of recovery have multiplied. Given such conditions, people began to expect higher interest rates and to act accordingly.

Swimming against a tidal wave of adverse expectations—based either on the belief that the economy is headed upward or that the System will soon abandon its efforts—is extremely difficult. The difficulties should not be forgotten when we judge current open market practices.

What, then, has been accomplished? It is very difficult to appraise the impact of our policies. There are many powerful forces at work and we can't easily isolate the results of System efforts; we never will know what might have happened had we pursued other policies; in addition, as yet we do not have sufficient perspective to make the best possible judgments—it is still early.

I should like, however, to cite some facts. It would appear that we have passed the low point

of this recession, and that economic activity is headed up. Last month's rise in industrial production was particularly encouraging. At the same time, long-term interest rates have not changed much from the levels in the latter part of February. Corporations and municipalities seem to be taking advantage of the current rates and meeting with success. The flow of funds into capital markets has accelerated. Moreover, banks have also contributed substantially to the general expansion of credit.

Meanwhile the bill rate has been fluctuating around $2\frac{1}{4}$ to $2\frac{1}{2}$ per cent; and the spread between short-term rates here and short-term rates in leading European countries has narrowed considerably over the past year. In recent months, the net purchase of foreign short-term obligations has declined; and there have been other indications as well that the speculative outflow of funds has subsided. Our gold losses declined considerably in February; since then we have actually gained gold.

These developments, I believe, are significant. They represent substantial improvement. I would not by any means argue that the Federal Reserve System has singlehandedly brought them about. But I do think that our policies have been instrumental in ameliorating the problems and that they have been strategically correct.

The challenges ahead

It would be a tragic error, however, to assume that our domestic and international economic problems are now solved or that monetary policy alone can ever solve them. Although the economy seems poised for recovery, we still have about 5 million people unemployed and a good deal of excess capacity in our industry. Although our balance of trade is exceptionally strong at the moment, with exports up and imports down, a

significant part of the improvement seems to have been cyclical in character, a result of the boom abroad and recession here.

We should be forewarned that gimmicks designed to avoid the imperatives of international relations could set forces in motion that would weaken our present position. For example, the mere suspicion that we might raise the price of gold from \$35 an ounce—in other words, devalue our currency—would in all likelihood lead to a wave of speculative activity and a rapid flight of funds.

The remedies we seek for our excess unemployment and our balance-of-payments deficit should be consistent with the kind of world we and our friends and allies have been trying to create ever since the end of the war. We want a world with a maximum degree of freedom for international trade and international investment. Quoting Chairman Martin:

One of the worst things that could happen to compound our balance of payments difficulties would be to adopt a restrictive trade and investment policy. It would wipe out the hard-won gains of years of effort to promote freer international exchange.

A free flow of international trade has many benefits. We all know of the powerful impact foreign competition has had in inducing our domestic automobile manufacturers to produce the kinds of products consumers evidently desire. Their response demonstrates what our ingenuity can achieve when “the chips are down.” Furthermore, there is a cliché in the lexicon of American politics: “The tariff is the mother of trusts.” I think our recent experience has shown that foreign competition is both a healthy stimulant to American business and a powerful silent partner of the Anti-Trust Division of our Department of Justice.

Presumed remedies, advocated by some, could be dangerous. Direct controls including higher tariffs, quotas, and exchange controls—all designed to promote American exports and discourage imports—would move us away from free, multilateral trade and the increased welfare associated with large volumes of trade. And, of course, our trading partners could retaliate. Because we now have a large export surplus, we have more to lose than to gain in such a contest.

We know that changes in comparative advantages between nations can cause unfortunate dislocations and personal hardships. We should certainly find remedies to ameliorate the economic hardships of these dislocations. But we should not in principle seek a remedy in artificially restricted trade. This will not solve our unemployment problem, nor, for that matter, improve our balance-of-payments position.

Domestically, as well as internationally, we must eschew rigidities. We shall find our happier solutions, I think, in retraining our workforce to meet the demands for labor that are currently being made and, generally, in improving the mobility of both labor and capital.

It is my opinion that rigidities in policies and practices throughout our American enterprise system are luxuries that we cannot afford in our dynamic economy. They represent, perhaps, the most serious difficulties we face. In some respects they underlie the gold outflow, excessive unemployment and even the seriousness of the Soviet menace.

The world is changing fast. When we do not adjust to change, we are left behind or act as a drag on the course of events. Policies of industry and labor unions—including price and wage policies—may have to be adapted to the changing world society in which we live. Tax and expenditure policies of governmental units

also can become too unbending.

Many policies and practices in use today grew out of responses to the problems of yesterday. Meanwhile, the problems, though they may not all be solved, have changed in form and character. All segments of our society should examine themselves to see that they have truly adapted to the world as it exists in 1961.

Conclusions

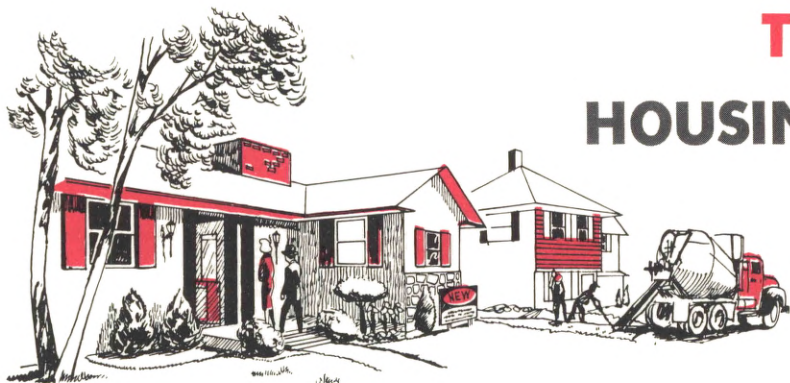
Let me summarize now some of the points I have been trying to make. The System has been faced with unusual problems in the past year. The System has moved with flexibility toward ameliorating these problems. We have had, we believe, some success. But problems still remain. And the problems that remain are not within the System's power to solve alone. If we have learned anything in the past ten years it is that monetary policy is not a panacea. It cannot substitute for intelligent decisions elsewhere in the economy—intelligent decisions by Government and by private individuals and groups. Monetary policy is, however, an important complement to intelligent decisions made elsewhere in the economy. It can reinforce and magnify

them and speed the attainment of our goals.

I raised a point at the beginning of this talk which I wish to bring up in closing. I said that the past year has tested our ability—the ability of the Federal Reserve System—to adapt its traditional ways of doing things to meet the new problems of the day. The System is an organization with traditions that extend deep into our past and, indeed, deep into the past of the Western World. Some critics have complained that these traditions have controlled our outlook and our policies beyond the period of their relevance and usefulness. At the other end of the pole, some have complained that we have adapted too easily to the irrational pressures of the day. The record in meeting the new complexities of this year does not support either of those arguments.

The fundamental fact that historians and biologists alike have pointed out is that all institutions and all species must adapt if they are to make a contribution—indeed, if they are to survive. Adapt, yes, but in accordance with our convictions. We must, in other words, play heads-up ball. We hope that this, too, is one of our traditions.

THIS IS OUR HOUSING MARKET



Encouraging signs of mild recovery are appearing in several sectors of the local economy. The important housing market is one such area.

We have talked with builders, realtors, and lenders operating in the Philadelphia Federal Reserve District, listened carefully to their analyses of the current market, and asked the question: "What are 1961 housing prospects in our area?" These same businessmen who predicted a more or less limited market in 1960 now say they look for modest improvement during the current year. But, so far, they see little in the picture to make 1961 another of those well-remembered years of boom activity in home building and home sales.

Some problems are being resolved

As those in the building fraternity see it, some but not all of the problems present at this time last year are in the process of being resolved. Mortgage money is in ample supply, so arranging a loan is a relatively simple matter for anyone who can qualify for home ownership. Interest rates are becoming more attractive to prospective borrowers on conventional lending. And, what were considered prohibitively high discounts on federally underwritten mortgages are diminishing and some cases have largely disappeared.

. . . others remain

The basic demand pattern, however, has not changed significantly. Prospective homebuyers still are much too casual. This remains a buyer's market, say the builders, with lots of lookers, too many of whom go right on looking—almost indefinitely, it seems. In their opinion, this year's sales market again may depend more heavily on those seeking to upgrade their housing accommodations than on the demand from first-time buyers, much of which originates from new-family formation.

The pace of new-house sales is a little faster

Although sales volume has increased somewhat in recent weeks, most builders say the gain is hardly more than seasonal. And the market still is a little spotty, with some operations moving quite well, while others are on the sticky side. Each succeeding weekend, however, brings out more prospective buyers to sample-house locations, and an increasing number of sales agreements to prove that some are more than just interested spectators. Our builders say they carried few completed houses unsold over the winter, so they are not facing an inventory problem. Over-all, their situation is a healthy one—and they seem determined to keep it that way.

Demand for existing houses is improving

Activity in the used-house market also is gaining some ground. To be sure, just how fast these properties sell depends on location and on the asking price. In all except the older neighborhoods, where relaxed zoning regulations have permitted commercial enterprises, the demand for existing houses has become seasonally active. The main problem in this area of the market is said to be price. Some owners, in no special hurry to sell, still place an unrealistic value on their properties. Many times, these houses are taken off the market after a short time—an indication that sellers as well as buyers are taking a leisurely pace in today's housing market. Most builders tell us that new-house sales are not being seriously delayed by the sale of an old house, as was the case over much of last year when these properties were experiencing some financing difficulties.

Rental demand is fairly strong

Relatively few houses are on the rental market this spring, according to most realtors. Some of them speak of a shortage of such listings, with those that are offered being taken up promptly. But this is not the case with apartments, where a somewhat wider choice is offered this year. We have had a lot of apartment house building in the past several years and this market has grown more competitive. Occupancy, however, still is not a serious problem and rents have been well maintained. About the only reports of a weakening rate structure come from agents of converted apartments, particularly in some of the older neighborhoods.

Mortgage money has grown plentiful

Easing in the local mortgage market has been an uninterrupted development during the past year.

Lenders call it a complete turnaround. Conventional loans still account for the bulk of current lending but the volume of FHA mortgages is increasing. VA loans are said to be regarded with growing favor, also. Most builders say they are in a position to offer all three types of financing. At present, savings and loan associations and savings banks appear to be the most active among large lenders. Private lenders in some areas also are reported to be making more loans. In the secondary mortgage market the greatest activity seems to be in loans for immediate to 60-day delivery. Futures still are moving slowly.

The price of mortgage money is lower

Rates on conventional loans, which as recently as last fall were quoted in a range of $5\frac{3}{4}$ to 6 per cent, have come down to a $5\frac{1}{2}$ to $5\frac{3}{4}$ per cent range. Brokers speak of the strong pressure of funds seeking investment, particularly in metropolitan areas, but they are not looking for any further easing of rates in the near future. The situation also has improved considerably with respect to discounts on federally insured and guaranteed mortgages. Points charged on FHA loans have all but disappeared where new construction is covered and they are said to have declined sharply on existing properties in good locations. However, the Government order effective May 29 reducing the maximum interest rate on these loans from $5\frac{1}{2}$ to $5\frac{1}{4}$ per cent is expected to result in some return to discounting, at least for a time. Lower discounts also are reported in the case of VA mortgages, particularly on new houses and those not more than five years old.

Construction costs still are rising

The trend of building costs continues upward, although less sharply than in some other recent

years. We hear less now about material prices than we do about wages, land costs, and how expensive site development has become. Average prices of building materials at the national level turned downward in the spring of last year. The long decline seems to have ended in March, with prices near the levels prevailing during the first half of 1958. Our builders tell us essentially the same thing has happened; that material prices locally have been very sensitive to the demand, with the result that this market has seen some fairly wide fluctuations in recent weeks, but little over-all increase.

It was quite a different story when builders spoke of the other cost components—wages, land, and building site development. Pressure for higher wages has shown little letup, and many builders in this area are either in the process of negotiating new contracts or will be doing so shortly. Land—that is, desirable land near some of our metropolitan areas—is said to be growing scarce and prices are reacting accordingly. Perhaps one of the most persistent cost increases in recent years has been for the development of building sites, which involve cutting through streets, grading, and installing sewer, water, and utility lines. This appears to be about the most difficult area of the cost complex in which to

effect economies.

Builders' plans are flexible

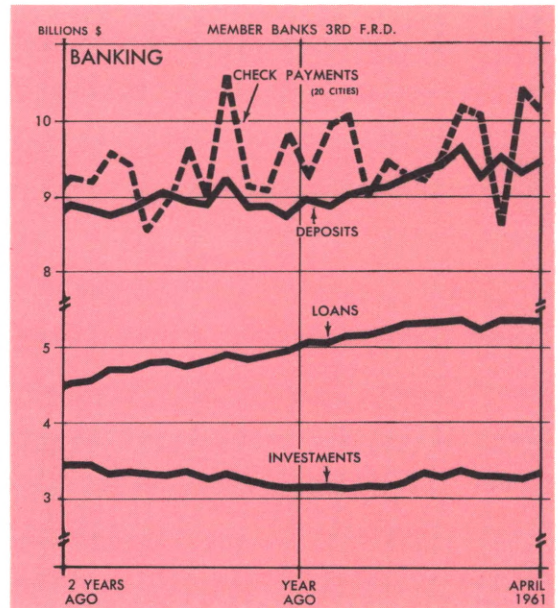
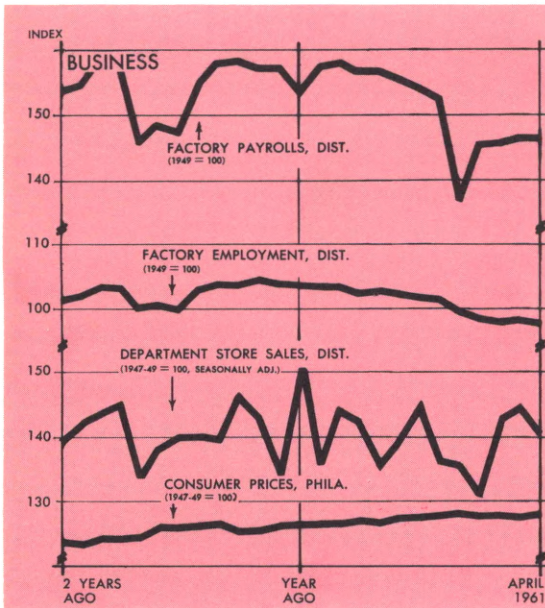
A larger supply of mortgage money at lower rates than prevailed last year and a relatively small carryover of unsold new houses seem to have encouraged many builders to draw up plans for starting more houses this year than in 1960. But, based on their experience in the past, they have incorporated into these plans about as much flexibility as can possibly be achieved. Most builders say they have sufficient land to permit a fairly high rate of activity in coming months and are not thinking of adding to their holdings at this time. Implementation of these plans will depend entirely on their market.

Projects under way at present are small in nearly all cases, consisting of a sample and maybe a half dozen or so partly finished houses on which work can be speeded or slowed as the sales picture develops. All builders shy at developing new sites much in advance of actual construction needs. They say they can increase their rate of output about as fast as any conceivable situation might warrant. But in the meantime, caution is their watchword and building close to the market their established procedure.

MONETARY POLICY: DECISION MAKING, TOOLS, AND OBJECTIVES

A new pamphlet published by the Federal Reserve Bank of Philadelphia, is available on request. It is a collection of articles dealing with such topics as the relation between government and the central bank, how policy decisions are made, guides to monetary policy, administration of open market operations and the discount window, and the problem of conflicting objectives. Requests for copies should be addressed to the Department of Public Information, Federal Reserve Bank of Philadelphia, Philadelphia 1, Pennsylvania.

FOR THE RECORD...



SUMMARY

	Third Federal Reserve District			United States		
	Per cent change			Per cent change		
	Apr. 1961 from		4 mos. 1961 from year ago	Apr. 1961 from		4 mos. 1961 from year ago
	mo. ago	year ago		mo. ago	year ago	
MANUFACTURING						
Production .....	.....	.....	+ 3	- 4	- 7	
Electric power consumed ..	- 2	- 3	- 6	.....	.....
Man-hours, total*	- 1	- 7	- 8	.....	.....
Employment, total	0	- 6	- 5	0	- 6	
Wage income*	0	- 5	- 7	.....	.....
CONSTRUCTION**	-13	-25	- 3	+ 4	- 2	+ 3
COAL PRODUCTION	- 4	-19	-19	+10	-12	-15
TRADE***						
Department store sales ...	- 3	- 7	- 4	+ 1	- 4	- 2
Department store stocks ..	0	0	.....	0	+ 2	.....
BANKING						
(All member banks)						
Deposits	+ 2	+ 6	+ 6	+ 1	+ 6	+ 6
Loans	0	+ 6	+ 8	0	+ 4	+ 4
Investments	+ 2	+ 5	+ 3	+ 2	+10	+10
U.S. Govt. securities	+ 2	+ 5	+ 4	+ 2	+11	+11
Other	+ 1	+ 3	+ 1	+ 1	+10	+ 7
Check payments	- 3†	+ 9†	+ 5†	-10	+ 2	+ 4
PRICES						
Wholesale	0†	+ 1†	+ 2†	0	- 1	0
Consumer .....	.....	.....	.....	+ 1	+ 1	.....

*Production workers only.

**Value of contracts.

***Adjusted for seasonal variation.

†20 Cities

‡Philadelphia

LOCAL CHANGES

	Factory*				Department Store†				Check Payments	
	Employment		Payrolls		Sales		Stocks		Check Payments	
	Per cent change Apr. 1961 from		Per cent change Apr. 1961 from		Per cent change Apr. 1961 from		Per cent change Apr. 1961 from		Per cent change Apr. 1961 from	
	mo. ago	year ago	mo. ago	year ago	mo. ago	year ago	mo. ago	year ago	mo. ago	year ago
Lehigh Valley	+ 1	- 5	+ 2	- 8	.....	.....	.....	.....	-10	+ 4
Harrisburg ...	- 2	- 7	- 2	- 8	.....	.....	.....	.....	- 2	+ 5
Lancaster	0	- 4	- 2	- 1	+26	+ 2	- 4	- 1	- 9	- 2
Philadelphia ..	0	- 5	+ 1	- 1	- 3	- 6	+ 1	+ 3	- 1	+ 9
Reading	0	- 6	+ 4	- 3	- 2	-13	- 3	- 2	- 6	+17
Scranton	- 2	- 5	- 2	- 1	- 4	- 6	- 1	- 4	-15	- 8
Trenton	- 1	-13	- 2	- 9	+ 4	- 2	- 1	+ 6	+29	+ 8
Wilkes-Barre ..	- 2	- 6	- 1	- 2	- 5	-11	- 1	- 7	-14	+ 2
Wilmington ..	0	- 8	- 2	- 4	- 8	-11	+ 1	- 2	-16	+19
York	- 1	- 3	+ 1	+ 2	+ 4	- 9	+ 2	- 4	- 1	+ 8

*Not restricted to corporate limits of cities but covers areas of one or more counties.

†Adjusted for seasonal variation.