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The Municipal Bond Market and Tight Money

Municipal Borrowing Experience in 1966

The Metropolitan Money Gap

About This Issue

The urban crisis now facing Americans has many facets—jobs, transportation, welfare assistance, education, air and water pollution, recreational facilities, housing of the poor, fire and police protection . . . and the list goes on. While many cities and other local governments are attempting to meet soaring demands for improved public services, difficult problems arise in financing these services and the facilities they require.

This issue of the **Business Review** is devoted to three articles dealing with two fundamental problems of municipal finance: borrowing during periods of tight money and urban-suburban distribution of financial burdens in the Philadelphia area. We hope that these studies may be of value to private citizens as well as to policymakers concerned with municipal finance.

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The Municipal Bond Market and Tight Money

by William F. Staats

Because it is now necessary to use monetary policy to dampen inflationary pressures in our economy, tight money is here again. Although 1968 may not witness a credit crunch of the severity experienced in 1966, one question of current concern is how the secondary market for state and local government bonds would fare during a prolonged period of restrictive monetary policy. We have some new data (see box) on the 1966 experience which give clues to what happens in that market during tight money.

ABOUT THE DATA

Much of this analysis is based upon data supplied by the J. J. Kenny Company, a major municipal bond brokerage house in New York City. We are grateful for the cooperation of Mr. John J. Kenny and his staff. Neither Mr. Kenny nor any member of his staff is responsible for the interpretations or statements in this article. The J. J. Kenny Company provided no information regarding identity of dealers participating in the market.

Data on individual trades for two one-month periods in 1966 were used. The first period was from August 15 to September 15, and the second from December 1 to December 31. During the first period, the municipal bond market was in a highly demoralized state as financial pressures had pushed money and capital markets to the brink of crisis. By December, monetary policy had eased and the market for municipals was strong.

Of course, these data do not represent a random sample of all municipal bond transactions during two periods because bonds were also sold through media other than the J. J. Kenny Company. However, operations of the company are so large that a reasonably good cross-section of transactions was represented. We were unable to secure complete data on trades involving 25 bonds or less; therefore, this segment of the market is not sufficiently represented in our sample.

Two major forces in the market

As shown in Chart 1, yields on municipals climbed sharply in 1966, reaching a peak in late August and early September, and then dropped during the remainder of the year after monetary policy eased a bit.[1] Of course, during periods of restrictive monetary policy, market yields on all types of debt—whether issued by corporations, the Government, state and local governments, or other debtors—move up. But yields on municipals tend to rise faster than yields on other types of issues largely because of the activities of banks and bond dealers, the two major institutional forces in the market.

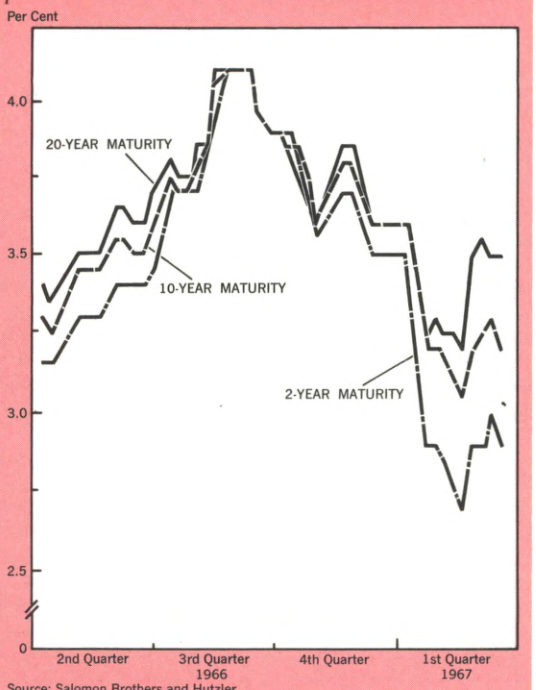
Commercial banks. The secondary market for state and local government bonds has come to be dominated by commercial banks. Bankers have begun to view municipal bonds, particularly short-maturity issues, as a type of secondary reserve in which they can invest temporarily funds not needed to meet loan demand. When loan demand slackens, commercial banks having an adequate supply of reserves aggressively buy municipal bonds. But when loan demand builds up, banks simply quit adding to their municipal

[1] *"Municipal" is used as a synonym for state and local.*

Chart 1

MUNICIPAL BOND YIELDS FOR SELECTED MATURITIES

Yields on shorter-term municipals moved up faster than those on longer-term maturities during tight money in 1966. As yields declined late in the year the usual yield spread reappeared.



Source: Salomon Brothers and Hutzler.

portfolio and, in the face of tight money, may liquidate portions of their holdings.

In contrast with 1965, when commercial banks bought an amount of state and local bonds equal to about 75 per cent of new municipal issues, in 1966 banks absorbed an amount equal to less than 33 per cent of new issues. Moreover, some banks did not replace maturing municipals and others dumped large amounts in the secondary market. One or two large banks slashed their municipal investments by as much as 35 per cent.

The influence of banks in the municipal bond market has increased as banks have become the largest holders of tax-exempt securities. In contrast with 1960, when they owned just over one-fourth of state and local government securities outstanding, banks now hold about 40 per cent. More importantly, only in recent years have many bankers begun to view municipals as a type of secondary reserve subject to liquidation when funds are needed for other purposes.

Some banks, after taking substantial capital losses upon liquidation of state and local bonds in 1966, may have avoided building up large holdings of municipals, but evidence indicates that the 1966 episode left most banks unshaken. As monetary conditions eased late in 1966 and early 1967, commercial banks returned to the market with a large appetite for municipals and vigorously expanded their tax-exempt portfolios.[2]

In recent weeks, banks apparently have again begun to curtail purchases of tax-exempts as monetary policy impedes growth of bank reserves and as demand for business loans builds. It is too early to tell how severe pressures in the municipal market may be, but some participants foresee developments similar to those of two years ago.

Bank domination of the secondary market for state and local bonds—and the effects of such dominance during periods of tight money—are not just temporary phenomena. Other market participants will have to continue adjusting their expectations and plans to a market highly subject to cyclical swings.

Municipal bond dealers. Because bond dealers may be net buyers or sellers of municipals at any particular time, their actions also affect prices of bonds. Dealers vary the size of their

[2] *For a more complete discussion of the importance of banks in this market, see William F. Staats, "Commercial Banks and the Municipal Bond Market,"* Business Review, *Federal Reserve Bank of Philadelphia, February, 1967.*

inventories over time, depending on several factors. Perhaps the most important is their expectation of future market conditions. For example, if dealers expect higher prices at some specific time in the future, they will build up inventories now in order to realize capital gains. Of course other factors of an institutional and professional nature also help determine the desired level of inventory.[3]

The planning horizon is rather short and flexible for most firms. Inventory decisions are subject to almost constant review as market conditions change. Inventory data secured from forty-seven of the nation's leading municipal bond dealers confirm statements of market participants and indicate that dealers' investment behavior tends to be pro-cyclical—that is, dealers tend to reduce inventories when prices are falling and increase inventories when prices are rising. Such behavior reinforces both the direction and pace of price movements. From mid-August to mid-September of 1966—at the height of the credit crunch—the aggregate inventory of dealers surveyed declined by more than 10 per cent. Some dealers slashed their inventories by as much as 75 per cent. About half of the dealers reduced them and only a little over one-fourth increased inventories. One-sixth held them unchanged. Most of the larger dealers decreased their inventories.

In contrast, in December when money was easier, the same dealers increased their inventories by one-third. Half of the dealers increased inventories, and two-fifths of them decreased their holdings.

Effects on yields. Because of the way banks change their investments and the way dealers manage their inventories, yields on municipal bonds tend to fluctuate more widely than those of other securities of comparable maturity. In times of restrictive monetary policy, yields on tax-exempt securities climb faster than yields on other types of securities, and during periods of monetary ease they decline faster. In dollar terms, price movements are even more pronounced. Because municipal bonds sell at lower yields than taxable bonds, percentage declines in municipal bond prices would be greater than those of corporate or U.S. Government bonds even if the absolute yield differentials among types of securities remained unchanged during a period of tight money.[4] Actually, the yield differential does *not* remain unchanged during periods of tight money; rather, it tends to narrow—that is, yields on tax-exempt bonds move up faster than yields on Governments or corporates—and widen in easy money, as shown in Chart 2.

Bond characteristics and price

Prices of municipal bonds having different characteristics such as maturity, coupon rate, and

[3] *For some dealers the cost of carrying municipal inventory may be a determinant of inventory size; however, for larger dealers the costs of holding tax-exempt securities frequently may be negative because of tax factors.*

[4] *The following illustrates price changes of a municipal bond and a corporate issue when the market yield on each security increases and the same absolute differential between yields remains.*

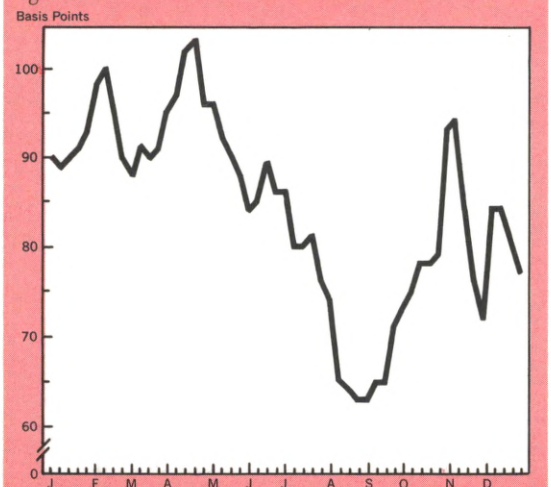
	Initial		*New*		*Percentage change in price*	*Absolute change in price*
	Yield	*Price**	*Yield*	*Price**		
Municipal	*3%*	*$1,000*	*8%*	*$375*	*— 62.5*	*— $625*
Corporate	*5*	*1,000*	*10*	*500*	*— 50*	*— 500*
Absolute yield differential	*2%*		*2%*			

**Disregarding yield to maturity.*

Chart 2

YIELD DIFFERENTIALS FOR LONG-TERM SECURITIES—U.S. GOVERNMENTS VERSUS MUNICIPALS DURING 1966

The difference between yields on long-term (10-year and longer) Government securities and municipal bonds decreased sharply from April to September, 1966. As monetary conditions eased after mid-September, the differential widened again.



Source: Federal Reserve Bulletin and The Weekly Bond Buyer.

rating are affected differently by market forces during tight money than during monetary ease.

Coupon rate. As may be expected, the dollar price of a bond is most importantly related to coupon rate and time to maturity. Given any market yield, coupon rate is directly related to price—the higher the coupon, the higher the price. Preliminary regression analysis indicates that the relationship between these variables may be different in periods of tight money than during times of monetary ease. For example, in August-September, 1966, a one basis point (.01 per cent) difference in coupon rate was associated with a price difference of 64¢ per thousand-dollar bond; the same differential in coupon rate during December was related to a price difference of $1.56 per thousand-dollar bond. In other words, a bond carrying a coupon rate of 3 per cent sold, say, for $910 in August-September while another bond, identical in all respects except that it had a coupon rate of 3.01 per cent, sold for $910.64. In December, however, prices of the two bonds differed by $1.56.

These differentials reflect investors' attempts to compensate for capital gains taxes. While interest income (coupon rate times par value) on municipal bonds is tax-free, realized capital gains on them are not. For bonds selling at discounts from par, yield consists of the two elements—interest income and capital gains. As far as an investor is concerned there is a substantial difference in *after-tax* yield between one bond having its yield comprised entirely of interest income (market yield equals coupon rate) and another bond where capital gains provide nearly all of the yield (market yield is greater than coupon rate).[5]

Maturity. As shown in Chart 1, yields on municipal bonds having different maturities did not move up equally during the summer of 1966. For example, yields on bonds with two-year maturities jumped about 95 basis points from the first of April to the late summer peak, while yields on 20-year maturities climbed only 70 basis points during the same time. And as monetary policy eased late in 1966, yields on shorter-maturity municipals fell faster than those on longer-maturity issues.

During tight money, yields on short-maturity securities are about equal to those on bonds having long maturities. In contrast, during monetary ease short-maturity issues usually carry lower

[5] *For example, the net yield after tax on a bond having a 3.1 per cent coupon rate and sold at par is 3.1 per cent. But the net yield after tax on a 15-year bond with a 1.5 per cent coupon and priced to yield 3.1 per cent is just 2.81 per cent (assuming the maximum capital gains rate of 25 per cent). Therefore, an investor would not be willing to pay the same price for each bond but would bid low enough on the second bond to secure the same 3.1 per cent* after-tax *yield available on the first bond.*

yields than longer-maturities. This is not unique to the municipal bond market. The same phenomenon is experienced in the corporate as well as in Government bond markets. Several factors are at work. Investors expecting interest rates to fall like to invest in longer-term securities to lock up high yields for a number of years; so they tend to put upward pressure on prices of long-maturity issues. Often, investors switch out of short-term securities when long-term rates appear attractive compared with expected future short-term rates. By selling short-maturity issues, investors increase the supply and help push prices down (and yields up) on such securities. Short-term rates are also boosted when debtors, expecting lower rates, borrow for shorter periods so as to avoid committing themselves to high rates too far into the future. In addition, in the spring and summer of 1966, commercial bankers put considerable pressure on the short end of the maturity spectrum by liquidating huge volumes of low-coupon issues having from one to five years to maturity.

As shown in Chart 3, over 38 per cent of the bonds included in our data and traded in August-September were in the shortest-maturity category. This compares with only 14 per cent of those traded in December. In contrast, nearly 53 per cent of the municipals sold in the secondary market in December, but only 28 per cent of those in August-September, had maturities of 15 years or more.

Rating. Our data also show that investors shift their preferences for bonds of a given rating during periods of tight money. For example, an AA-rated bond commanded a price of about $13 more than an A-rated security during the peak of the credit crunch. However, the same difference in rating was associated with a $25 price differential in December.

Changing demand and supply factors account for the narrowing price differential among bonds of different ratings during tight money.[6] As monetary conditions ease, the differential widens again. Smaller relative yield (price) swings in lower-rated municipals may offset quality factors, making these issues useful in tax-exempt portfolios requiring the highest possible degree of price stability over interest-rate cycles.

Market characteristics

The impact of tight money on participants in the secondary market for municipal bonds is reflected in some of the market characteristics.

Price continuity. A good market is able to

[6] *There are two reasons for the narrowing differential during tight money. The first—a segmented market view—is that the effect of investment behavior of banks is concentrated in high-grade bonds. When, for example, banks liquidate municipals in tight money, usually higher-rated issues are dumped. Therefore the supply of high-grade municipals in the market increases more than the supply of lower-rated issues; so, the prices of the former drop relatively further than those of the latter.*

The second reason, based upon a risk-premium concept, suggests that investors are more eager to buy lower-rated municipals during tight money because of interest-rate considerations. Yield consists of two parts: the pure cost of money and the risk premium. (See Harry Sauvain, Investment Management, *second edition, Prentice-Hall, Inc., 1959, p. 115.) For high-grade issues, nearly all of the yield represents the pure cost of money. But for lower-quality bonds risk factors account for a large proportion of total yield. The risk premium remains practically unchanged regardless of monetary conditions. Increased interest rates during tight money will cause a relatively greater increase in those yields where the pure cost of money is the larger proportion of total yield.*

For example, assume the pure cost of money (the prevailing interest rate on a perfectly riskless security) is 4 per cent, and that a high-grade municipal yields 4.50 per cent and a lower-grade issue yields 6 per cent. The risk premium, then, is .50 per cent and 2 per cent, respectively. If, because of a restrictive monetary policy, the pure cost of money rises to 5 per cent the high-grade bond would yield 5.50 per cent and the lower-rated one would carry a 7 per cent yield (assuming, of course, no change in the risk premium). Thus, the yield on the high-grade security increased 22 per cent and that on the lower-grade bond rose only 17 per cent. Expressed in terms of prices, the price of higher-rated municipals would drop relatively further than those of lower-grade bonds, so that the differential between the two prices would narrow.

adjust readily to disturbances in the normal supply-demand relationship so that there is little change in price from one trade to the next in a given security. Evidence indicates that during periods of a restrictive monetary policy, price continuity in the tax-exempt bond market may be disrupted. During August-September of 1966 the difference in prices of two consecutive trades in the same bond averaged about 1.6 times the December average.

Number of bids. As commercial banks dumped huge volumes of municipals on the secondary market in late summer of 1966, market conditions deteriorated and many dealers essentially stopped making markets in tax-exempt bonds. Some dealers were wary of even entering bids for fear of acquiring bonds whose value was depreciating hourly. The extent of dealer chariness is revealed in the average number of bids submitted on each block of municipals offered for sale. During August-September, the average number of bids per transaction amounted to only four-fifths of the December average.

In August-September, the number of bids seemed to be significantly related to the maturity and rating of bonds being offered. The longer the time to maturity, the smaller the number of bids. Also, higher-quality bonds attracted more bids than did lower-rated obligations. The number of bonds offered in each transaction had no relationship to number of bids.

Perhaps the relationship among number of bids, rating, and maturity in this period can be explained by the high degree of uncertainty which prevailed during late summer of 1966. Dealers who got up enough nerve to enter bids concentrated on high-quality issues with short maturities because of the greater potential for profit on these bonds. As indicated earlier, prices of higher-quality bonds fluctuate more widely than those of lower quality, so dealers expected to chalk up large profits when interest rates declined.

By December 1966, however, dealers had become more venturesome in the wake of a less restrictive monetary policy. They were willing to bid more frequently on lower-quality issues and on larger blocks of bonds. In December, larger block sizes attracted larger numbers of bids; and bonds with lower ratings and coupon rates received more bids than did high-quality, high-coupon issues. Moreover, by December, dealers' proclivity to bid more frequently on bonds having short maturities had apparently disappeared.

Increased bidding on lower coupon issues as monetary conditions ease reflects increased investor interest in these issues stemming from capital gains factors mentioned earlier. As market yields fall, prices rise faster the deeper the discount from par value.[7] Perhaps as more speculators discover opportunities for capital gains in price swings of municipals, discount bond prices will become less depresssed during tight money.

Bid spreads. The uncertainty which haunts

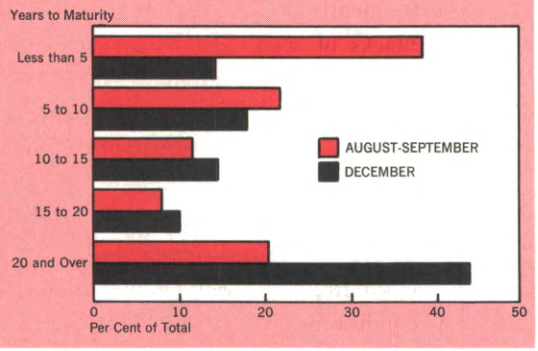
[7] *For example, assume there are two bonds both with 15-year maturities. One of the issues carries a 2 per cent coupon and the other a 3.5 per cent coupon. In order to achieve an after-capital-gains tax yield of 4.25 per cent, the first bond must be priced at a 4.675 per cent yield basis (or $713.90 per thousand-dollar bond) and the second at a 4.375 per cent basis (or $909.60), as shown in the table. If market yields fall to, say, 3.60 per cent, the price of the deeper discount issue would jump 10.07 per cent and the other bond's price would increase just 8.52 per cent.*

	2 per cent coupon	*3.75 per cent coupon*
To yield a net 4.25 per cent, price must be:	*4.675 per cent basis before capital gains or $713.90*	*4.375 per cent basis before capital gains or $909.60*
To yield a net 3.60 per cent, price must be:	*3.90 per cent basis before capital gains or $785.80*	*3.6125 per cent basis before capital gains or $987.10*
Percentage change in price:	*10.07*	*8.52*

Chart 3

MATURITY DISTRIBUTION OF BONDS TRADED

During the period of tight money, municipals having short maturities dominated trading; but in December, under easier monetary conditions, longer-term municipals were predominant.



the municipal market during tight money causes increased bid spreads (dollar difference between the highest and lowest bids). For example, in late summer of 1966 the average spread was $27.74 but in December it had eased to $26.01. Moreover, December bids were more concentrated around the average than those in August-September.[8] During the tight-money period, one or two dealers frequently entered very low bids, either bidding to lose or perhaps hoping to snare real bargains in the depressed market.

Implications for 1968 and the future

The secondary market for state and local government bonds, along with other financial markets, was under stress during the late summer of 1966. Investors, dealers, brokers, issuers, and monetary authorities will long remember their experience. Tight money was not invented in 1966. Financial markets, including the municipal market, had experienced restrictive monetary policy before. But what made the 1966 episode unique was the increased importance of commercial banks in the tax-exempt market. Because of bank behavior, pressures were intensified; dealers became demoralized as each summer day two years ago brought a new wave of municipals offered for sale by banks. So, the 1966 tight money experience was different from those which preceded it.

But what about the future? Having been through the experience once, market participants know better what to expect when tight-money pressures again grip the municipal market.

Banks remain dominant in the market, and they may again dump huge volumes of municipals during a prolonged period of tight money. But the disruptive impact of heavy bank liquidation of tax-exempt bonds could be ameliorated if other investors were waiting in the wings to buy municipals when banks unload. Recent reports of rising "odd lot" or individual investor interest in municipals are encouraging. Certainly, the lofty yields currently available on tax-exempt issues should whet the appetite of individuals who have never bought municipals before. At least some dealers have decided to invest greater resources in attempts to sell municipals to individuals.

Speculative investors in municipals may become a more stabilizing force in the tax-exempt market. Demand and supply factors for different types of municipals shift from tight money to ease. And as these shifts become apparent, speculators may be more willing to take advantage of opportunities as they arise. For example, as more speculators discover the wide price fluctuations of state and local government issues, they may be more willing to invest in a depresed market, thus moderating the range of price swings. Or, as they understand the changing price gaps among municipals of different ratings, they may find potential profit opportunities. More speculative interest in the municipal market could help to make it a stronger market during tight money.

[8] *The standard deviation was $27.89 for August-September and $22.58 in December.*

Monetary authorities, too, have learned from the 1966 episode. Clearly, the link between the banking system and the market for tax-exempt bonds is stronger than ever before. And, as banks use the municipal market for a significant portion of their asset adjustments the Federal Reserve System will maintain a keen interest in the secondary tax-exempt market.

Investors, dealers, speculators, issuers, and monetary authorities affect conditions in the municipal market. As they have learned in 1966 what to expect during tight money, they may discover opportunities to benefit themselves and at the same time moderate the impact of tight money on the secondary market for state and local government bonds.

A survey of larger state and local governments shows that **most** governments in the Third Federal Reserve District were able to borrow about as much as they planned in 1966, and that their capital spending barely felt the impact of tight money at all.

Municipal Borrowing Experience in 1966

by Susan R. Robinson

It is widely thought among financial analysts that state and local governments bear much of the burden of monetary restraint principally because commercial banks, the major institutional investors in municipal securities, shift funds away from municipals and into business loans to accommodate their corporate customers when money becomes tight. Also, borrowing by local governments may be constrained when interest rates rise above legal limits often imposed by various states, city charters, or bond referenda. For these reasons, some economists believe that municipalities may be unable to sell as many bonds as they want, and consequently are unable to spend as much as planned. The real effectiveness of monetary policy is reflected in spending. Although a restrictive monetary policy may inhibit sale of new debt, curtailed borrowing is significant only in that spending is influenced as a result.

What happened in 1966?

Financing plans of large governments in the Third District were not heavily affected by monetary policy in 1966. Fifty-four per cent of the 56 governments surveyed in the Third District had no plans to raise long-term funds during the year, so that conditions in the capital market presumably were irrelevant to their spending plans. Of the 22 entities which did borrow, only four decided to postpone a 1966 bond offering temporarily (until a later date within 1966) or to accept a financing operation smaller than originally planned, and five governments said they aban-

doned a bond issue or postponed borrowing beyond 1966. Of these nine, two cited factors other than credit conditions as the main reason for not borrowing as planned. Thus only seven—or 14 per cent of all governments, and 32 per cent of borrowing governments—changed their plans because of high interest rates and market conditions.

In dollar terms the problem of municipalities and therefore the effectiveness of monetary restraint appears somewhat greater. The Third District accounted for almost 10 per cent ($607 million) of the dollar volume of municipal bond offerings in the United States in 1966. However, bond offerings totaling $319,606,000 were abandoned or postponed into 1967 in the District. This represents almost one-fourth of all abandonments and long postponements in the United States, and is the highest of all Federal Reserve Districts. A large issue abandoned by a turnpike authority accounted for the District's lopsided share of the total. Reductions in offerings in the District totaled $1,107,000, or nearly one-tenth of all reductions, and shorter postponements equal to $13,428,000 were only 3.6 per cent of the United States total.

To be effective, monetary restraint must slow the rate of increase in expenditures. How did tight money affect capital spending? Of the units which reduced, postponed or abandoned bond financing, only two reported that new contract awards were postponed or cancelled as a result. Total awards in the District were only $3.4 million less than planned. For the United States as a whole, actual awards fell short of planned awards by $120 million. The volume of construction awards postponed or cancelled seems rather small when compared with the total general expenditures during fiscal 1966. *No* Third District government reported lower spending during 1966 on equipment or on projects for which contracts had already been awarded.[1] Only four large governments in the country had such a curtailment. One government in the District plus 17 elsewhere in the United States indicated that borrowing difficulties in 1966 caused postponement or cancellation of contract awards during the first part of 1967. This illustrates problems caused by lags in monetary policy—some of the impact of restraint was felt after the need for restrictiveness was past.

How did governments adjust?

One reason why contract awards and capital outlays were less affected than borrowing is that pressing needs do not necessarily coincide with availability of funds. Municipal authorities find that some outlays cannot be delayed if there is any possible way of financing them.

Higher interest rates and scarcity of funds had a greater impact on the ability of large governments to borrow than on their ability to spend. The six governmental entities in the District which did not borrow as planned in 1966 but did not cancel construction contract awards relied on a variety of adjustments. The most important

[1] *Our evidence seems to indicate that the tight money did not significantly affect capital spending by large governments in our District, but it requires a qualification. The questionnaire asked about cancellation and postponement of those issues which municipalities had "contemplated" making—meaning issues which were under serious consideration. However, because of the difficulty of obtaining reliable data, we have no information about projects—and bond offerings to finance them —which may have been in the early planning or formulation stage and were dropped because of anticipatory credit conditions. Also, comparisons of spending and borrowing in 1966 with that of earlier and later years, either planned or actual was beyond the scope of the questionnaire. Thus, possible variations in the rate of growth of expenditures have not been considered. Finally, the questionnaire was not able to focus on the problem of curtailed capital spending except in relation to borrowing. That is, only governments which experienced some difficulty in borrowing answered questions about spending plans.*

were postponement of cash disbursements, reduction of current expenditures, short-term borrowing, and use of cash and liquid assets. For the U.S. as a whole, many governments used long-term funds which had been borrowed in advance and kept as a buffer. Several of these measures show a decrease in the level of total spending as a result of tight money. And, since these alternative sources are all temporary in nature, the evidence suggests that, had the period of monetary restraint been prolonged, there would have been a more appreciable decrease in outlays from desired levels. On the other hand, if we assume governmental entities have some level of desired liquidity, they would have had to replace liquidity later. In this way the impact of tight money would be transferred into later periods.

What were the characteristics of governments involved?

There is no way to tell on the basis of our information why thirty of the large governments in the District had no plans to borrow at all during calendar 1966. Presumably, the decision not to make capital expenditures financed by bonds was made before 1966, prior to the period of monetary stringency, and was not influenced by monetary policy. We can, however, make a few comparisons between governments without plans to borrow and those which had plans. For example, the average Moody's rating for potential borrowers and those without borrowing plans were virtually identical, midway between AA and A (with a number of cities being unrated).

The survey results show that cities and townships which had no borrowing plans in 1966 were smaller in population on the average than those which borrowed (or tried to do so). The reverse was true for counties, although most of the counties had higher population than cities and townships. The average population for all non-borrowing units was 174,830, while for all potential borrowers it was 267,604.

Some entities such as special local districts were included in the survey on the basis of bonded debt because population was inapplicable. The same relationship is true here—potential borrowing units had more bonded debt than those which didn't borrow—$218.7 million as opposed to $64.6 million.[2]

Therefore, if population and debt are used as indicators of size, the smaller of the "large" units did not come to the market place in 1966. It is possible that smaller governments were discouraged because of expectations of tight money conditions, although it is likely that the smallest of the large governments didn't plan to borrow for reasons unrelated to conditions in the financial market.

The survey also sheds some light on what sort of governments had difficulty arranging bond financing during tight money. Those which reported postponement, reduction, or cancellation of bond offerings had a slightly and, perhaps, insignificantly lower average rating than those which borrowed successfully—2.13 vs. 2.54 (where 3.00 = AA and 2.00 = A). Although not all smaller governments had difficulties, the eight governments (with the exception of two state authorities) which experienced some difficulty in financing were generally smaller than average in population or debt.

How costly was borrowing in 1966?

One major concern of municipal managers is the net interest cost of borrowed funds. Borrowing governments did "pay" extra to borrow in

[2] *To some extent, this divergence may represent a difference in policies toward borrowing rather than a difference in size of the borrowing unit.*

1966, as net interest costs were higher than in previous years. Costs reflect the general movement of rates during 1966, especially the major municipal bond yield indices. Two-thirds of the borrowing by large Third District governments (including one of two issues which had been postponed earlier in the year) took place in the second and third quarters when interest rates were *highest*. For the U.S. as a whole, however, borrowing was evenly spread throughout the year. This points up the difficulty which municipal authorities have in timing their bond offerings to take advantage of more favorable capital market conditions. Inclination of municipalities to pay more interest in order to borrow during periods of tight money rather than postpone expenditures serves to blunt some of the effects of a restrictive monetary policy.

Social consequences

If monetary stringency results in spending cutbacks by state and local governments, the question of social consequences should also be considered. To what extent must public services, as provided by municipalities, be sacrificed in order to achieve the goal of economic stability, the advantages of which are felt more indirectly? Because monetary policy may have an uneven impact, does the municipal sector suffer more through curtailed expenditures and higher interest costs than do others during tight money? And, if so, is this an unnecessary social cost of monetary policy and economic stability? These questions obviously cannot be answered simply on the basis of the survey, but the results suggest that the social costs of tight money—at least in the Third Federal Reserve District—in 1966 were small.

SURVEY

This analysis is based on responses of governmental units in the Third Federal Reserve District to the **Federal Reserve Survey of State and Local Government Financing and Capital Outlays in Calendar 1966.** The survey dealt with plans for bond issues in 1966, the experience with long-term financing during that year, and the effects of this experience on capital spending. The survey sample included only state governments; larger counties, cities, and townships as determined by population data; and special local districts, state agencies and educational institutions which were designated "large" on the basis of their outstanding debt or other criteria. (A survey of smaller entities is currently in process.) The minimum size limitations by type of entity were:

County	250,000 population
City	50,000 population
Township	50,000 population
Special local district	$5 million debt outstanding
Local school district	25,000 enrollees
States	All
State agencies and state and local institutions of higher learning	All except very small

The response rate in the Third District was better than 90 per cent, as 53 local governments and the state governments of Pennsylvania, New Jersey, and Delaware answered the questionnaire. The U.S. total includes replies from 983 governmental units. These results are analyzed in the June 1968 issue of the Federal Reserve **Bulletin.**

The Metropolitan Money Gap

by Richard W. Epps

In the late forties when suburbia was gaining its current size, cities, often, were better off financially than the suburbs. Fortunes have turned in the past 20 years. Suburbia has matured, filled out its stock of public facilities, and begun to enjoy the benefits of a high-income population. Left with a largely low-income population and aging physical plant, central cities have incurred increased costs while resources have relatively dwindled. The result is an expenditure differential —city expenditures are relatively higher than suburban—and a consequent heavy load on the resources of city dwellers.

Some observers suggest that suburban residents should share part of the city's burden, and for two reasons.[1] First, suburban residents depend, in part, upon the city for jobs. And since both employers and suburban commuters require government services, these jobs for suburbanites cost the city money. In the Philadelphia area, nearly one out of three suburban workers commutes to the city for employment.[2] Since suburban residents benefit from these jobs, some observers say suburban residents should help pay the public bill which results.

Second, and more important in the estimation of some, the city houses a large share of the region's low-income population, providing them with needed public services like education, and health and police protection. Nearly one-fifth of Philadelphia's families fell below the $3,000 poverty line at the time of the last Census, while only one-tenth of suburban families were in the low-income classification. Traditionally, responsibility for paying for services to the low-income population has been with the middle- and high-income population. Many observers argue that suburban residents have escaped, in part, this social responsibility by moving to the suburbs where they do not share in the heavy city government tax bills.

How appropriate are these arguments to the Philadelphia area? This article reports on expenditures by local governments in the Philadelphia area and the distribution of the public bill among the region's residents. Summarized, the findings are:

1. In 1965, the City of Philadelphia spent 12 per cent more than did the governments of surrounding suburban areas.[3] This differential was less than that in the nation's other large metropolitan areas.

2. The two expenditure bundles that make up total government spending—education and general government—have strongly contrasting patterns. The City of Philadelphia spends only two-thirds as much per capita as suburban governments on public education whereas the city

[1] *Interdependence between city and suburbs was discussed in the December 1967 edition of this Review in an article entitled "Foundation of Interdependence."*

[2] *The analysis in this article concerns the eight-county Philadelphia Metropolitan Area with Philadelphia as the central city and Bucks, Chester, Delaware and Montgomery counties in Pennsylvania and Burlington, Camden and Gloucester counties in New Jersey as suburbs.*

[3] *Government, as used in this article, includes county, municipal and school district governments.*

spends twice as much as suburban governments for general government purposes (such things as fire protection and police protection).

3. Three factors are particularly important in determining the differential in spending for general government purposes: the concentration of business and industry, relative size of the low-income population, and relative size of the high-income population, in descending order of importance. Combined, the three may account for more than half of the spending differential, and in large part support the two arguments posed above.

LIMITATIONS OF THE STATISTICS

The Philadelphia Metropolitan Area, the subject of this article, includes more than 800 units of local government in its eight counties. In each of the counties the menu of public services is divided up somewhat differently among the levels of government although the total menu is much the same from county to county. For example, in Chester County essentially all road maintenance is carried out by municipal governments, but in Delaware County a large share of road maintenance is carried out by the county government. Thus, to compare counties, we must use total figures for all the governmental units within each county. Use of these totals has a drawback. They probably are not representative of any one of the multiple local governments. Thus, the conclusions of this article cannot be applied arbitrarily to any single local government—only to the total.

The statistics have a second limitation. Services provided by government in one area may be provided privately in another area. For example, the City of Philadelphia pays for most refuse collection, but suburban communities often rely heavily upon contractural agreements between haulers and residents.

While the service is provided in both areas and residents of both areas pay for the service, it shows up in the public budget in only one area. The extent of such substitution of private for public spending cannot be consistently determined, but is probably greater in the suburbs.

4. However, state and federal aid, taxes paid by commuters, and taxes paid by business all act to reduce the tax bill of non-business residents of the City of Philadelphia, leaving it in 1965 slightly lower than the tax bill of suburban residents. The suburbs, in effect, are carrying a part of the city's financial burden.

Government spending

Spending by the city and the suburbs in the Philadelphia area is compared with that by governments in the nation's 36 other largest metropolitan areas in Chart 1.[4] In total, Philadelphia government spends more per capita than suburban government—by about 12 per cent. However, the spending differential is not as severe as that in most of the nation's other large metropolitan areas.

The total hides two differing patterns in Philadelphia, however. For general government, the city spends substantially more per capita than the suburbs, and this local differential is about in line with the differential in other areas (second set of bars in Chart 1). For education, on the other hand, the city-suburbs differential in Philadelphia is both substantial, and substantially worse than that in other areas (third set of bars in Chart 1).

Buying education. Although suburban governments spend relatively more on public education than does Philadelphia, spending levels

[4] *The thirty-six areas include: Los Angeles-Long Beach, San Bernardino-Riverside-Ontario, San Diego, San Francisco-Oakland, Denver, Washington, D.C., Miami, Tampa-St. Petersburg, Atlanta, Chicago, Indianapolis, Louisville (Kentucky-Indiana), New Orleans, Baltimore, Boston, Detroit, Minneapolis-St. Paul, Kansas City (Missouri-Kansas), St. Louis (Missouri-Illinois), Newark, Paterson-Clifton-Passaic, Buffalo, New York City, Rochester, Cincinnati (Ohio-Kentucky-Indiana), Cleveland, Columbus, Dayton, Portland (Oregon-Washington), Pittsburgh, Providence, Dallas, Houston, San Antonio, Seattle, Milwaukee.*

are not uniform in the suburbs (Chart 2).[5] Bucks County residents spend most for public education —$125 per capita. Delaware County comes in last among the suburbs with $85 per capita; Philadelphia is below all the suburban counties with $75 per capita.

What do these spending differences mean? Spending for education on a per capita basis gives an indication of the relative financial load upon the community. To get an idea of the meaning of spending for educational quality, we turn to spending on a per student basis. Expenditures in the City of Philadelphia appear decidedly higher on a per student basis—only slightly below the suburban average—and higher than some of the New Jersey counties. The reason for this improved appearance for Philadelphia is that the city has relatively fewer public school students than do the suburbs, in part because the city population is the most elderly of the region's counties and in part because the city's non-public school population is large relative to that in suburban areas.

Still, Philadelphia does rank below the suburban average. This is an example of the spread between needs and expenditures. With many of the city's students coming from poverty backgrounds, the city's educational needs are likely greater than those of the suburbs.

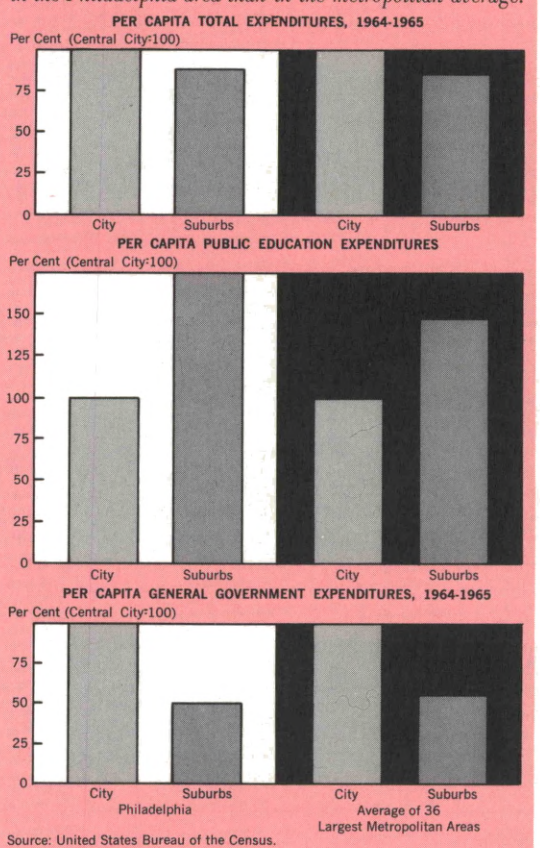
General government expenditures. In contrast to education, Philadelphia spends considerably more for general government purposes than do the suburbs (see Chart 3). General expenditures include all of the noneducational functions of local government, except water (e.g., fire and police protection, sanitation, health services, street and highway maintenance, parks, recreation, and urban renewal). These are government services provided to residents, businesses, commuters and transients.

[5] *Money spent for public education is, of course, only part of the total education bill. To compare total education spending, expenditures for private education must be added to the public spending. Such a comparison would still leave a large gap between city and suburb because most private education in Philadelphia is parochial, a system that depends heavily on volunteers for its staff, thus having low per-student costs.*

Chart 1

PHILADELPHIA'S SPENDING DIFFERENTIAL IS LESS THAN THAT OF OTHER LARGE METROPOLITAN AREAS

Indexes of per capita spending by city and suburban governments are presented in the bars below for the Philadelphia region and for the nation's 36 other largest metropolitan areas. On total government spending, Philadelphia's city-suburban differential is less than the metropolitan area average. However, the two components of total spending—education and general government—both display larger contrasts in the Philadelphia area than in the metropolitan average.



Source: United States Bureau of the Census.

Why does the city spend more than the suburbs? A complete explanation is difficult for two reasons. First, the City of Philadelphia provides some services that suburban governments often do not provide. Fire protection is an example. Second, Philadelphia provides some services that are only partially provided, either publicly or privately, in the suburbs. Airports are an example. Still, three factors may be singled out as important in causing the differential.[6]

Among them are two often mentioned as reasons for the suburbs to share part of the city's burden.

1. Business generally requires more public services than do residents. Thus, the City of Philadelphia, with its heavy concentration of business and industry, spends relatively more than the largely residential suburbs. A 1 percent increase in business concentration, measured by the proportion of assessed real estate in business use, leads to between a $2 and a $5 increase in per capita expenditure.

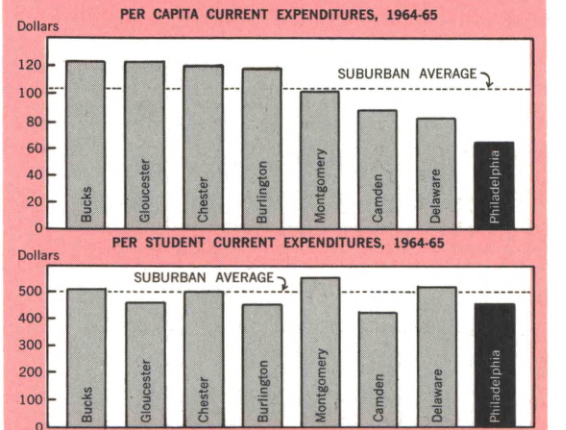
2. Low-income residents also increase local expenditures. The rate of increase is probably somewhat less than that with business, however—a $1 to $4 increase in per capita spending with each percentage point increase in the proportion of families with income below $4,000.

3. Finally, families at the other end of the

Chart 2

PHILADELPHIA SPENDS LESS THAN THE SUBURBS ON EDUCATION

The differential in spending for education can be viewed in two ways—per capita (upper bars) or per student (lower bars). The first represents the load on the community, with a wide spread between the city and suburban values. The second is an indication of quality of education, and makes Philadelphia look substantially better. Still, the city lags the suburbs.

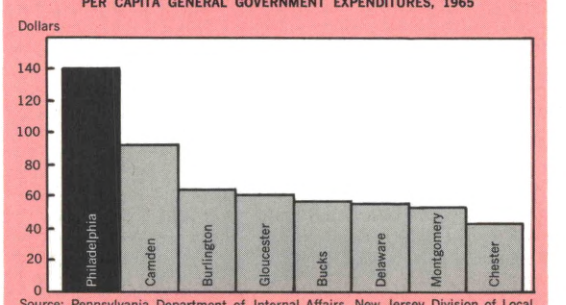


Source: Pennsylvania Department of Public Instruction and New Jersey Taxpayers Association.

Chart 3

GENERAL GOVERNMENT EXPENDITURES IN PHILADELPHIA ARE TWICE THE SUBURBAN AVERAGE LEVEL

PER CAPITA GENERAL GOVERNMENT EXPENDITURES, 1965



Source: Pennsylvania Department of Internal Affairs, New Jersey Division of Local Government.

[6] *The importance of various factors was measured via regression analysis upon a sample of 46 Pennsylvania municipalities. Only Pennsylvania municipalities were included in the sample in order to avoid problems resulting from differing legal structures. The dependent variable was general government expenditures per capita, and independent variables experimented with were median income, business and residential density, owner occupancy, per cent of assessed value in commercial use, population in each of 12 income classes, percent nonwhite population, and employment. The results should be interpreted as only indicative of the relative importance and impact of the factors studied, since data are for 1960 and 1962 and county expenditures were not included in the observations. Partial correlations between spending and families under $4,000 income, percent of assessed value in commercial use, and families over $10,000 income were respectively, .56, .40, and .49.*

A number of these and other factors were investigated in a study carried out by Williams, Herman, Liebman and Dye entitled Suburban Differences and Metropolitan Policies, *1965, University of Pennsylvania Press, Philadelphia.*

income scale increase the public spending bill, though not so much as either business or low-income population. A one percentage point increase in the proportion of families with over $10,000 income leads to a rise in public expenditures of between 40¢ and $1.20.

Combined, these three factors could account for the majority of the differential in spending.[7] Philadelphia has relatively more business and low-income population than the suburbs, with both tending to increase the differential. Partially offsetting these two factors, Philadelphia has less high-income population.

Revenues

How is the financial burden of supporting these public expenditures distributed across the region? Philadelphia raised about 12 percent, or $35, more money per capita than did the suburbs in 1965. Neither Philadelphia nor the suburbs, however, collect all their revenues from their own constituents.

Chart 4 shows the distribution of the revenue load among three types of revenue—fees and user charges, state and federal aid, and local taxes. Fees and charges are mostly local revenues, collected from local businesses and constituents of each government. Their level is nearly the same in city and suburb, thus leaving the distribution of the revenue load unaffected.

[7] *Due to the possibility of errors in measurement, the effect of each factor must be stated as a range. With the ranges noted in the text, and using measures from the last census, the effects of the three factors are:*

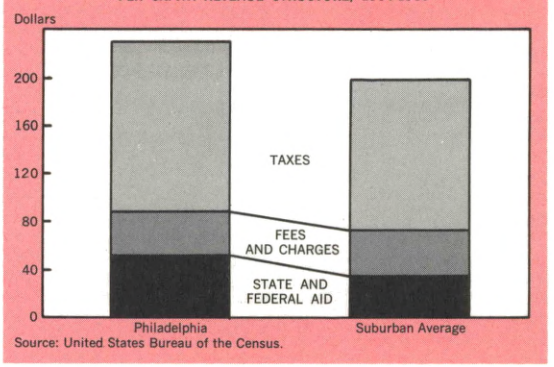
Amount of differential accounted for:

	Low Estimate	*High Estimate*
Concentration of business	*$24*	*$60*
Low-income population	*$10*	*$40*
High-income population	*—$ 2*	*—$ 7*
Other factors	*$48*	*—$13*
Total Philadelphia-Suburbs differential	*$80*	*$80*

Chart 4

HOW SPENDING IS SUPPORTED

State and Federal aid are greater in Philadelphia than in the suburbs, relieving some of the city's financial burden. Still, about half of the difference in spending is supported by higher city taxes.



Source: United States Bureau of the Census.

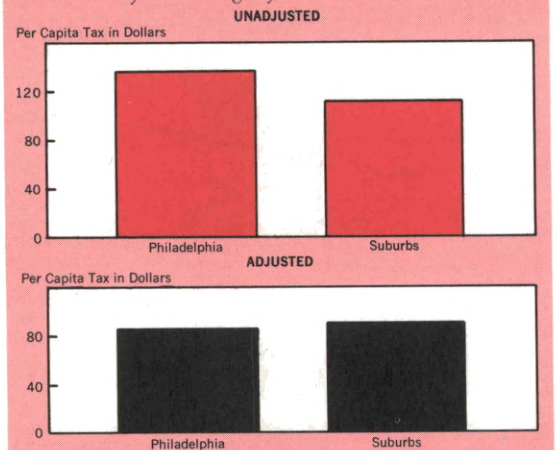
State and federal aid is more complex. The actual redistributional effect of the aid is the difference between the pattern of state and federal tax collections and the pattern of aid. In fact, state and federal taxes are not tabulated by county, and so a comparison of tax and aid patterns is not possible. All we know is that Philadelphia receives nearly 50 percent more aid than do the suburbs. Just how much of this is a redistribution of the revenue burden is not clear.

After state and federal aid, a $20 difference remains between Philadelphia and suburban revenues—a $20 difference in per capita taxes. The tax-level difference is actually less than it appears on the surface, however. Two factors act to decrease it. First, more than one-third of the Philadelphia tax revenue comes from the wage tax, which is in part paid by suburban residents. Nearly one-fourth of the workers in Philadelphia live in the suburbs and pay the wage tax. Thus, per capita local tax actually paid by Philadelphia residents is lower, and that paid by suburban residents is higher. Second, the heavy industrial

Chart 5

THE TAX BILL

The upper set of bars represents the per capita tax bill in Philadelphia and the suburbs, with Philadelphia having the heavier load. This high Philadelphia burden is substantially reduced, however, when taxes paid by business are removed, and non-resident tax payments are redistributed. The result is the tax paid directly by residents, the lower set of bars, in which the city load is slightly lower than the suburban load.



Source: United States Bureau of the Census.

and commercial development in Philadelphia gives the city an added tax base.[8] The tax contrast must be adjusted for this also, yielding for each area the tax actually paid by non-business residents.

[8] *The taxes paid by business offset, to some extent, the increased public spending to which business gives rise. Whether the offset is complete is difficult to determine since measurement of the added public costs is necessarily uncertain.*

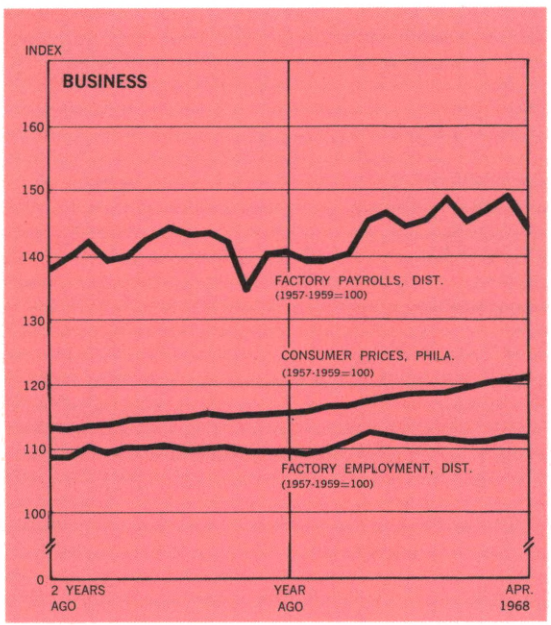
The result of these two adjustments—that is, the distribution of Philadelphia wage tax and removal from each area of the tax paid by business establishments—is dramatic. The lower set of bars in Chart 5 represents the per capita tax bill on non-business residents after adjustment. The load, after adjustment, is about the same in city and suburbs.

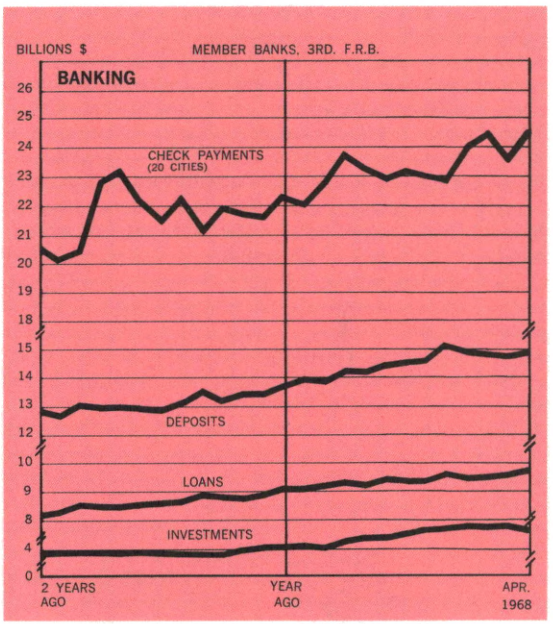
Disparities reconsidered

Expenditures are high in the City of Philadelphia, partly because of the services Philadelphia provides to the rest of the region—jobs and housing of the low-income population. However, within the current revenue structure, Philadelphia non-business residents pay no more in taxes than do suburban residents, in part because employers pay taxes and in part because of revenue sharing through the wage tax.

What of the future? The expenditure differential will increase. Pressures within the Philadelphia school system to raise the per student expenditure are great. Moreover, the increasing voice and militancy of the low-income population to raise the level of city services will have an impact on city spending. Revenues of the city will have to increase, probably at a higher rate than suburban revenues. Where the increased load will fall—city or suburbs—will be one of the major fiscal questions for the region.

FOR THE RECORD . . .





SUMMARY

	Third Federal Reserve District — Per cent change			United States — Per cent change		
	April 1968 from		4 mos. 1968 from year ago	April 1968 from		4 mos. 1968 from year ago
	mo. ago	year ago		mo. ago	year ago	
MANUFACTURING						
Production	.....	.....	.....	0	+ 4	+ 3
Electric power consumed	.....	.....	.....	.....	.....	.....
Man-hours, total*	— 3	— 2	0	.....	.....	.....
Employment, total	0	+ 2	+ 2	.....	.....	.....
Wage income*	— 3	+ 3	+ 5	.....	.....	.....
CONSTRUCTION**	+ 2	+17	+22	—10	+ 7	+15
COAL PRODUCTION	+ 2	+ 3	— 2	— 2	— 1	0
BANKING						
(All member banks)						
Deposits	+ 1	+ 8	+11	0	+ 8	+10
Loans	+ 2	+ 8	+ 8	+ 2	+ 8	+ 8
Investments	— 2	+15	+19	— 1	+11	+15
U.S. Govt. securities	— 4	+ 6	+10	— 3	+ 5	+ 8
Other	+ 1	+24	+28	+ 1	+17	+21
Check payments***	+ 4†	+10†	+10†	+ 4	+14	+15
PRICES						
Wholesale	.....	.....	.....	0	+ 3	+ 2
Consumer	0‡	+ 4‡	+ 4‡	0	+ 4	+ 4

*Production workers only
**Value of contracts
***Adjusted for seasonal variation

†15 SMSA's
‡Philadelphia

LOCAL CHANGES

Standard Metropolitan Statistical Areas*	Manufacturing: Employment — Per cent change April 1968 from		Manufacturing: Payrolls — Per cent change April 1968 from		Banking: Check Payments** — Per cent change April 1968 from		Banking: Total Deposits*** — Per cent change April 1968 from	
	mo. ago	year ago	mo. ago	year ago	mo. ago	year ago	mo. ago	year ago
Wilmington	+ 2	0	— 2	+ 3	— 1	+27	— 4	+ 7
Atlantic City	.....	.....	.....	.....	—10	+ 7	+ 1	+ 2
Trenton	0	— 3	— 2	0	—17	+13	+ 4	+10
Altoona	0	+ 2	— 2	+ 7	+24	+29	+ 2	+ 9
Harrisburg	0	+ 2	0	+ 6	+ 6	+ 5	+ 1	+11
Johnstown	+ 3	0	+13	+14	+ 6	+14	+ 3	+ 7
Lancaster	0	0	— 4	+ 2	+ 5	+12	+ 2	+ 8
Lehigh Valley	0	0	+ 1	+ 5	0	+ 8	+ 1	+11
Philadelphia	0	— 1	— 4	0	+ 7	+ 6	+ 1	+ 9
Reading	0	+ 2	— 6	+ 4	+10	+28	+ 2	—26
Scranton	0	0	— 3	+ 8	— 8	+ 2	+ 1	+13
Wilkes-Barre	— 1	— 2	— 6	— 3	+ 3	+ 7	+ 1	+12
York	0	+ 1	— 3	+ 4	+ 8	+13	— 2	+ 2

*Not restricted to corporate limits of cities but covers areas of one or more counties.
**All commercial banks. Adjusted for seasonal variation.
***Member banks only. Last Wednesday of the month.

Remarks
By

Andrew F. Brimmer

Member
Board of Governors of the
Federal Reserve System

Statutory Interest Rate Ceilings and the Availability of Mortgage Funds

Supplement to **Business Review,** June 1968
Federal Reserve Bank of
Philadelphia

Statutory Interest Rate Ceilings and the Availability of Mortgage Funds

By
Andrew F. Brimmer*

As frequently happens when market processes are subjected to statutory regulation, the attempts by the Federal and State governments to fix the maximum rates of interest which lenders can charge on residential mortgages have produced effects the reverse of those intended: usury laws, originally designed to protect individual borrowers, have increasingly prevented these potential borrowers from obtaining mortgage funds. While most public attention has been focused on the adverse effects of statutory ceilings on Federally underwritten mortgages, many State-imposed ceilings also severely limit the access of homebuyers to mortgage funds in a number of areas.

In the last few years, and especially in the wake of the severe difficulties experienced by the homebuilding and financing industries during the period of monetary restraint in 1966, a major effort has been launched, on both the Federal and State level, to moderate the rigidities of statutory ceilings on mortgage interest rates. This effort has achieved varying degrees of success. Statutory limits on FHA and VA mortgages have been suspended temporarily, and in a number of States maximum rates have been raised. Nevertheless, as market interest rates (including rates on residential mortgages) have continued to rise under the impact of growing credit demands during the current period of monetary restraint, usury ceilings remain a serious obstacle to the flow of mortgage funds in some States. Moreover, in some geographical segments of the mortgage market, maximum rates are still generally frozen at the extremely unrealistic ceiling of 6 per cent. Thus, the task of coming to grips with the problems posed for housing finance by outdated statutory interest rate ceilings are still before us.

The principal points of these remarks can be summarized briefly:

— *The inherent deficiencies of the residential mortgage as a capital market instrument are compounded by rigid statutory ceilings on interest rates which lenders can charge.*

— *Statutory interest rate ceilings, whose roots are deeply imbedded in historical experience, are so low in a number of States that they pose a serious obstacle to the functioning of their mortgage markets.*

— *The adverse effects of usury ceilings—while most evident in the behavior of lenders—are particularly harsh on builders of new houses and on owners of existing homes. These effects can be seen most clearly in the case of FHA and VA underwritten mortgages, where discounts provide a sharp and readily measurable indicator of the impact of inflexible rate ceilings.*

* *Member, Board of Governors of the Federal Reserve System.* *This paper was presented before the 74th Annual Convention of the Pennsylvania Bankers Association at Atlantic City, New Jersey, on May 29, 1968. It was revised on June 4, 1968 prior to publication by the Federal Reserve Bank of Philadelphia. I wish to express my appreciation to Mr. Robert M. Fisher and Miss Mary Ann Graves of the Board's staff for assistance in the preparation of the paper.*

Note: More arguments and data presented in this paper refer to home *mortgages, and multifamily mortgages involving borrowers other than corporations, which are usually excepted from* State *usury ceilings, but not Federal ceilings.*

— The recent moves to suspend statutory ceilings on FHA and VA mortgages and to raise ceilings in several States have been only partially successful. Discounts are again sizable on FHA and VA mortgages, and newly raised ceilings in a number of States are again interfering with the flow of mortgage funds.

— Thus, there is still a major job ahead if we are to develop a mortgage market capable of meeting the expanding demands for residential finance.

— Finally, when the Truth In Lending Act *becomes effective in mid-1969, the lender will be required to supply a complete statement of the finance charges involved on home mortgages. Consequently, the argument for usury ceilings as a "protection" for the borrower will be further weakened.*

Structural defect in mortgage financing

The deficiencies in mortgages generally—and in residential mortgages particularly—which make them a special type of financial asset are widely known. However, it may be well to remind ourselves again that a substantial part of the obstacle to the development of a truly viable mortgage market arises from the characteristic of the instrument itself. Furthermore, some policies and regulations affecting Federally underwritten mortgages have also helped to give mortgages a special standing (not always beneficial) in the capital market.

Most varieties of debt instruments other than mortgages are relatively homogeneous within broad categories. For example, investors normally accept corporate bonds of the same maturity and quality rating as reasonably close substitutes—with relatively small changes in yield differentials required to encourage substitution. In contrast, mortgages are differentiated in so many ways—by maturity, credit worthiness of the borrower, legal requirements of the State in which the property is located, etc.—that they clearly are not interchangeable. Federal guarantees and insurance tend to add homogeneity. However, while less than one-fifth of all residential mortgages on new homes in the period 1963-66 had such protection, the proportion has declined further in 1967-68. Moreover, additional fees and rate limitations have also tended to reduce the effectiveness of efforts to create a genuinely competitive, nationwide financial asset out of the residential mortgage.

The institutional structure of mortgage markets has also limited the ability of the mortgage to compete with other financial assets. Undoubtedly, one of the most serious obstacles is posed by Federal and State statutory ceilings. Interest rate limitations on mortgages established by such statutes inevitably make mortgages non-competitive in periods when generally rising interest rates force yields on market securities up to or beyond the statutory ceilings. While discounts can increase the yield on mortgages, many lenders find the use of discounts a difficult procedure for technical and other reasons. Moreover, both laws and administrative regulations inhibit their use, and the impact on the cash position of the seller or builder is often so large that it further reduces the use of discounts.

Origins and scope of statutory interest rate ceilings

Interest charges have been made since ancient times, and the efforts to regulate such charges are equally ancient. Apparently the practice of charging interest on loans fell into disrepute quite early after it began; undoubtedly this was partly because interest rates were high and penalties for default were heavy.

The historical record (from ancient Greece, through the Jews, to the Christian Church, to the secular authorities in Europe and to the American States today) is replete with efforts to prohibit or regulate interest charges—which almost from the very beginning became known as "usury." Over time, however, the authorities began to distinguish between low interest rates and high interest rates —with the concept of usury being reserved for the description and condemnation of high interest rates. On the basis of this distinction, England in 1545 eliminated the prohibition on usury and established a legal maximum interest rate. Other countries followed this example. Over the years, however, Great Britain ceased fixing legal interest rates, and left it to the courts to determine whether a rate is usurious.

In this country, it was the States—not the Federal Government—that followed the legacy stemming from the English action of the sixteenth century. In general, States fix a legal rate at which debts may be assessed after they have become due and remain unpaid, and they also fix the maximum rate permitted in a contract. With the advent of the Federally underwritten FHA and VA mortgages, the Federal Government did become involved in the making and administering statutory ceilings on mortgage rates.

Today, 46 of the 50 States have established statutory ceilings on mortgage interest rates. As shown in the table on the following page, if we put aside the four States which permit any rate to be charged, the vast majority of the States have set ceilings in the range of 7-8 per cent and 10-12 per cent. However, at the beginning of the year, nine States (Delaware, Maryland, New Jersey, New York, Pennsylvania, Tennessee, Vermont, Virginia, and West Virginia) still limited the maximum rate to 6 per cent. Moreover, at least two of those States had not yet raised the rate as of midyear.

As one examines the geographical pattern of mortgage rate ceilings, it is easy to discern the broad outlines of a mechanism designed to attract funds from surplus savings areas to capital deficit regions. Leaving aside New England (where apparently steps to free the mortgage market were undertaken years ago), it is evident that State statutory ceilings were set in the East at a fairly low 6 per cent, reflecting the sizable volume of savings generated in this area over the years. The advanced degree of industrial development, the high ratio of savings to personal income, and the growing stock of wealth of households—all supported the evolution of strong financial institutions. The latter in turn were able to mobilize savings in substantial volume to be invested in their immediate areas or channelled into distant regions where the demand for funds greatly exceeded the supply. The regions facing the greatest capital shortage were the South and West, with the Midwest falling between the two extremes. Thus, again leaving aside New England, as one generally fans out from the Middle Atlantic region, the contours of mortgages rate ceilings rise in a fairly regular pattern. While valleys appear in several instances, the average of the maximum rates is definitely higher the farther out one travels.

Unfortunately, the older Eastern regions are no longer blessed with as large a volume of excess savings as they were in the past. With the strong demands for funds—demands arising from the large and persistent deficit in the Federal budget, from State and local governments, from corporate borrowers, from foreign borrowers, as well as from households competing for mortgage funds —savings intermediaries in these older regions of the country are behaving in exactly the way one would expect them to behave: they are investing their funds where they can obtain the

highest returns. In the process, mortgage borrowers in a number of States are attracting a declining share of the total savings flows.

Adverse impact of statutory rate ceilings

Low statutory interest rate ceilings affect the home mortgage market adversely by reducing the demand for credit as well as the supply of funds. This in turn means reduced activity in homebuilding and in the transfer of existing dwellings. These adverse effects can be traced in the behavior of lenders, of builders, and of households.

Lenders: The principal reaction of lenders to low rate ceilings is to reduce the supply of new commitments. As one would expect, as market

STATE STATUTORY CEILINGS ON CONTRACT INTEREST RATES ON HOME MORTGAGES JUNE 4, 1968

Rate Ceiling (Per cent)	Number of States	Names of States
Any rate	4	Connecticut,[1] Maine, Massachusetts, New Hampshire.
21	1	Rhode Island.
12	4	Colorado, Hawaii, Nevada, Washington.
10	12	Arkansas, California, Florida, Kansas, Montana, New Mexico, Oklahoma, Oregon, Texas, Utah, Wisconsin,[1] Wyoming.
9	1	Nebraska.
8	16 and D.C.	Alabama, Alaska, Arizona, Delaware,[2] District of Columbia, Georgia, Idaho, Indiana, Louisiana, Maryland,[3] Minnesota, Mississippi, Missouri, New Jersey,[4] Ohio, South Dakota, Virginia.
7½–5	1	New York.[5]
7	8	Illinois, Iowa, Kentucky, Michigan, North Carolina, North Dakota, Pennsylvania, South Carolina.
6½	1	Vermont.
6	2	Tennessee,[6] West Virginia. (In Tenn. and W. Va., S & Ls may charge a premium above the limit.)

[1] On loans of $5,000 or less, the maximum rate is 12 per cent.

[2] The State legislature on May 23 passed a bill for the rate to go from 6 per cent to 8 per cent.

[3] As of July 1, 1968.

[4] The State assembly on June 3 passed a bill for the rate to go from 6 per cent to 8 per cent.

[5] The State legislature on May 21 passed a bill, which the Governor signed on June 3, to give the State Banking Board the discretion to set the rate between 5 per cent and 7½ per cent.

[6] On loans exceeding $50,000, the maximum rate is 7½ per cent.

Note: In many States with ceilings, FHA-insured and VA-guaranteed mortgages are excepted.

interest rates (including those on mortgages) converge on statutory ceilings within a given State, domestic lenders tend to reduce in-State lending and to expand the investment of funds out of State. At the same time, low rate ceilings discourage in-State lending by out-of-State institutions. In general, such ceilings divert funds to investments whose yields are more free to move in response to market forces.

This pattern of reaction was amply illustrated by the behavior of New York City savings banks. In view of the 6 per cent ceiling (which had been in effect until midyear) in New York State, savings banks were investing an increasing proportion of the funds in properties in other States and in high-grade corporate bonds. This is clearly understandable when the maximum of 6 per cent generally obtainable on mortgages secured by properties located in New York was set against market yields in the first four months of this year in the neighborhood of 6¾ per cent on out-of-State conventional mortgages and against slightly higher secondary market yields on mortgages underwritten by the Federal Government. Also during the first four months of this year, newly issued high-grade corporate bonds have offered yields well over 6½ per cent. The magnitude of out-of-State mortgage investing that the New York savings banks were doing was indicated in early March by the Superintendent of Banks while testifying in support of a bill that would empower the State Banking Board to fix mortgage rate ceilings in line with current market yields. He reported that in 1967, savings banks in New York State had invested $916 million in mortgages within the State and $1.1 billion in out-of-State mortgages. He also reported that there was a rising trend toward out-of-State mortgages throughout 1967, and that no reversal had occurred so far this year.

Where legal, lenders charge discounts or adopt other means of raising the effective yield. Expressed in the form of "points" (i.e., a given percentage of the principal amount involved), such discounts on FHA-insured loans provide an indication of the market's changing evaluation of the effective rate on mortgages in excess of the statutory ceiling. For example, on 6 per cent FHA-insured loans, the market yield in April, 1967, was 6.29 per cent and the discount was 2.5 points. Over the following twelve months, as interest rates rose generally, the same category of 6 per cent FHA-insured loans in April of this year were yielding 6.94 per cent in the secondary market, and the discount had risen to 7.9 points. However, for public relations reasons, lenders are often reluctant to make loans subject to substantial discounts. Instead, many lenders prefer to withdraw from the market.

Home builders: Other adverse effects of low statutory ceilings during periods of rising market yields can be seen in the behavior of builders. The first place to look is the interaction between lenders and builders. During such periods, banks and other short-term lenders reduce construction loan commitments to builders as the volume of permanent takeout commitments from long-term lenders is cut back and as the stiffening terms of such permanent commitments shift more of the risk to construction lenders.

As market rates press against statutory ceilings, homebuilders may have to absorb an increasing share of mortgage discounts in their profits, thus weakening incentives to build. Whenever possible, however, builders try to pass discounts along to buyers in higher prices or lower quality construction. Lower-priced construction, where profit margins are probably smaller than in higher-priced dwellings, may be hit the hardest. When mortgage discounts become "excessive," builders

may withdraw from home construction and temporarily go out of business or into other lines of construction activity where discounts are less of a problem.

Households: The impact of statutory mortgage interest rate ceilings on individual households can be seen in the behavior of both buyers and sellers of homes. Homebuyers, presumably the party for whose benefit maximum mortgage rates are set, are discriminated against in a number of ways: the availability of funds is reduced, and housing prices are inflated by discounts. Many borrowers would be better off financially by paying market interest rates rather than higher housing prices, involving large down payments and about the same monthly housing outlays. The range of choice of available housing is restricted by reductions in new construction and the withdrawal of some existing homes from the market. And whatever volume of credit is provided by mortgage lenders is extended on more restrictive non-rate terms than would otherwise prevail.

In circumstances where statutory ceilings generate discounts, home sellers, whenever possible, try to pass such discounts in higher prices, rather than absorb the amount in reduced capital gains. Otherwise they may temporarily withdraw their homes from the market, or seek to finance the sale through possibly higher-cost (to buyers) financing involving the use of take-back second mortgages. The propensity of sellers to withdraw their homes from the market can be seen dramatically in the behavior of applications for FHA insurance on used dwellings. For example, in late 1961, FHA-insured mortgages were carrying discounts of about 4 points, and insurance applications were at a seasonally adjusted annual rate of approximately 560,000. For almost two years, discounts fell steadily and leveled out close to 2 points in mid-1963. Over the same period, insurance applications climbed steadily to around 650,000 at an annual rate. With the maintenance of a fairly easy monetary policy through the fall of 1965, discounts remained in the neighborhood of 2 points, and loan applications on existing homes rose further to a peak of almost 900,000 units. However, with the adoption of a policy of monetary restraint in late 1965—which was pursued until the fall of 1966—discounts rose sharply and reached nearly 7½ points in the third quarter of 1966. Under the market pressures implied by such deep discounts, loan applications were cut by more than half, dropping below some 400,000 units at an annual rate. The relatively easy monetary policy of 1967 brought a noticeable decline in discounts to about 2.5 points by April, and loan applications recovered to an annual rate of about 700,000. But this respite was short-lived. The strong competition for long-term funds (particularly from corporations) put new pressure on market yields as the year progressed, and discounts on FHA-insured mortgages again rose steeply. By April 1968, such discounts had reached about 7.9 points, and loan applications on existing houses had fallen below 600,000 at an annual rate as sellers progressively withdrew their homes from the market.

In many cases, rather than withdrawing their homes, sellers try to bury the discount in a higher price. Actually, he gains little by such an effort, because any real-estate brokerage fee is calculated on the total price. In fact, the seller's net proceeds would be somewhat lower under these circumstances than would be the case if no discount were involved and capitalized.

Recent developments in ceilings on mortgage rates

The types of behavior examined above were responsible for much of the frustration—on the

part of lenders, builders, and households—which stimulated the recent efforts to modify mortgage statutory ceiling laws at both the Federal and State levels. Federal action involved Congressional passage of PL 90-301—and Presidential approval on May 7—which suspends temporarily (until October 1, 1969) statutory limits applicable to interest rates on all FHA and VA market rate mortgage programs. The limits had been 6 per cent on home loans and from 5¼ to 6 per cent on multi-family loans. In addition, the legislation raised the permanent ceiling on all market rate multi-family programs to 6 per cent.

The same law authorized a regulatory rate ceiling on Federally underwritten loans adequate "to meet the mortgage market." Acting under this authority, FHA and VA specified an across-the-board limit of 6¾ per cent for all market-rate programs within States permitting this level of rates on Government underwritten loans. The effect was to bring about some reduction in discounts. However, since market yields on FHA and VA mortgages currently exceed 7 per cent, discounts remain fairly substantial. At present such discounts probably range between 4 and 6 points nationwide, compared with more than 8 points at the time the law became effective.

At the State level, several liberalizing moves were made recently. North Carolina raised its ceiling on mortgage loans to 7 per cent from 6 per cent, effective in June, 1967. Effective March 1 this year, Virginia adopted a ceiling of 8 per cent, compared with the previous 6 per cent maximum.

On May 7, the Governor of Maryland signed a bill raising the usury ceiling to 8 per cent from 6 per cent, effective July 1. In the interim, apparently some FHA and VA mortgages were closed under terms calling for 6 per cent interest payable through June 30 and 6¾ per cent thereafter. A special (and unusual) feature of the legislation would apparently prohibit the charging of any discounts, points, or similar fees on all mortgages, presumably including FHA and VA loans. It is reported that the Maryland Attorney General is preparing an opinion on the precise application of this unusual feature. If all FHA and VA mortgages were included, of course, no lender could make a Government underwritten loan at a discount in Maryland, and funds for this type of investment could become scarce indeed. In fact, much of the benefit of the move to a higher ceiling on mortgages would be erased.

In Pennsylvania, the Governor on May 17 signed a bill permitting a lender to charge a premium of 1 percentage point above the existing 6 per cent usury ceiling. Formerly, only savings and loan associations could charge up to 7 per cent. Permission to charge the premium, which expires five years from the effective date, applies only to newly made mortgages. No existing mortgage, according to the law, may be renegotiated at the premium.

It is reported that many long-term mortgages in Pennsylvania were made under a provision calling for renegotiation of the rate after each successive 3-year period. Apparently, the new law would prohibit renegotiation of such loans at the premium rate, although the courts may have to resolve the uncertainty. In the meantime, while the new law in Pennsylvania is definitely a step forward, on closer examination, the stride seems not to have been as long as one originally thought.

Efforts in other States, notably New Jersey and New York, to liberalize the 6 per cent usury ceiling also met with some success this year. But the outcome of these efforts assumes even more critical importance in light of the trend of mortgage rates. From spring to midyear, home mortgage yields rose above 7 per cent for the first time

in the postwar period. If further increases should occur, investment in home mortgages will come under increasing restraint within an additional 8 States with 7 per cent usury ceilings. Last year, these 8 States (Illinois, Iowa, Kentucky, Michigan, North Carolina, North Dakota, South Carolina—and Pennsylvania which just moved to 7 per cent) accounted for 18 per cent of all housing units for which building permits were issued within the nation's 3,014 permit-issuing places.

Concluding observations

Thus, a significant task remains ahead of us, if we are to develop a truly viable mortgage market. A critical ingredient in the process is the early abolition of statutory rate ceilings.

The public policy objective of usury ceilings is to protect mortgage borrowers in unfavorable bargaining positions from "excessive" charges on loans extended by private lenders. But when going yields exceed usury ceilings substantially, this objective becomes increasingly difficult to achieve. Meanwhile, other unintended and unfavorable consequences (as mentioned above) are produced. The anomalous outcome may be that borrowers in States with quite high usury ceilings, or with no usury ceilings, are more successful in their quest for adequate credit from private sources on more reasonable overall terms than are borrowers in low-rate States. Retention of below-market usury ceilings thus inevitably inhibits lending in the private sector, giving rise to demands for greater lending from public sources.

To the extent that more Government agency credit is forthcoming, public credit tends to be substituted for private credit, and when subsidies are involved they are granted at the expense of all taxpayers. The substitution of public for private credit runs exactly counter to the settled position of public policy as set forth in an interagency committee report on "Federal Credit Programs" presented to the President in 1963. This committee recommended that "Government credit programs should, in principle, supplement or stimulate private lending, rather than substitute for it."

Personally, I am not aware of any reports showing that mortgage borrowers in such States as Massachusetts, Maine, and Connecticut—where any mortgage rate may be charged—have been forced to borrow at exorbitant rates of interest, even on junior financing. On the other hand, we have learned from informal sources that since going market yields (rates) tend to prevail in these States, lenders have been more willing to make new commitments on local properties there than they have been in adjacent or nearby States such as New York, Vermont, or Pennsylvania, where usury ceilings are (or were) 6 per cent and discounts may or may not be charged.

Finally, the need for any usury "protection" will also be substantially lessened, if not eliminated, when the truth-in-lending legislation that has been passed by Congress and signed by the President is in force (July 1, 1969). The Consumer Credit Cost Disclosure provisions of the Consumer Credit Protection Act (cited as the Truth In Lending Act) require that the borrower be given a complete statement of all charges involved. Those charges that are defined to be part of the finance charge are to be computed in terms of an annual interest rate. In the case of real estate, the computation of the annual interest rate includes any points which may be involved on the mortgage. Because of this required statement, the borrower should have a more accurate idea of the actual costs involved with any particular mortgage and also a more useful basis for comparison in his choice of mortgage contracts.

In the meantime, the efforts to remove State usury ceilings on mortgage interest rates are still worth pursuing.

The Budget, Regulation Q, and Gold:

Three Issues for Today and Tomorrow

By
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65th Annual Convention of the New Jersey Bankers Association
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The Budget, Regulation Q, and Gold: Three Issues for Today and Tomorrow

by
Karl R. Bopp

So much has happened in banking and finance since we last met that it is difficult to choose which of many current events to talk about. Meanwhile, critics of the Federal Reserve System, whatever their leaning, have had a field day. By choosing the measure that supports his view, the critic can prove almost anything—to his own satisfaction—but not to the satisfaction of other critics who choose another measure.

For example, those who believe simply that the Federal Reserve controls the money supply and that the money supply controls everything else in the economy insist that the Federal Reserve began a disastrously easy money policy about the time we met here last year. They conclude we followed an easy money policy because last spring and summer the money stock was increasing at a near-record rate of 9 per cent and total member bank deposits at a rate of almost 12 per cent.

On the other hand, those who believe simply that the Federal Reserve fixes interest rates and that interest rates fix the rest of the economy describe that same period as one of extremely tight money because interest rates rose even faster than in 1966 and to the highest levels in decades.

Incidentally, it is a bit—well—disconcerting to learn that in some cases the same individuals who a few years back criticized us severely for not paying enough attention to rates are now criticizing us for paying *any* attention to rates at all, but such is the life of any banker—central or commercial!

My view is that neither central bankers nor observers should measure policy or the need for a change in policy by movements in a single or even a few financial variables. The System has been and is continuing to invest large efforts in order to develop a better grasp of the relationships among financial variables and developments in the real economy—which, after all, is the ultimate objective of policy. I am a member of a so-called Steering Committee which has devoted several years with first-class staff assistance to studying possible benefits from a redesigned discount window which, among other things, might reduce administrative surveillance and make changes in the rate more meaningful.

We now publish our policy record approximately 90 days after each meeting of the Federal Open Market Committee. The record and our reasoning are there for all to see.

I shall not, therefore, go into that record in detail today. Instead, I shall concentrate on three interrelated developments—each of which could be a speech in itself. The first might be entitled "The Failure of Fiscal Policy"; the second, "The Dilemma of Regulation Q"; and third, "The Twilight of Gold." These titles, though over-dramatic, sum up three basic issues of the past year and—more important—of the long run as well. Indeed, the thrust of my remarks is that in all three cases we are confronted with presssing problems that not only call for immediate solutions, but have important implications for the longer run.

The Budget

Most—if not all—of our current financial problems stem from the failure to get timely changes in fiscal policy. Substantial and continuous budgetary deficits, in an economy utilizing nearly all of its resources, have been heavily responsible for recent price increases. This renewed burst of inflation, in turn, has contributed to a further deterioration in our balance of payments and further weakening of the prestige of the dollar.

The need for restraint in the fiscal program of the Federal Government has been obvious for many months. Whether one is a New Economist or an Old Economist, the combination of a budget deficit of over $20 billion, which is what it will amount to in the fiscal year 1968, and a price level rising at an annual rate of 4 per cent spells bad economics.

It also spells bad politics. A tragedy is that differences of political views as to how to close the budgetary gap have stalemated action on both spending and taxes for so long. Because of partisan political considerations, as well as more fundamental philosophical disagreements, lawmakers and administration officials are clinging to their respective concepts of the ideal solution to the budgetary problem and are unwilling to make concessions in spite of the urgency of the situation. This is the short-run failure of fiscal policy.

Perhaps even more serious is the implication for the longer run. Are we to face such grave situations again and again as time rolls on? Although the theory of flexible fiscal policy is just as sound as it ever was, the possibility of it being put to practical use has been dealt a severe blow. This is a great disappointment, particularly inasmuch as the tax cut of 1964 had led many to believe that the principles of flexibility were finally taking hold as a working proposition. The current stalemate indicates once again that two-way flexibility—use of fiscal policy to restrain as well as to stimulate—remains to be mastered. As a result, some observers of economic developments have become disenchanted and are moving to the view that the best that can be hoped for is to establish a stable fiscal policy and leave responsibility for counteracting swings in the economy to monetary policy. The disadvantages of such a course are obvious when we observe the level of interest rates today. A more flexible fiscal policy remains worth striving for, and I haven't lost hope.

Regulation Q

The second issue with important short- as well as long-run implications is the dilemma of Regulation Q. The Federal Reserve's experience in changing ceiling rates on time and savings deposits is brief and inconclusive. When ceilings were raised in December 1965, they helped make possible a rapid growth of money and credit in early 1966. When they were not raised in the summer and fall of 1966, they helped to produce the credit crunch.

As credit tightens and interest rates rise to historically high levels, commercial bankers find it increasingly difficult to compete at existing ceilings. If, however, commercial bank ceilings are set too high, other financial institutions, subject to various restrictions, may find it difficult to compete with commercial banks. If open market rates rise above the ceiling rates, many investors—principally large investors but increasingly even ones having smaller portfolios—channel funds out of financial institutions and into marketable securities. This disintermediation can have far-ranging effects upon financial institutions and the particular markets which they serve.

The Federal Reserve has just recently raised the ceilings for large-denomination CD's. This indicates clearly a desire to avoid the kind of crunch that occurred in 1966 without precipitating the kind of disintermediation that drained funds out of the housing and municipal markets during the same period. Whether these new ceilings will be adequate only time will tell.

The problems with interest rate ceilings stem largely from efforts of monetary policy to keep the rate of economic growth within sustainable limits. To the extent that appropriate fiscal measures are carried out, the burden upon monetary policy is decreased and the pressure on interest rates is reduced. Therefore, a short-run solution to the problem of interest rate ceilings under Regulation Q is a timely and appropriate fiscal policy to supplement a restrictive monetary policy.

The dilemma posed by Regulation Q points up a longer-run problem which gives rise to it. Principally, this is the imperfection of competition in financial markets. Personally, I would prefer not to be in the business of setting ceiling rates on time and savings deposits. I would rather operate in an economy in which institutions would be free to compete against each other for existing supplies of funds; and price would regulate the allocation of funds.

Unfortunately, the various kinds of financial institutions have special restrictions that govern their activities. Savings and loan associations, for example, cannot invest in corporate bonds. Mutual savings banks can operate only in certain geographical areas. Secondary markets for mortgages are not as fluid as some other kinds of markets. Federal agencies regulate the rate of interest which savings institutions can pay for funds. Furthermore, many states impose usury ceilings on the rates which these institutions can charge on loans.

Institutional and statutory rigidities which impair efficient functioning of our financial structure are man-made problems; so it would seem that they could be removed readily. As you know, however, artificial and arbitrary market impediments are difficult to eliminate, mainly because of the support they receive from special-interest groups in legislative halls throughout the nation.

Longer-run solutions to the problems of interest rate ceilings are possible. I do not give up on this as an ultimate goal. First, it is desirable to broaden opportunities for the various kinds of financial institutions to compete with each other. This would mean that arbitrary distinctions among types of institutions would be reduced. Second, it is desirable to develop broader and more efficient secondary markets for mortgages and other debt instruments. Improved flows of funds among markets make it easier and more efficient for banks to adjust their asset positions. For example, the better the secondary market for municipal bonds, the easier and less costly it is for banks to use them as a type of secondary reserve.

I believe that usury restrictions deserve special attention now. Originally, usury legislation was adopted to protect the public from unscrupulous money lenders—a goal which is still in favor in this era of concern over consumer protection. I am sympathetic with the principle of aiding consumers; but there is a difference between consumer protection and interest rate ceilings established by usury laws.

Usury ceilings were established in relation to interest rate levels prevailing at the time. Perhaps framers of usury provisions thought that the ceilings were set high enough to present no substantial future problem to borrowers or to lenders.

However, as rates have climbed to historically high levels, the usury limitations *have* become a problem. They may protect the borrower from paying high rates; but in today's markets they are more likely to prevent him from getting the funds at all.

I am reminded of a story from the days of wartime rationing.

A woman went into a store to buy pork chops. The butcher told her the price was a dollar a pound.

"Why your competitor across the street is charging only 75¢."

"Please, madam, why don't you go there to get them?"

"Oh! he doesn't have any to sell."

"Well, when I don't have any to sell, my price is only 50¢."

Because interest rate ceilings vary among states, lenders often find it advantageous to shift funds to other geographical areas. The shift may not coincide with the relative need for funds among the areas. Now, roughly four-fifths of the states have more lenient usury laws than do Pennsylvania, Delaware, and New Jersey.

As you know, new truth-in-lending legislation passed Congress and was sent to the White House yesterday. Knowledge of costs can give real protection to the consumer-borrower. Companion legislation on the state level to remove or substantially revise usury provisions would be timely and appropriate. Recently the Pennsylvania Legislature has raised the interest limitation on mortgage loans in the state. The action may not be adequate, but is a step in the right direction.

I would hope that in the months and years ahead substantial efforts could be devoted toward eliminating the arbitrary, man-made impediments to free competition within and among various financial institutions and markets. Recently, the Federal Housing Administration raised the ceiling on interest rates on mortgages which it insures. Also, Fannie Mae has instituted an auction process for determining prices of mortgages it buys. These actions are a step toward removing some of the impediments to funds flowing into the mortgage market. More such actions are needed if we are not to be faced periodically with financial disruptions in periods of high interest rates.

Gold

The third issue before us is the twilight of gold. I use the word "twilight" advisedly because the question of gold still sets off a great deal of pyrotechnics. Nevertheless, it seems clear that the role of gold as well as that of the dollar has been weakened by recent events.

In the short run, gold has occupied the center of the stage. The decline of over $2.5 billion in United States gold reserves since your meeting a year ago is an indication of the difficult state of the U.S. dollar in the world economy.

The liquidity considerations of the United States should not be confused with questions of solvency. Each year our nation grows wealthier in relation to the rest of the world. During the ten years ended in 1966, U.S. investments and assets abroad jumped by 126 per cent to $112 billion, while foreign assets and investments in the U.S. increased by 91 per cent to $60 billion. So, the United States with net investments of over $50 billion in the rest of the world is an economically sound nation—and it has grown stronger year by year. But, we do have a liquidity problem that demands solution.

The gold problem has been caused by a failure of the United States to achieve reasonable equilibrium in its balance of payments with other countries. Over the past ten years the aggregate

deficit in balance of payments has approached $27 billion. These deficits have resulted from a number of factors. The United States has poured billions of dollars into economic assistance programs, helping war-ravaged nations back to their feet. American corporations, alert to expanding overseas opportunities, have boosted investments in foreign lands. Our rising income levels have enabled more individuals to travel and spend abroad. Our military commitments around the world and particularly in Southeast Asia have been a large drain on dollars. Moreover, foreign nations have stepped up competition with American firms for important markets both in the United States and elsewhere. Domestically, inflationary pressures have encouraged foreign businesses to sell goods in United States markets, thereby putting pressure on our favorable balance of trade. All of these factors have been operating for a number of years.

Our Government has taken a number of short-run, stop-gap measures to stem the outflow of dollars and gold. There is the voluntary foreign credit restraint program with which you are cooperating splendidly. Also, we have the interest equalization tax levied against foreign investments by United States citizens. We have the foreign investment restraint program which asks businesses not to ship dollars overseas for investment purposes. The Government has cut the value of items tourists can bring back duty-free in an attempt to curtail tourists' spending abroad. Restrictions on overseas travel by individuals have been proposed. And the list goes on.

In spite of these stop-gap measures, the near-term outlook for the balance of payments is far from good. The likely increase in economic activity during the rest of the year will continue to produce a large demand for imports. Further increases in prices will make it harder for American producers to export to foreign markets and will entice foreign businesses to increase sales in American markets. Military outlays overseas can be expected to continue at a substantial level even if shooting stops in South Vietnam. And it remains to be seen how much over-all reduction in the balance-of-payments deficit will be achieved by the President's program announced on January 1.

The most important step in bringing the balance of payments closer to equilibrium has not yet been taken. That step is a move toward fiscal restraint. A reduced Federal deficit should help restrain domestic demand, thereby slowing down imports; it should help to hold down domestic prices and thus stimulate exports. Furthermore, it should pay handsome dividends in improved psychology around the world with respect to the health of the dollar.

Looking to the longer run, progress toward establishing special drawing rights is an encouraging development. The supply of gold is too uncertain to provide a base for a growing world economy, and it is clear from recent experience that there are limits to how far dollar liabilities can be expanded through balance-of-payments deficits.

The new "paper gold" is another step in the evolution of a more viable international monetary system begun with the creation of the International Monetary Fund. As this system has evolved, gold has been a declining portion of world monetary reserves—from 72 per cent in 1948 to 56 per cent in 1967. The "paper gold" will be a further supplement to gold, enabling world trade to grow in a more orderly way. It is, however, no less vital to pursue other policies which will encourage economic growth throughout the world, and not restrain it. Recourse to quotas and other restrictions on trade would

frustrate these very promising efforts.

The long-run goal of a more viable international monetary system cannot be achieved, however, unless we bring our international payments closer to equilibrium.

Conclusions

There are many lessons to be drawn from recent experience. The one I want to emphasize is the importance of working toward long-run solutions to current and persistent problems. The danger in resorting to *ad hoc* expedients which at best only postpone a showdown is that fundamental solutions may be made even more difficult to attain. I am fully sympathetic to the view that today's fast-moving world calls for great flexibility. Actions of the Federal Reserve System in recent years, in fact, have exhibited more flexibility than in any other period of the Fed's history.

In the case of the Federal budget, efforts should go forward to prevent recurrence of the kind of fiscal impasses that we are now experiencing. In the case of Regulation Q, the Fed will be faced with a dilemma every time interest rates get high and money gets tight. Efforts to make financial markets freer and more competitive are essential if we are not to be confronted with recurring problems of disintermediation and adverse allocation of credit. Finally, in the case of gold, action to put the world's financial system on a more flexible footing should proceed as rapidly as possible. The first step to assure this long-run solution is for the United States to get its balance of payments closer to equilibrium.

We cannot let the house burn down while we design the most efficient water system. But without such a system, we shall be in grave danger each time a fire breaks out.