For release on delivery

Statement by

William McChesney Martin, Jr.

Chairman, Board of Governors of the Federal Reserve System

before the

Committee on Banking and Currency

House of Representatives

Concerning H. R. 13939

October 6, 1969

I appreciate the opportunity to present to this Committee the views of the Board of Governors of the Federal Reserve System on H.R. 13939, a bill to extend for one year the authority to limit rates of interest or dividends payable on time and savings accounts, and for other purposes.

The first section of the bill would extend through September 22, 1970, the discretionary authority to regulate rates of interest on time and savings deposits initially granted to the Federal agencies in 1966. In the establishment of ceiling rates, that authority permitted a distinction between time certificates of deposit sold in large denominations and other types of time and savings accounts; it also extended to insured nonbank savings institutions the type of rate regulations applicable to insured commercial banks. The flexible authority provided by the present law has proved to be useful during the past several years. However, it would be desirable to grant this authority to the Federal agencies permanently, rather than merely extending it for a year.

Permanent extension of the present authority--under which ceiling rates on time and savings accounts may be suspended, whenever economic and financial conditions warrant--would permit the Federal regulatory agencies to formulate and implement plans for moving toward the long-range objective of freer competition among depositary institutions for the savings of the public. Over the long run, the prospects for using our financial resources more efficiently, and for rewarding both small and large savers more fully for their contribution to financing investment, would be enhanced by a market-determined allocation of the flows of savings among financial institutions and between such institutions and the securities market.

The second section of the bill would broaden the authority of the Federal Reserve to acquire securities which are direct obligations of Federal agencies, or are fully guaranteed as to principal and interest by any agency of the United States, so as to permit direct purchases from these agencies as well as purchases in the open market. The bill would also express the sense of Congress that this authority be utilized to further the objectives of the Housing and Urban Development Act of 1968.

General authority for Federal Reserve purchases of Federal agency securities in the open market was initially granted by the Congress in 1966. Very shortly thereafter, the Federal Open Market Committee amended its continuing authority directive to the Manager of the Open Market Account so as to permit transactions in such securities under repurchase agreements. This authority has been utilized regularly since then. When the Open Market Account has made repurchase agreements with dealers, the practice has been to use either direct Treasury obligations or Federal agency issues, at the option of the dealer. The Federal Open Market Committee has kept under review and study the question of outright transactions in such securities, but as yet no outright purchases have been made.

Whether outright operations in agency issues by the System would contribute meaningfully to improvement in the functioning of the market for these issues is, of course, a matter of judgment. Among the factors that one has to consider 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 I interpret section 2 of this bill, however, it is designed to achieve objectives considerably more fundamental than improvements in the functioning of markets for agency issues. It would provide direct access to Federal Reserve credit to these agencies without limitations as to amount--an unlimited line of credit at the central bank that our laws have denied even the U.S. Treasury, and I think wisely so. Furthermore, it would require that Federal Reserve authority to acquire these securities be utilized to support a specific industry, rather than for the general purposes of monetary policy.

In assessing the merits of such a proposal, we all recognize that the housing market should not be made to shoulder an undue share of the burden of restraint during periods of inflationary pressures, as it often has in the past. Housing is especially susceptible to policies of monetary and credit restraint, both because home buyers depend heavily on credit as a source of financing, and because unusually large swings occur in mortgage credit availability.

It is appropriate, therefore, that special Federal programs should be available to moderate these swings in the supply of mortgage money, and thereby to avoid undue strains in the housing market during periods when monetary restraint must be used to combat inflationary pressures. The Federal National Mortgage Association and the Federal Home Loan Bank System have made a significant contribution to this objective. This year, for example, increased commitments by FNMA have been an important factor in preventing the flow of private funds into new home mortgages from declining further. Also, increases in loans by the Federal Home Loan Banks to member savings and loan associations over the first eight months of 1969 were about twice as large as in 1966. This source of funds has enabled the savings and loan associations to continue committing funds to the mortgage market in amounts exceeding those that would have been permitted by new inflows of savings, repayments on existing mortgages, and reductions in liquidity. Funds put into the mortgage market by these agencies have, of course, reduced the supply of credit available to other classes of borrowers in other markets.

However, an attempt to ensure that the housing market would be sheltered from the effects of monetary restraint during periods of inflation by providing the Federal housing agencies with direct access to Federal Reserve credit would, in the Board's view, have potentially serious consequences. The amounts of funds that would have to be provided to offset the effects of monetary restraint on the housing industry could be extremely large. An impression of the potential scale of such operations is conveyed by the pace of FNMA commitments to the mortgage market this year. Recently, these commitments have been at an annual rate of $9 to $10 billion.

It would be clearly inappropriate to add large amounts to bank reserves in an effort to solve the problems of housing at a time when inflation is so serious a threat to economic stability. Consequently, the Federal Reserve could not acquire Federal agency issues in volume without, at the same time, engaging in simultaneous sales of direct Treasury obligations, or raising reserve requirements. Unless such compensatory actions were taken, the resulting expansion of bank credit and the money supply would be extremely inflationary. Indeed, it would be tantamount to abandoning the use of monetary instruments as tools of economic stabilization. And once the principle was established that the credit-creating powers of the central bank could be utilized to subsidize programs benefitting the housing industry, it would not be long before others would present their claims for similar support. Surely, a practical solution to the problems of the housing market--problems that have typically emerged in periods of inflation--lies in other measures than those that would make inflationary pressures vastly worse.

If, on the other hand, we were to offset the effects on commercial bank reserves of purchasing agency issues by selling Treasury securities or by raising reserve requirements, the most immediate result would be to exert general upward pressure on market rates of interest. This would, of course, increase the cost of borrowing to the Treasury and to other borrowers. More importantly, however, it would worsen considerably the kinds of difficulties that nonbank thrift institutions that specialize in mortgage lending are already facing. More of their depositors would be induced to transfer funds out of savings accounts and into market securities, as they have been doing this year, and the institutions would then have still fewer private financial resources to commit to housing. The result of this process would thus be to substitute Federal sources of funds for private sources in the mortgage market, with little real gain in the overall flow of funds to housing.

For these reasons, the provisions of section 2 of this bill do not seem to the Board a practical or appropriate solution to achieving our national housing goals. A more constructive approach would be to move as quickly as we can towards additional structural reforms that would break down further the institutional barriers that interrupt the flow of credit to the housing market during periods of credit restraint. We have already made progress in this area during the past few years, but there is clearly more to be done. Greater flexibility in the asset and liability management of the nonbank thrift institutions seems especially important, if these institutions are to have more freedom to compete with banks, and with market securities, for consumer savings. The Board believes that a number of the suggestions contained in the recent report of the Commission on Mortgage Interest Rates would also be helpful. These include the need for a review of State usury laws which may impede the flow of funds to housing; the permanent abolition of statutory ceilings on FHA and VA mortgage loans; amendments of the Federal Reserve Act to permit loans to member banks on the security of any sound asset--including mortgages--and to enable national banks to participate more actively in the mortgage market. In the Board's view, these are the kinds of measures that would be of substantial long-run value to the housing market.

In conclusion, we must recognize that home buying and therefore home construction, will probably always be quite sensitive to overall changes in credit market conditions, irrespective of all our efforts to provide buffers for the housing market. The postponable nature of housing outlays, the large percentage of total cost that consists of interest payments, and the dependence of the home buyer on borrowed funds, all tend to make investments in housing vary markedly in response to inflationary pressures and monetary policy. These are inherent characteristics of housing that we must live with. But if we are more successful in using our fiscal and monetary tools to keep inflationary pressures under control than we have been in recent years, the housing market will be able to look forward to considerably fewer, and less pronounced, interruptions in its long-run expansion.