

## *The Role of Government-Sponsored Intermediaries*

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Mortgage and housing market activity has been a matter of national concern for several decades. As early as 1918, Congress considered proposals for a credit facility to support the residential mortgage market.<sup>1</sup> The creation, in 1932, of the Federal Home Loan Bank System, consisting of 12 banks, was a direct outgrowth of one of the 1918 proposals. This set of institutions can be regarded as the first permanent Government-sponsored intermediary in the residential mortgage market.

The history of the other major intermediary, the Federal National Mortgage Association, dates from 1934. Title III of the National Housing Act, June 1934, provided for the establishment of national mortgage associations to support the market for FHA-insured mortgages. The first, and so far the only mortgage association, created pursuant to this legislation came into being in February 1938 as a subsidiary of the Reconstruction Finance Corporation. Through a series of legislative changes, the Federal National Mortgage Association evolved into a privately-owned, Government-regulated, secondary market facility for Government insured or guaranteed mortgages.<sup>2</sup>

<sup>1</sup> See testimony in *Hearings before Senate Subcommittee on Banking and Currency* re S. 2959, 72nd Congress, 1st Session, 1931, p. 613.

<sup>2</sup> One may also call attention to the Government National Mortgage Association and the Farmers Home Administration which make contributions to residential mortgage market activity. The ensuing discussion, however, deals with the first two entities.

\*This paper represents the personal views of the writer and does not reflect the position of the Federal National Mortgage Association.

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The function of these intermediaries reflects two important characteristics of the mortgage market. To a large extent mortgages are a residual investment for a number of lenders—insurance companies, commercial banks, and, to a degree, mutual savings banks. The second characteristic is that the flow of savings to commercial banks, mutual savings banks, and savings and loan associations has proven quite sensitive to fluctuations in market interest rates, the savings flows rising when market interest rates are declining and falling when market interest rates are rising.<sup>3</sup> The net effect on the availability of mortgage money of changing credit conditions, consequently, is greatly amplified in comparison with the economy as a whole. The discussion which follows traces the development of these institutions, examines the goals which they pursue, and reviews some of the issues that they have raised.

### *The Federal Home Loan Bank System*

The legislative history of the Federal Home Loan Bank System, while lacking specific standards, does outline in rather general terms the goals that Congress had in mind.<sup>4</sup> The language of the House Committee Report is fairly extensive, but the broad intent is mirrored in the following precis.

One can distinguish the desire for a mechanism to equilibrate the supply of mortgage funds in relation to demand regionally. The eradication of geographic barriers or frictions to flows of funds is an end long honored in economics, and the founders of the System deserve high marks for their adherence to this cardinal principle. In fact, the Federal Home Loan Bank Board, as the governing body of the System and other regulatory mechanisms has performed admirably in trying to achieve this goal. That it may not have succeeded completely, that is interest rates on mortgages are not everywhere uniform, is not an indictment. Flows, and rather large ones at that, have been generated which otherwise would probably not have

<sup>3</sup> Note should be taken of the fact that policy loans at life insurance companies increase substantially when market interest rates rise introducing an impact on life insurance companies not unlike that affecting thrift institutions but to a lesser degree.

<sup>4</sup> Report No. 1418, House of Representatives, 72nd Congress, 1st Session, May 1932, pp. 10 *et seq.*

occurred. Beyond these brief observations, this goal need not detain us further, except to note that more work could be done in this area and, although desirable, an improved inter-regional flow may not be as urgent a matter as the other goals.

There was also evident a desire to create a credit reservoir to buttress the lending capabilities of thrift institutions and to provide them with a short-term cash flow adjustment mechanism.

Most important, however, was the explicit statement that supply of mortgage credit should be regulated so as to avoid building booms and to support normal construction overtime. This is the buffer or contra-cyclical device reinforced by an injunction to prevent excesses in residential construction activity. It is this function which would appear most important to maintaining an adequate volume of mortgage credit, and it is this phase of the FHLB's activity that has been at the center of many episodes of criticism and debate.

During the 1930's the FHLB's provided advances which accounted for from 5 to 8 percent of the mortgage loans outstanding at member institutions, but on a marginal basis, supplied as much as 16 percent of the net increase in mortgage portfolio in given years. After an early postwar peak activity in 1950, both ratios declined rather sharply into the mid-sixties reflecting growth in savings which far exceeded a strong secular rise in advances outstanding.

How did advances behave in relation to the standards discussed earlier of acting as a contra-cyclical force to purely private sources of mortgages and as a device for protecting the soundness of credit in the mortgage market? Prior to 1966, advances moved with no strongly discernible pattern, and to the extent any pattern existed it tended to be procyclical and seemingly perversely so at times. A correlation of changes in advances and mortgages flows reveals a small positive coefficient of correlation with an  $R^2$  of less than .12. Similar results are evident for correlation with housing starts. While no important relationship is supported by the correlation between advances and the need for mortgage funds, a tendency for advances to parallel the availability from other sources is apparent.

An earlier study of the FHLB's described the System as furnishing accommodation for members, or as a lender of first resort.<sup>5</sup> To some extent, this was unavoidable because the FHLB's extend credit for

<sup>5</sup> Ernest Block, "The Federal Home Loan Bank System," in *Federal Credit Agencies*, GMC, Prentice-Hall, 1963, pp. 160-1.

balancing day to day as well as more fundamental disequilibria. But the absence of any clearly articulated policy other than to protect the creditor position of the FHLB's, a practice of keeping advance rates as low as possible, and liberal repayment and renewal provisions placed the decision-making process in the hands of the borrowing members without any significant explicit review by the FHLB's.

#### *Two Attempts at Restriction*

There were only two attempts at any restriction. The first was during the Korean War and amounted to little more than changing the upper limits for advances to expand mortgage portfolios to an inconsequential degree. A brief period of restriction in 1955, announced in a style that appeared very forceful, induced a great deal of industry criticism of the Federal Home Loan Bank Board and many suggestions for reform, but produced only a slight moderation in the growth in advances. Block discusses this episode in some detail<sup>6</sup> and argues, but from annual rather than monthly data, that the restriction had no effect.

On the whole Block's description of the operation of credit policy of this Government-sponsored intermediary is well taken. More important than the general accommodative posture was the cyclical variation in advances, particularly in the early 1960's. To an important extent this accommodative posture was reinforced by a desire to stimulate the economy and to use housing for that purpose.<sup>7</sup> Appropos of the 1962 experience the Board wrote:

The events of 1962 also pointed up the dual role of the Federal Home Loan Bank System. On the one hand, advances by the Federal Home Loan Banks are designed to permit members to meet expanding demand not matched by savings inflow. At the same time, the Board and the several Banks have a responsibility for the soundness of credit and the argument could be made that credit should be restricted. The obvious conflict of the two goals in circumstances such as those in 1962 made the role of the Board difficult. While the Board did take steps to protect the soundness of credit, it did not take any direct action through the advance mechanism to restrain credit levels. The needs of the economy appeared to clearly exceed any imminent threat to credit quality and tipped the scale in favor of continuing existing practices during 1962.<sup>8</sup>

<sup>6</sup> *Ibid*

<sup>7</sup> *Economic Report of the President*, January, 1963, p. 49.

<sup>8</sup> *Annual Report, Federal Home Loan Bank Board*, 1962, p. 6.

It would appear that some recognition of the contra-cyclical role of the System in relation to the mortgage market had developed. But, unlike Saturday's child, the Board and others still had much wisdom to acquire. The following table illustrates the point.

FLOWS OF RESIDENTIAL MORTGAGE FUNDS  
1960 - 1965  
(FIGURES IN BILLIONS OF DOLLARS)

	1960	1961	1962	1963	1964	1965
Home mortgages	10.4	11.7	13.5	15.7	15.4	15.4
Multifamily mortgages	1.7	2.6	2.8	3.2	4.5	3.6
Total	12.1	14.3	16.3	18.9	19.9	19.0
Less FNMA	.9	-	-	-.8	-.1	.5
FHLB's	-.2	.7	.8	1.3	.5	.7
Net flow private	11.4	13.6	15.5	18.4	19.5	17.8

Between 1960 and 1963 flows of mortgage funds to the residential market from non-Government intermediaries increased over 60 percent (55 percent for home mortgages alone). In the same interval, however, advances from the FHLB's rose from minus \$.2 billion to \$1.3 billion. This increase reflected not only the factors already mentioned but also the use of advances by some associations to accelerate the growth of book earnings so they could compete more vigorously for savings. The resulting growth, however, created problems for some of these associations because of the high risk accepted, in order to convert funds into earning assets. This occurred in the face of rising vacancies and sharply increased foreclosure rates. Grebler and Doyel have observed that:

On the whole, then, it appears that the bank System from 1961 to 1965 supplied resources in amounts not consistent with the relatively easy conditions in financial markets, with the ample flow of savings into member institutions, and with the funds available from lenders for mortgage investment and housing construction.<sup>9</sup>

<sup>9</sup>Leo Grebler and Tom Doyel, "Study of 1966 Experience," in *A Study of the Federal Home Loan Bank System*, G.P.O. 1970, p. 1333.

The Grebler-Doyel conclusion, while valid in the main, is somewhat too sweeping. It does not allow for the restrictive steps taken by the Board beginning in late 1963, on an informal basis, and put into effect in formal terms in late 1964.<sup>10</sup> The restrictions were based largely on the quality of credit records of individual institutions but did have the effect of reducing the increase in advances substantially from the 1963 level and did impart some contra-cyclical aspect to track advances followed, although it did not fully respond to the type of criticism made by Grebler-Doyel.

More controversial than the 1963-64 action was a program instituted in April 1965 which restricted the borrowing rights of those institutions increasing dividend rates. If the institutions had a superior lending record, operated in the housing market with an average or lower rate of foreclosures, and had to raise dividends to maintain a reasonable flow of funds, the restriction was eliminated. The procedure was quite complex and is discussed in the Board's *Annual Report* for 1965.<sup>11</sup> The essence of this program was to protect the quality of credit which had deteriorated sharply at some institutions which were large users of advances and aggressive in their competition for savings. At the same time, the policy recognized the need to limit injections of funds by the FHLB's because of the flows of funds from other sources.

Controversy raged about this program because the entry point for restriction was dividend-rate policy and because its adoption was aimed at institutions with aggressive dividend rate practices. Critics focused on the dividend rate charges as a trigger and argued that it constituted an interference with market forces. They discounted the intent to protect the soundness of credit or to achieve a contra-cyclical effect.

The one element of this program which could be criticized is that it was kept in effect too long, the entire first half of 1966. But part of the reason for keeping it in effect beyond the opening months of 1966 was that some of its more adamant critics in 1965 argued in the second quarter of 1966 that its elimination could result in a savings rate war!

From the 1965 restriction program, the Board was plunged into the debacle of 1966 occasioned by the higher rate ceilings made

<sup>10</sup>*Annual Report*, 1964, Federal Home Loan Bank Board, pp. 17-19.

<sup>11</sup>pp. 50-54.

effective for commercial banks in December 1965. The consequent competition from banks for savings grew apace and became particularly severe beginning in March. As for advances, they increased at an annual rate exceeding \$4 billion in the first quarter.

#### *Forces Hampering Expansion*

Had this pace been maintained throughout 1966, or at least through September, the System would have established an enviable record in support of the mortgage market. Three forces, however, hampered continuance of this policy. First, the liquidity reserves of the FHLB's, which had been clearly ample for any previous emergency and had even been criticized as being too large, appeared inadequate for the drain which seemed in prospect; second, the massive uncertainty and the need to have a strong liquidity pool to meet advances for savings withdrawal induced caution; third, the FHLB's had a debt maturity structure so short and so crowded that it impeded raising as much new money as would have been desirable.

The restriction imposed in April 1966 resulted in some slowing in advances, but from March through July advances continued to rise at a \$3 billion annual rate, but then proceeded to decline slowly, at about \$800 million annual rate, through October, and fell sharply in the closing months of the year, at about a \$3 billion annual rate. The latter development was not a choice by the Board and was in contradiction to its intent. It reflected, instead, a pattern that associations had followed before—a sharp reduction in commitments when savings flows decline so that a savings flow recovery results in a repayment of advances for a time. The same phenomenon appeared in April 1970 when advances dropped at an annual rate of over \$7 billion and only a subsidy program to induce members to retain advances avoided massive repayments.

The decline in advances into 1967 has also been a question relevant to the development of this intermediary. The decline was contra-cyclical in relation to flows of funds from other lenders, housing starts did rise very rapidly, mortgage money availability was ample enough to quench the thirst of the most vocal lobbyist for ample housing credit, and FNMA's mortgage purchase pattern paralleled the course of FHLB advances quite closely. Given the massive interruption to the mortgage commitment level and residential construction in process during 1966, the decline in FHLB

advances and FNMA purchases seems to have been inevitable. The Grebler-Doyel argument that the System failed to prime the pump in 1967 and that the repayments of advances reflected only the tighter quality of credit policy<sup>12</sup> seems to be off the mark. This is particularly so since repayment of advances was as prevalent among borrowing members not affected by the tighter standards as it was among those of lesser credit worthiness.

#### *FHLBB's Primary Role to Stabilize Mortgage Markets*

What emerged from the experience of the 1960's was a strong recognition by the Board that its primary role was sector stability, with mortgage credit soundness a very close second. This passage from an accommodative, procyclical lender, with occasional dabbling in general stabilization, to a force for stabilizing the mortgage market is clearly stated in the Board's *Annual Report* for 1967.<sup>13</sup> Similar statements were made in a number of speeches by Board members, particularly former Chairman John Home.

That the lessons had found their mark is evident from the large liquidity pool accumulated at the end of 1968; the advice to members to count upon prospective advances in making commitments; and the events of 1969. In that year, the FHLB's extended \$4 billion in credit to the mortgage market and supported over 40 percent of members' increases in mortgage portfolios. A correlation test for January 1966 through April 1970 shows a still positive correlation coefficient, but one close to zero for which the R<sup>2</sup> value is .06. In effect, the cocyclical pattern had almost been eliminated. Examination of a monthly chart reveals substantial contra-cyclical movement in critical periods. The statements of the new Board, since early 1969, reveal a continuing contra-cyclical propensity. It is from the posture of recent years that this mechanism needs to be considered.

#### *The Development of FNMA*

The development of FNMA followed a less fortuitous and more consistent role in terms of the objectives of acting as a buffer for the

<sup>12</sup>*op.cit.* pp. 1336-38.

<sup>13</sup>pp. 50-52.

mortgage market. From 1954 through 1965, there were numbers of periods when its performance was clearly contra-cyclical. Two types of difficulties are apparent if one inspects a chart.

First, is a purely arithmetic problem. Once the net increases in portfolio reach a particularly low or high level, they tend to change more slowly than mortgage flows. This reflects, in part, the fact that FNMA has dealt only with Government-backed mortgages, thus limiting its scope to an important degree. It also reflects a variety of other frictions which are also part of the next problem.

Second, for most of its history so far, that is prior to October 1968, FNMA had either an indirect or a direct effect on the Federal budget. Thus, a chart would reveal a few cocyclical movements, reflecting restraints imposed by the Bureau of the Budget in efforts to protect the fiscal program of the Government. This, of course, interfered with FNMA's explicit responsibility to support the mortgage market.

However, in contra-distinction to the FHLB's, there has been much less uncertainty about FNMA's role within the organization itself.

FNMA's role in the mortgage market is clearly consistent with sector stability or reallocation of open market credit to the mortgage market. From January 1955 through April 1968, the month before FNMA adopted its present forward commitment process, FNMA's activity produced a small negative coefficient of correlation in relation to flows of mortgage funds from other lenders, reflecting, in large part, constraints imposed by the Federal budgetary process. Although near zero, the coefficient of correlation was minus as was the coefficient of regression. An examination of a chart of monthly data will show sub-periods in which contra-cyclical activity, in relation to other lenders, was much stronger than the correlation itself suggests. This is particularly so for the years from 1961 through 1964 when the FHLB's were strongly pro-cyclical a large part of the time.

Since May 1968 FNMA's contra-cyclical role has been much clearer and statistically more significant. The coefficient of correlation is minus .87 and the coefficient of regression with mortgage flows, as the independent variable, is minus .36. The markedly improved evidence of contra-cyclical activity between the two time periods reflects two developments.

First, FNMA became a private corporation on September 30, 1968, thereby gaining exclusions from Federal budgetary processes. This meant that the restraints on its borrowing of funds were its own net worth, its borrowing ratio, and such limitations as the Secretary of Housing and Urban Development might find appropriate. As matters developed, the Secretary has seen fit to authorize FNMA to take a strong position in support of the mortgage market. At times in 1969, FNMA was committing at an annual rate of over \$10 billion a year. Its net purchases were \$3.8 billion and its gross acquisitions \$4.3 billion.

Second, in May 1968, FNMA adopted a forward commitment program in contra-distinction to its prior over-the-counter program. Even the over-the-counter program had a mild forward component since the contract allowed 45 days for delivery and occasionally 90 days. In addition, standby commitments were made for periods of 12 months but in relatively minor volume. The new commitment process, subject to an auction procedure, offers commitments for as long as 18 months and there is a weekly or bi-weekly announcement of the amount of funds available. A majority of commitments, 60 percent, have been in the six-month category and the one-year and over group has averaged about 24 percent. Thus, the uncertainties of the over-the-counter program have been eliminated, and with substantial forward commitments in hand, loan originators have not tended to cut back on lending as they often did prior to 1968.

#### *Importance of FNMA to Mortgage Market*

The importance of FNMA to the mortgage market has varied over the years. From 1955 through 1959 FNMA's purchases were never over 11.5 percent of total home mortgages (i.e. one-to-four family) and 30 percent of the FHA volume. In 1958, FNMA actually supplied mortgages rather than funds and did so again from 1961 through 1964. In 1966, FNMA accounted for more than 60 percent of the volume of FIIA-VA home mortgages, and 18 percent of all home mortgages. In 1968, as the market for FHA-VA mortgages came under pressure, FNMA took 42 percent of the rising volume of such mortgages. In 1969, FNMA took 60 percent of this group and 24 percent of all home mortgages, and in the fourth quarter of the year the ratio to all home mortgages was 50 percent and held at that level in the first quarter of 1970.

The size and importance of FNMA as a stabilizing force is apparent from these numbers. It is also important to recognize that originators of mortgages are reluctant sellers to FNMA. It charges for commitments, requires stock purchases and stock retention, and imposes other costs that lead mortgage bankers in particular to prefer deposit institutions or insurance companies as outlets. Thus, FNMA received offers to sell only as other lenders reduced forward commitments, and currently receives offers for commitments in similar environments. It is important to bear in mind that FNMA does not play an important role until others depart or indicate their intention to depart from the mortgage market.

#### *Some Issues*

Can these two intermediaries, which jointly raised \$7.2 billion in credit markets or about 8 percent of total funds raised or about 12.5 percent of capital market and commercial paper flows in 1969, negate the effect of monetary and fiscal policy? An over-simplified set of assumptions would hold that monetary policy sets the overall volume of available credit or loanable funds and various competing entities determine its distribution among sectors. With a pre-determined, fixed supply of loanable funds these institutions merely act as reallocative mechanisms and have no effect in negating monetary policy. This answer somehow seems too pat.

Ample evidence is available that loanable funds are to a degree a function of interest rate levels although the volume of liquidity tends to be dominant. Economic units have the option of holding money or securities and shifts can and do occur between the two. Witness the fact that the income velocity of money has risen from about two in 1946 to almost five currently. The path has not been entirely smooth, with significantly sizeable fluctuations from year to year positively correlated in direction with interest rate changes. The argument could be made, therefore, that an avid issuer of securities could entice loanable funds from the stock of liquidity held by economic units thereby raising the velocity of money and offsetting monetary policy.

If the two intermediaries under discussion here are to have such a consequence then three other conditions must pertain. First, they need to be of sufficient size to have a substantial impact. Second, the elasticity of the supply of loanable funds must be such that increases

in credit demand induce increases in the supply of loanable funds which are significant. Third, we need to be certain that the absence of the FHLB's and FNMA from the fray would not result in other security issuers replacing them.

#### *Importance of Intermediaries*

As for the size of these intermediaries in relation to the total credit and equity volume, they have not been important, except in two critical years. Their only year of really substantial size was 1969. Does an 8 percent addition to flows constitute a critical margin? Certainly, if the total credit raised had been 8 percent less, then spending would have been lower, all other forces remaining unchanged. How much lower is an open and perhaps unanswerable question. It would appear, however, that a reduction in spending of \$8.2 billion expanded by some investment multiplier could have been recorded.

Second, the interest elasticity of loanable funds, with interest rates rising as credit demand increases, must be greater than zero and close to unity through the entire range of the supply curve for loanable funds. In effect, a rise in credit demand induces an increase in interest rates which causes a shift by economic units from idle balances to securities almost equal to the increase in credit demand.

While supply curves for loanable funds may have substantial elasticity at low interest rates, the elasticity declines as interest rates rise. The supply curve approaches a near zero elasticity as interest rates reach increasingly higher levels. The more inelastic the supply curve, the less will be the effect of an increase in the quantity of credit demanded on the quantity supplied. Yet, the proposition under discussion argues that elasticity of credit supply is large enough to negate monetary restraint.

This would be a strange world, indeed. For no matter what monetary policy turned out to be, increases in credit demand would attract sufficient supply until interest rates were so high and liquidity so thin that the supply of credit and, therefore, investment would shrink sharply.

In fact, the evidence denies this kind of a world. Funds raised in credit markets tend to be greater, under the circumstances of recent decades, when monetary policy is relatively easy rather than when it

is tight. The years 1966 and 1969 are characterized by reduced rather than increased credit availability; that is, restriction in the growth of money can offset any observable interest elasticity in the supply of loanable funds. The assumption that these institutions negate monetary policy seems unsustainable, although they may complicate the process.

As for the third point, the retreat of these institutions from the market may not solve the problem. Other borrowers may appear to take their place. One of the reasons given for the failure of bond yields to decline substantially so far this year is the entry of borrowers who had been waiting for a better market. If others do enter to take the place of these intermediaries, the reduction in credit demand could be zero or some number not importantly greater than zero. For example, in 1966, these intermediaries took less than 5 percent of the funds raised in credit and equity markets. Although interest rates were lower than in 1969, many of the characteristics of 1969 were evident that year. But the decline in total funds raised was less than 3 percent in 1966 compared with almost 8 percent in 1969.

There are those who argue that these intermediaries may indeed not have an important effect on the total amount of credit raised, but that their reallocation of funds tends to hurt the economy. This, it is said, results from a restraint on business capital spending as credit is diverted to the housing market. To the extent that such a diversion takes place, it may be desirable rather than damaging. Business overspending on capital in boom periods is endemic. At the same time, the restriction of housing in such periods often leads to shortages. These intermediaries may, although quite fortuitously, prevent misallocation of resources.

Insofar as fiscal policy is concerned, the issue is one of definition and relevance. The Federal budget can be defined to include or exclude a significant variety of activities. In addition, the financing by sponsored agencies or Government agencies will, if large, always have a market impact. The issue of where to draw the line around Government expenditures is beyond the scope of this paper. What is significant is how one views the budgetary position of the Government. If the view is taken that fiscal policy should bring balance to the overall demand and supply for goods and services or to the overall demand for investment in relation to savings, then the budget is to be used as a counterweight to the private sector, however defined. The need for a deficit or surplus would be based on what the

analysis of the relevant demand-supply relationship revealed. The degree of surplus or deficit would be related to the budget definition employed, and the more that one includes within the budget the smaller might be the needed deficit or surplus to achieve balance in the appropriate demand-supply relationship. Selecting one or more agencies, because of Government sponsorship, as the critical focus can be misleading. Any imbalance may be in direct Government expenditures and related revenue or in the private sector. If the role of the agencies is emphasized to the exclusion of other sectors of the economy, then the real problem can be hidden from view.

Another hypothesis which has been put forward recently appears to be the converse of the first line of reasoning. It argues that these intermediaries absorb savings that would otherwise be placed with thrift institutions. By so doing, the argument holds, there is no net gain for the mortgage market.

The key assumption here is that the supply of loanable funds is inelastic. Furthermore, it assumes that only the issues of these intermediaries attract savings away from thrift institutions. It also holds that thrift institutions have a propensity for mortgage investments approaching unity in relation to savings flows.

We can pass the assumption that the supply of loanable funds has a zero elasticity. Previous comments suggest the elasticity is other than zero, and proponents of the hypothesis may argue that this is not part of their position.

The second assumption can be rebutted on the basis of experience in other tight money episodes. Flows to thrift institutions in the 1956-57 period averaged slightly less than in 1955 in contrast to substantial increases in earlier years. The amount of funds raised by the two intermediaries averaged less than 2 percent of all funds raised, and residential mortgage flows declined substantially. In 1959, these intermediaries took about 3.25 percent of all funds raised; savings flows declined 10 percent; residential mortgage credit actually increased. The 1966 experience is more revealing. Federally-sponsored intermediaries absorbed just under 5 percent of total funds raised; savings flows declined 50 percent; residential mortgage flows declined 30 percent.

What these figures demonstrate is that flows to thrift institutions are adversely affected even when the intermediaries are relatively minor forces in the market. There seems to be only a modest relationship between savings flows and intermediary activity. For example, in 1969, the Government-sponsored intermediaries took

about 8 percent of all funds raised and savings flows to thrift institutions declined about 40 percent. Yet, in 1966, these flows dropped 50 percent, even though the intermediaries were much less active. Even more important is the fact that in 1969 residential mortgage volume (both home and multi-family) increased over 6 percent against a decline of 30 percent in 1966.

The hypothesis fails on several grounds: first, the absence of significant correlation between the taking of funds by the FHLB's and FNMA and savings flows; second, these intermediaries supply more funds to the mortgage market than they allegedly take from savers of thrift institutions. The 1969 data shows that households acquired \$5.3 billion in agency issues out of \$9.1 billion issued by non-budget agencies. Assuming that the \$5.3 billion is accurate and all of it represented a drain on thrift institutions, the investment in these securities for households accounts for only 58 percent of the funds raised by the intermediaries. Third, agency securities are not the only vehicle for household investment. Households acquired \$8.5 billion in direct Government obligations in 1969. This is reinforced by the fact that households also acquired \$8.7 billion in debt obligations of state and local governments and corporations. Thus, agency securities are not the only competitors of thrift institutions. Finally, the much greater stability of the mortgage market in 1969 than in 1966 can be attributed directly to the efforts of these intermediaries.

The hypothesis can be restated in terms that hold these intermediaries responsible for increasing interest rates just enough to cause a reduced flow of savings to thrift institutions. It would be disingenuous to argue that these intermediaries have no effect on interest rates. However, even if one assumes that their withdrawal from the market would not be offset by other issuers, the impact on interest rates would probably not be enough to stop drains at thrift institutions. As evidence, one can hark back to 1966 or even to the massive purchases by households of other securities in 1969.

The principle, perhaps, is more sharply brought into focus by the events since February when savings flows to thrift institutions have improved very substantially even though the two Government-sponsored intermediaries have remained active in the credit markets. What this suggests is that the aggregate of all credit demand, the supply of loanable funds, monetary policy, and even expectations have to be taken into account in evaluating interest rate changes. Focusing on just these intermediaries can lead to seemingly logical but erroneous conclusions.

The hypothesis that these intermediaries are a dominant factor in causing savings drain may appear to be a purely *ad hominem* argument. In mitigation, however, it should be recognized that continued expansion of the relative size of these intermediaries could have a greater impact on credit and savings markets than has so far been apparent. It should not be concluded that, since an 8 percent share in funds raised has caused little difficulty, there is no upper limit to the amount of funds these intermediaries can take. It may not be possible to specify such a limit and there probably is no fixed threshold. However, the more these intermediaries attempt to take from the market the greater the likelihood that they could have some adverse effects on their own objectives.

This last observation brings us to the crux of the question about the function these intermediaries serve and what we should expect of them.

The desire to use the mechanisms as tools for general economic stabilization has already been mentioned. There is no necessary coincidence between a need for general economic stimulation and a need for supplementing flows to the mortgage market, nor is there any coincidence between the need to restrain economic activity and limit activity in the mortgage market. In fact, the proper strategy may be the other way around.

In many periods of economic slack, the mortgage market may be amply supplied with funds. Indeed, there may be periods of general economic slack in which the housing stock is adequate or in surplus. General economic conditions and economic conditions by sector may not be and have not been in phase for all sectors at all times.

Conversely, general restraint may not necessarily indicate that instrumentalities designed to assist the housing market should reduce or limit their activity. The record demonstrates rather clearly that general credit restraint has a more than proportionate impact on housing and a less than proportionate impact on business investment. Thus, if housing supply is in balance or especially if it is in short supply, these instrumentalities should act to offset that stringency. Any funds attracted away from business investment may ameliorate the chronic tendency for business to overdo capital spending. The role of these intermediaries has to be judged on an *ad hoc* basis given the conjunction of factors in any given cyclical setting.

Nor is it wise to regard credit as the sole and indispensable cure for each and every malaise. One of the participants in Federal Home



Loan Bank System policy formation in the late 1930's related the efforts of that instrumentality to stimulate housing activity by urging member institutions to take advances and pursue mortgage loans more aggressively. This presumed an underlying demand for housing which could not be expressed solely because of the lack of credit. Yet, that was a period when income and expectations about income were the major restraints on housing activity. Expanding an already adequate credit supply in order to reduce mortgage interest rates slightly more seems a rather remote and ineffective way to try to offset depressed income and expectations.

Finally, it is well to look at these intermediaries and their future potential if the notion that they are designed to provide stability to the mortgage market is accepted and the record of 1969 is examined, the conclusion may be that the magic wand is now in hand and no further thought needs to be given to the subject.

Fundamentally, these two entities provide tactical tools for dealing with mortgage market problems. They are means for reallocating the volume of savings and such liquidity in being that can be attracted to securities. These entities do not create money or even savings. As the London *Economist* pointed out in its January 31, 1970 issue, "It is the shortage of money which pushes out (mortgage) borrowers." There is the crux of the issue--money, used in the sense of total credit availability.

The mortgage market needs the assistance of these intermediaries when the demand for credit is outrunning supply. Obviously, they can provide some correction for this imbalance, but one should not conclude that this process can be maintained indefinitely. If the savings-investment equation tends to be overbalanced on the investment side, then interest rates must rise with all the apparent consequences for the mortgage market. What is more, general economic policy which permits this tendency toward imbalance to become cumulative could defeat the efforts of these intermediaries.

While mortgage activity was well maintained in 1969, the volume of funds supplied by sources other than the two intermediaries fell by more than 50 percent between the fourth quarter of 1968 and that of 1969. To maintain a continuing demand for advances by member institutions, the Federal Home Loan Bank Board had to institute a subsidy. Had savings flows continued to fall, the ability of the intermediaries to further expand their assistance would have been severely tested, particularly since the market for agency securities would have been less and less favorable.

As a summary observation, the potential of these intermediaries has to be kept in perspective. The flow of mortgage funds through certain private lenders being a residual moving inversely to general credit conditions, the Government-sponsored intermediaries are needed most in tight money periods. That they can make a substantial contribution to mortgage market stability is evident from the 1969 experience. It is important to avoid the conclusion that they can deal successfully with all degrees of stringency no matter how long or short their duration. These instrumentalities provide us with tactical tools for combating relatively brief episodes of severe credit market imbalance, or the need for a continuing moderate supplement to move traditional sources of funds. Continuing imbalance of increasing severity could offset their effectiveness. Economic policy-makers should not assume that a tactical tool can substitute for appropriate strategic decisions. The crux of the problem is restoring or maintaining a savings-investment balance at interest levels which avoid massive diversion of funds from the mortgage market. This requires above all an appropriate fiscal policy which avoids fear of rapid inflation or induces expectations of ever rapidly expanding demand for capital goods.