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Statement by

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before the

Committee on Banking and Currency

United States Senate

concerning the

Report of the Commission on Mortgage Interest Rates

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I welcome your invitation to comment on the Report of the Commission on Mortgage Interest Rates, published in August of this year. The report of the Commission--established by statute "to study mortgage interest rates and to make recommendations to assure the availability of an adequate supply of mortgage credit at a reasonable cost to the consumer"--serves as another reminder of the problem areas in this important sector of our economy.

Included among the Commission's proposals were several recommendations in the financial area which the Board of Governors itself previously advanced for consideration. Expressed broadly, these proposals include a strong contribution from fiscal policy toward overall economic stabilization; closer integration of the mortgage market with the rest of the capital market; and recognition that special public measures may at times be required to aid housing, without sacrificing the overall objectives of public economic policy.

At the outset, it should be recognized that monetary and credit restraints inevitably have their largest effects on sectors of the economy most dependent on credit financing. Housing is particularly susceptible. Not only are a large proportion of housing outlays heavily dependent on credit financing, but new housing expenditures involve fixed interest costs which are high relative to other and more variable costs over the life of the structure.

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Apart from this general consideration--which applies in some degree to all types of capital outlays--housing has also been adversely affected in periods of tight money by well-known structural problems in the mortgage market itself, reflecting characteristics of the principal financing institutions, of the financing instrument, and of the real estate collateral. These structural problems in housing, in turn, have complicated the task of framing and carrying out a timely and effective monetary policy. For this reason, we have been closely following the progress of structural change in the housing area, and have been interested in supporting measures for change.

During recent years, progress has been made in lessening some of the mortgage market difficulties. Among the improvements are more flexible FNMA and Federal Home Loan Bank operations; raising, and in some cases eliminating, State usury ceilings; better management of liquidity positions and commitment policies of financial institutions; and temporary removal of the statutory ceilings on FHA and VA mortgage interest rates. But certainly more can and should be done to improve the methods of financing, producing, and distributing the housing required to fulfill our shelter requirements.

While further progress needs to be made in enhancing the flexibility of institutional arrangements in the mortgage market, the single most important factor that would contribute to greater

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viability in the housing area would be to bring current inflationary trends and expectations under control. And over the longer run, housing will be best served by a mix of fiscal and monetary policies which, as the Commission states, makes "greater use of fiscal policy as a stabilizing force, so that monetary policy is freer to maintain an even flow of credit at reasonable rates of interest that American families can afford." To permit changes in the fiscal-monetary policy mix when needed, there is much to be said for procedures that would lead to greater flexibility in setting Federal tax rates as is recommended by the Commission.

For the mortgage market at the present time, the overriding importance of containing inflation is also well recognized in the Commission's report. As recent developments have emphasized, an inflationary environment inhibits flows of savings to private depositary institutions that invest in mortgages. It stifles private investor interest in long-term, fixed-rate mortgages that typically finance home purchases. Hence it bears particularly heavily on residential construction, and especially on housing for lower-income groups that are less able to afford the rising cost of shelter. Inflation thus tends to foster a shift in the distribution of private resources away from housing, and a return to non-inflationary growth would lay the basis for shifting these resources back to housing.

Since late 1968, new commitments for residential mortgages have been curtailed in a period in which monetary policy has been

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bearing a major share of the anti-inflationary effort. Reflecting the change in mortgage market conditions with some lag, housing starts have dropped sharply through August of this year from their rapid pace of the first quarter.

Nevertheless, the impact of restrictive monetary policy on housing activity has been softened so far this year by the variety of reform measures adopted during the last few years to shift more of the burden of monetary restraint to other parts of the economy. Imperfections in the mortgage market have been reduced, with the result, among other things, that mortgage borrowers have had greater access to the restricted supply of overall credit. In consequence, interest rates in securities markets generally have risen more than might otherwise have been the case, given the credit restraints in force.

Interest rates in all markets, in fact, have risen to the highest levels in decades. The competitive attractiveness of direct security investment relative to savings account depositary intermediaries has thereby been enhanced. This, in turn, has tended to divert some savings flows away from institutions which normally supply funds to the mortgage market. As a result, the cushioning effect of the reform measures on housing has been partially offset.

If the fortunes of the housing market remain heavily dependent on flows of savings placed at short-term in depositary intermediaries, residential construction is likely to continue to exhibit

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larger variations between periods of ease and restraint than most other types of spending, as long as monetary actions are a major tool of economic stabilization. But even as efforts are made to rechannel credit flows to housing as a result of measures involving Federal credit or guarantees, the funds so obtained may in part substitute for money that would have found its way into the housing market through other means. While additional changes in institutional arrangements in the mortgage area are clearly necessary, they should be expected, in and of themselves, to cushion, but not fully eliminate, the inherent sensitivity of housing to variations in overall credit conditions.

Among the many recommendations made by the Commission on Mortgage Interest Rates, I would like to comment first on several proposals for which the Board of Governors would have a special responsibility. A major general recommendation of the Commission is that in formulating the annual Budget and in implementing overall fiscal and monetary policy, the Administration, the Congress, and the Federal Reserve should incorporate as many of the proposals contained in each year's report on national housing policy as possible.

Federal Reserve policy, of course, must always take into account the impact of its actions on various sectors of the economy, to the extent that this is consistent with the overall requirements of stabilization policy. And in recent years, the regulatory and

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monetary policy instruments have been adjusted to take account of, and in a degree cushion, the reaction of housing to overall credit restraints. But whenever total demands for goods and services press against our physical resources, restraint in public economic policy will be necessary. Such restraints will inevitably affect the housing market in some degree, and particularly to the extent that monetary policy bears most of the burden.

Another set of recommendations of the Commission concerns Federal authority to regulate interest rates on time and savings deposits. The Board of Governors has already gone on record as favoring permanent regulatory authority in this area, as endorsed by the Commission on Mortgage Interest Rates. In the short run, such authority may be useful in preserving balanced competition among depositary institutions. Over the longer run, however, we should move in the direction of freer competition for the public's saving, with market forces rather than administrative regulation playing the predominant role in determining the rate of return paid to savers. Indeed, the cumulative power of market forces and the capacity of credit markets to innovate and adapt suggests that regulatory rate ceilings themselves can only be of relatively limited value in channeling credit flows and affecting overall market interest rate levels.

With respect to Federal Reserve transactions in Federal agency securities, the Commission has recommended that the Federal

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Reserve should make a meaningful effort to improve the market by buying and selling such issues with some regularity in the open market on an outright basis. More or less continually since late 1966, the System has undertaken repurchase agreements on Federal agency securities. These agreements, made as part of our regular reserve supplying operations, have provided additional financing to the agency market.

Whether System outright operations in agency issues would contribute meaningfully to the further improvement of the market is, of course, a matter of judgment. Among the factors that one has to consider, for example, are the difficulties of outright transactions in a market characterized by relatively small and frequent issues offered by a large number of different agencies. In such a market, the System would inevitably be faced with problems of avoiding dominance of any one issue or of a series of issues of any particular agency. Thus, in view of the limited scope for System operations, the basic question is whether they would contribute more to market improvement than they would to market uncertainties about the nature, timing and objectives of possible System transactions. As a technical matter, some consolidation of the multiplicity of different agency issues would be helpful in improving their marketability and the functioning of the market.

Turning to the subject of paper eligible for discount, the Board has recommended legislation in this area several times, as the

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Commission report indicates. The Board's proposal--which the Senate passed in both 1965 and 1967--would permit member banks of the Federal Reserve to borrow from the Federal Reserve Banks on the security of any sound asset, including mortgages, without paying the "penalty" rate of interest required whenever paper technically ineligible under present legislative authority is presented. The Board continues to favor this approach as a means of encouraging banks to respond to the changing needs of the public for mortgage and other types of credit.

The Board agrees with the Commission's view that Section 24 of the Federal Reserve Act should be amended so that both the primary and the secondary mortgage markets can benefit from more active participation by the national banks. The amendments involved would allow national banks to make and hold fully-amortized conventional mortgage loans in amounts of up to 90 per cent of appraised value and with maturities of up to 30 years. Federal savings and loan associations are already authorized to originate and retain such loans to a limited extent. A further extension in the maximum maturity of construction loans beyond the present 36-month limit, as the Commission observes, may also be appropriate for national banks.

Turning to items that do not involve direct Federal Reserve responsibilities, the Board has for many years favored greater flexibility in contract interest rates on Government underwritten mortgages as a means of assuring maximum private participation in this market by home lenders, borrowers, and sellers alike. The Commission's recommendation that the Congress should permanently abolish the present

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statutory ceiling of 6 per cent on FHA and VA loans would represent a useful step in this direction. It is a step that would eliminate market uncertainty about the timing or extent of possible statutory changes.

The Commission has proposed a 3-year trial period during which a dual market system would be in effect--one part free and the other operating under administratively determined ceilings. This will provide a basis for evaluating how far it is feasible to go in moving toward greater flexibility in the FHA-VA market. In the case of conventional home mortgages that already compete on a rate basis in primary markets subject only to state usury ceilings, interest rate flexibility has typically minimized the amount of any discounts that may be charged.

More flexible FHA and VA interest rates would represent further progress toward closer integration of the mortgage market with other sectors of the capital market. Many other recommendations of the Commission--such as review of state usury laws, greater flexibility in asset and liability management of the thrift institutions, and the development of mortgage-backed bonds--would also work toward this end. And as a general point, abolition of the 4-1/4 per cent interest rate ceiling on Treasury bonds, as suggested by the Commission --and also, of course, over the years by many others--is most desirable. Apart from its general value in Treasury debt management, it could help at times to ease upward interest rate pressures in the

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short end of the market, thereby making it easier for thrift institutions to compete for funds that they put into mortgages.

Some of the Commission recommendations are designed to make use of Federal Government funds to supplement the overall pool of private capital. The recommended increase in the capacity of the Federal Home Loan Banks to borrow directly from the Treasury and the proposal to enable GNMA to sell special housing bonds to Federal trust funds are examples. While special programs to attain housing objectives or to cushion the disproportionate impact of monetary policy on housing may be necessary, the extent of subsidy elements in such programs should be revealed as clearly as possible.

In moving toward the nation's housing goals, we must take care to enhance the functioning of our private markets as well as to implement balanced fiscal and monetary policies. That seems to be the philosophy behind the Report of the Commission on Mortgage Interest Rates. That is the way to strengthen the quality of the economy that affects all our lives.

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