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Statement by

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Chairman, Board of Governors of the Federal Reserve System

before the

Committee on Banking and Currency

House of Representatives

on

H. R. 16092

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I appreciate this opportunity to present the views of the Board of Governors on H. R. 16092, to extend for one additional year the provisions of Public Law 89-597, which would otherwise expire September 21 of this year. This statute provides the authority for coordinated regulation of the maximum rates payable by Federally insured financial institutions to attract savings funds. It also fixes a 10 per cent statutory maximum on reserve requirements for member banks on time and savings deposits (in place of the former 6 per cent maximum), and authorizes the Federal Reserve Banks to buy and sell in the open market obligations of any Federal agency.

If the legislation before you were permitted to expire, the Federal Reserve and the Federal Deposit Insurance Corporation would retain authority to establish ceilings on the interest rates offered on savings and time deposits by member banks and nonmember insured banks, respectively. But we would lose a great deal of flexibility in distinguishing among types of deposits, and it was this flexibility that permitted us to establish a lower rate ceiling on time deposits under $100,000. Regardless of the reluctance all of us may feel about making such a distinction, the realities of today's market absolutely require some scaling in maximum rates by size of deposits if banks are to compete for funds in the money market without at the same time disrupting the markets for small savings. Moreover, as a practical matter, I think that we would find it very difficult to continue

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limiting the interest rates paid by banks for savings if their competitors--the savings banks and savings and loan associations--were left free to post any rate they wished.

For these reasons, the Board believes it essential that Public Law 39-597 be extended, and we recommend that the authority be made permanent. The need for effective rate limitation has been especially acute under recent circumstances, but the case for extending this legislation need not rest on current market conditions. One could, of course, conceive of circumstances under which rate ceilings would no longer be needed, as today's stresses in financial markets diminish in the future. In such an eventuality, the statute contains authority for suspension of rate ceilings. On the other hand, as long as ceilings are needed, it seems advisable to continue the flexible, coordinated approach embodied in the statute for establishing them.

If the rate ceiling authority is made permanent, the present statutory exemption for foreign official time deposits could be allowed to expire as scheduled on October 15 of this year. This exemption was originally adopted in 1962, before enactment of the present flexible authority over rate ceilings, and it was intended to permit banks to compete for foreign official funds and

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thereby to help alleviate the balance of payments situation. Since that situation has not improved during the intervening years, the exemption of foreign official deposits from interest rate ceilings continues to be justified. In recent amendments of their regulations, the Federal Reserve and the Federal Deposit Insurance Corporation have made clear their conviction that in present circumstances foreign official deposits should be free from interest rate ceilings. As improvements in the international payments position of the United States are achieved, however, the special treatment for foreign official deposits should be kept under observation in order to make sure that the discrimination involved is continued only as long as it is needed. If Public Law 89-597 becomes permanent law, the Board will then have the authority to continue, modify, or terminate this exemption administratively in the light of changing circumstances.

The authority in Public Law 89-597 for Federal Reserve purchases and sales of agency issues in the open market should also be made permanent. The objectives of this authority--to "increase the potential flexibility of open market transactions and . . . make these securities somewhat more attractive to investors" (S. Rept. No. 1601, 89th Cong., 2d session)--are long-range, and would be better served by eliminating uncertainty as to how long the authority may be exercised.

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The Board proposes also that two minor related amendments be added to H. R. 16092. The first would amend the eighth paragraph of Section 13 of the Federal Reserve Act to permit advances to member banks to be secured by any obligation eligible for rediscount or for purchase by Federal Reserve Banks. This would broaden such lending authority to include as eligible collateral all of the direct obligations of Federal agencies, as well as obligations fully guaranteed as to principal and interest by such agencies. Since the Federal Reserve Banks are authorized by Public Law 89-597 to purchase all such Federal agency obligations, we can see no reason why similar authority should not be granted as to their use as collateral for advances by Reserve Banks to member banks.

The second amendment we propose would broaden in similar fashion the types of collateral authorized for Federal Reserve Bank loans to individuals, partnerships and corporations under the last paragraph of Section 13 of the Federal Reserve Act. The collateral for such advances now may consist only of the direct obligations of the United States, and we propose to include also the obligations of Federal agencies. This provision of the Act is seldom used, but it could provide important protection to the business community under highly unusual or emergency conditions in financial markets. In June 1966, for example, we had made arrangements for the possible extension of credit to mutual savings banks, savings and loan associations, and other depositary-type institutions under this

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authority, though none proved to be necessary. Permitting such loans to be collateralized by Federal agency issues as well as by Treasury obligations would give wider latitude in such contingency planning, and we can see no reason why the types of assets made eligible for collateral should not, in this instance also, parallel the Reserve Banks' purchase authority.

I have suggested reasons for making permanent the rate ceiling and open market authority in Public Law 89-597. The Board believes also that the authority in that statute to raise reserve requirements on time deposits should be made permanent if it is to be effectively exercised. Statutory expiration dates confront the Board with the prospect that if they should raise reserve requirements on time deposits above 6 per cent, the action might be automatically reversed, thereby reducing reserve requirements, at a time when such a reduction would have undesirable consequences.

For your Committee's consideration, draft amendments to carry out the Board's recommendations are attached at the end of my statement.

Let me turn now to another proposed amendment which has received some attention recently, although it is not included in

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H. R. 16092 or in the draft extension bill as submitted to the Congress by the Secretary of the Treasury. This proposal would broaden the System's authority to purchase obligations issued or guaranteed by Federal agencies, so as to authorize such purchases directly from the agencies, in addition to the present authority to make such purchases in the open market. It would also express the sense of Congress that the broadened authority should be used "when alternative means cannot effectively be employed, to permit financial institutions to continue to supply reasonable amounts of funds to the mortgage market during periods of monetary stringency and rapidly rising interest rates."

Both the Congress and the Board are, of course, anxious to avoid a repetition of the experience in 1966 when the mortgage market became extremely tight. Just as monetary policy should not be expected to carry too much of the load of restraining an overheated economy, so also housing should not bear an undue share of the impact of monetary restraint. Yet both of these things happened in 1966.

Last year the Board submitted a detailed report to the Congress on the subject of monetary policy and the residential mortgage market. This report evaluated the effect of monetary policy on the availability and price of mortgage credit in 1966. In addition, the report set forth the Board's recommendations for corrective action to promote greater cyclical stability in the flow

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of residential mortgage credit in the future. I would like to submit a copy of the Board's report for the record as a part of my testimony today.

As indicated in this report, the Board believes that three broad guidelines are of crucial importance in considering what additional institutional reforms should be adopted to promote greater cyclical stability in the flow of new commitments for residential mortgages and in their direct and indirect costs:

First, a flexible fiscal policy should play a greater part than it did in 1966 in acting, when needed, to restrain aggregate economic activity.

Second, the residential mortgage market should be integrated closely with the general capital market, not insulated from it. But at the same time, certain institutional changes should be made to enhance the ability of the residential mortgage market to compete prudently for the limited aggregate supply of available credit.

Third, if special public measures appear warranted to ease the impact of tightening general credit conditions on the availability or price of residential mortgage credit, such actions should be taken without sacrificing the objectives of monetary restraint. Moreover, the extent of the subsidy element involved should be revealed clearly, and the substitution of public for private credit should be minimized.

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A number of important steps have already been taken at both Federal and State levels, in harmony with these guidelines, to assure a continued flow of private funds into mortgages. A Congressional directive to the Federal Reserve System to attempt to support the mortgage market by purchasing agency issues, however, could do the mortgage market more harm than good if, as seems likely, it involved a massive substitution of Federal Reserve funds for private funds.

Such a directive would violate a fundamental principle of sound monetary policy, in that it would attempt to use the credit-creating powers of the central bank to subsidize programs benefiting special sectors of the economy. There are, of course, legitimate grounds for concern about the mortgage market, just as there are many other areas in which Federal support programs may be called for. But thus far the Congress very wisely has refrained from attempting to finance such programs through creation of money by the central bank. At a time when confidence in our ability to manage our financial affairs responsibly is being severely tested, we simply cannot afford to create the impression that we are about to embark on a new support program to be financed in such a fashion.

Recognizing the dangers inherent in excessive extensions of credit by the Federal Reserve, the Congress has carefully limited the authority of the System to purchase obligations directly from the Treasury. Not only is there a statutory limit on the amount of

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such purchases, but the authority is temporary, subject to renewal by Congress every two years, and the legislative history established in the course of numerous extensions has repeatedly emphasized that the authority is to be used sparingly, and only for extremely short periods. Thus Congress has sought to prevent Federal Reserve credit from expanding to meet the Treasury's needs for funds at the expense of overall stabilization goals, and the Treasury has never borrowed more than $1.3 billion under the authority at any one time. Indeed, in the past decade the authority has been used only five times, and then for no more than 3 days, nor more than $207 million, at any one time. Yet the current proposal for Federal Reserve support of the mortgage market seems to contemplate a tap on Federal Reserve credit at below-market rates, unlimited as to time or amount.

If the Federal Reserve were directed to furnish several billion dollars to support the mortgage market, the result would be to add that amount of dollars to bank reserves, which would in turn stimulate the banking system to expand money and credit by several times that amount. This would of course be inflationary unless some way could be found to absorb these reserves. It has been suggested that the inflationary impact of our purchase of agency issues could be offset by sales of Treasury obligations out of the System's portfolio. Such sales, in the volume that would probably be necessary, would seriously complicate the Treasury's task of managing the public debt. The System might then face the

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difficult choice of abandoning the effort to support the mortgage market, or continuing it notwithstanding its inflationary impact, or attempting to make offsetting sales of Treasury obligations at the risk of disrupting the market for Treasury securities.

As spokesmen for home builders and mortgage lenders have recognized, the flow of funds into mortgages can be improved by bringing the Federal deficit into more manageable proportions, thereby alleviating the congestion in financial markets and easing the pressures on interest rates. After a long delay, legislation raising taxes and imposing expenditure controls has just been approved by Congress, and has already done much to reduce pressures in financial markets. Yet much of the benefit to be derived from this legislation could be undone by adoption of a directive for Federal Reserve support of housing. In part, this is a matter of market psychology. But it should be realized that in point of fact the proposed support program would involve a large increase in the amount of Treasury obligations the market would have to absorb. Insofar as the impact on Treasury bill rates and the other market rates that reflect increases in the bill rate is concerned, it would make little difference that the Federal Reserve System would be selling the obligations from its portfolio rather than Treasury marketing them directly.

The resulting rise in market yields would obviously shift some of the impact of general credit restraint onto other public and private non-mortgage borrowers, including State and local governments

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and small businesses other than builders. Costs of credit to such borrowers would escalate as the amount of Federal Reserve assistance provided to the residential mortgage market accelerated. It is thus conceivable that the same considerations leading Congress now to explore the feasibility of a Federal Reserve subsidy for housing might be extended later to other sectors of the economy affected by monetary restraint.

To try to influence flows of funds to the residential mortgage market significantly at times of severe credit squeeze, Federal Reserve acquisitions of FHLBank or FNMA obligations would have to be very large and concentrated within a few months. There is no way to predict how large such purchases would have to be.

Some idea of the possible order of magnitude that could be involved can be gained by observing the course of residential mortgage debt expansion in 1966. During that year, the seasonally adjusted annual rate of growth in outstanding nonfarm residential mortgage credit declined from about $18.2 billion in the first quarter to about $8.7 billion in the fourth, according to the most recent estimates. A large share of this reduction undoubtedly reflected a restricted supply of funds, following a period of unusual abundance in 1965. This large decline occurred despite a substantial increase in direct and indirect Federal support for the residential mortgage market. Net purchases of residential mortgages by Federal agencies--chiefly FNMA--totaled $3.9 billion during the

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first three quarters of 1966 at seasonally adjusted annual rates, compared with $1.0 billion in 1965. Loans from the Federal Home Loan Banks to member savings and loan associations rose at a $1.9 billion seasonally adjusted annual rate in those three quarters, in contrast with a net increase of $0.7 billion in 1965. Thus, the decline of about $9 billion in the annual rate of residential mortgage debt expansion occurred despite an increase of about $4 billion at annual rates in direct and indirect Federal support to the residential mortgage market.

An attempt to offset the effects of monetary restraint on residential construction during 1966, in other words, would have required massive Federal Reserve support to the residential mortgage market. As a first approximation, the amount of support could have ranged up to $9 billion at annual rates. The actual volume of support would have depended on what overall flow of mortgage funds would be sought in order to maintain amounts that were "reasonable," as called for by the proposal.

If the Federal Reserve sold Treasury bills to offset purchases of this magnitude, borrowing costs would rise sharply for the Treasury and for other non-mortgage borrowers. We have recently seen how rapidly Treasury bill rates can climb merely under the apprehension that financial markets would be subject to considerable additional future pressure. Following news that a $10 billion tax bill might not be forthcoming, the Treasury 3-month bill rate rose

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by 37 basis points in less than a month--from 5.55 per cent on April 29 of this year to 5.92 per cent on May 21.

Such upward interest rate pressures would, in turn, divert flows of savings from the depositary institutions directly to the market. This diversion would magnify the effects of tight money on the availability of mortgage credit from nonbank intermediaries. It would affect particularly adversely the savings and loan associations and mutual savings banks that specialize in residential mortgage lending. Then additional Federal Reserve support operations would be called for, in an effort to assure the "reasonable" flow of funds required by the proposal, with the same consequences.

Similar factors would discourage other types of diversified private lenders from acquiring residential mortgages. Yields on these mortgages, which would enjoy a relatively sheltered market position, would rise less than returns on other forms of investments. As the yield spread favoring mortgages declined, commercial banks, life insurance companies, and other types of private lenders would tend to shift funds away from the residential mortgage market. The gap between the desired overall flow of funds into mortgages and the amount supplied from private sources would widen accordingly. Additional Federal Reserve support would then appear to be needed. More public funds would consequently have to be substituted for private funds.

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Thus the proposal would attempt to shelter one segment of the industry providing funds for financing residential construction and housing purchases--a segment comprised of savings and loan associations and FNMA, which together ordinarily furnish no more than half of total mortgage flows in normal years. No comparable protection would be provided for other mortgage lenders, such as mutual savings banks and life insurance companies, which could be adversely affected by the rise in market interest rates. In attempting to provide support, moreover, the program would accelerate savings outflows from the very savings and loan associations being assisted. To offset such outflows of private savings, the program would endeavor to encourage these same lenders to borrow increasing amounts of public funds from the Federal Home Loan Banks. This might conceivably lead to a need for some relaxation of current Federal Home Loan Bank Board regulations, which now limit borrowings by member associations to a fraction of their share capital. Pushed to the extreme, the proposed support operation implies that some associations might even come to hold more public than private funds--thus becoming large-scale brokers of Federal aid.

It seems unlikely, however, that the typical savings and loan association would wish to borrow public funds in such large volume to expand its new mortgage commitments at a time when it was losing savings accounts on which it had relied for funds to honor its old loan commitments. Normally, only about half of the members

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of the Federal Home Loan Bank System borrow from it. In 1966, 51 per cent of all members did so, but principally to honor outstanding mortgage commitments rather than to make new loan commitments. Therefore, even if the Federal Home Loan Bank Board revised its lending limits to permit members to borrow larger percentages of their share capital and even if it invited borrowing for loan expansion purposes, there is no assurance that member S&L's would be eager to borrow for portfolio expansion in quantities sufficient to offset reductions in mortgage loans by other lenders.

Purchases of FNMA secondary-market debentures by the Federal Reserve might stimulate mortgage bankers to originate residential mortgages to be sold to FNMA. Such a result, however, would do no more than induce one Government-sponsored corporation to expand its mortgage portfolio with Government money at the same time that private lenders with private savings were leaving the market. Moreover, FNMA can acquire only Government-underwritten mortgages. Such loans account for less than a third of all residential mortgages outstanding, and for probably an even smaller share of new residential mortgages being originated. The latest version I have of the amendment being prepared by Mr. Reuss would confine Federal Reserve purchases to FHLBank obligations. With this one exception, however, the comments offered in this statement apply equally to the current version of the Reuss proposal.

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As time progressed, the effects of the Federal Reserve support operation would adversely affect savings flows to aided as well as to unaided mortgage lenders. At the same time, the operation would increase costs of funds to all non-mortgage borrowers. Ultimately, there would be little or no net increase in the overall availability of residential mortgage credit. There would be a substantial substitution of public for private funds. All this would occur at the expense of possible disruption to other financial markets if not to the formulation and implementation of general monetary policy as well.

Such a price, the Board feels strongly, would be too high to pay for so few positive results. Should the Congress decide that special efforts are required in times of overall monetary restraint to supply additional funds to the residential mortgage market, other approaches would, we believe, be less disruptive and more fruitful. Any such steps should, we suggest, be consistent with the broad guidelines mentioned earlier, and should avoid altogether the use of Federal Reserve support operations. And of course the basic aim should be to follow coordinated fiscal and monetary policy measures that will avoid congestion in financial markets.

The Board welcomes passage of the combination of tax and expenditure control measures agreed to by Congress. These fiscal measures have already alleviated the pressures on financial markets.

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We hope that this tendency will persist, and that the better balance between supplies and demands for credit resulting from the fiscal actions will begin to benefit the flows of funds into mortgages. However, if the Congress should determine that additional steps are needed to provide support for the mortgage market, we urge that they be designed in a fashion that will reinforce--not offset--the benefits that should flow from this highly constructive program of fiscal restraint.

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Amendments to Carry Out Federal Reserve Recommendations

1. To make Public Law 89-597 permanent: Strike out section 7 of that statute (H. R. 16092 as introduced amends section 7 to extend expiration date).

2. Collateral for advances by Federal Reserve Banks:

(a) Advances to member banks: Amend the eighth paragraph of section 13 of the Federal Reserve Act by striking out "secured by such notes, drafts, bills of exchange, or bankers' acceptances as are eligible for rediscount or for purchase by Federal reserve banks" and inserting "secured by such obligations as are eligible for rediscount or for purchase by Federal reserve banks".

(b) Advances to individuals, partnerships, and corporations: Amend the first sentence of the last paragraph of section 13 of the Federal Reserve Act by inserting after "secured by direct obligations of the United States" the following: "or by any obligation which is a direct obligation of, or fully guaranteed as to principal and interest by, any agency of the United States".

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