

The Role of Government Intermediaries

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The most striking development in the residential mortgage market in recent years has been the massive support provided directly or indirectly by governmental or quasi-governmental agencies. Table I shows the net increases in residential mortgage debt and the portion accounted for by (a) net acquisitions of residential mortgages by the Federal Government (largely GNMA and its predecessor, the special assistance and management and liquidating functions of old FNMA) and by FNMA, and (b) the change in advances by the Federal Home Loan Banks to savings and loan associations. Over the four and one half year period from the beginning of 1966 to mid-1970, Federal support, defined as the increase in mortgage holdings of the Federal Government and FNMA plus the increase in FHLB advances, amounted to 26.1 percent of the total increase in residential mortgage debt. In the latest year and a half--from the beginning of 1969 through the first half of 1970--Federal support amounted to 47.1 percent of the increase in mortgage debt. The recent volume of Federal support is much greater than was forthcoming in earlier years; from 1954 through 1965, Federal support averaged only 5.5 percent of the total increase in residential mortgage debt and in only two years did it exceed 10 percent.¹

There can be no doubt that a portion of this exceptionally high level of Federal support for the mortgage market in the last few years can be attributed to a desire to offset a part of the disproportionate impact of restrictive monetary policy on the housing sector. At the same time, however, I believe a substantial part of it can be attributed to a change in the importance attached to housing among our national goals and to changes in the structure and functioning of the mortgage market, the full implications of which we have not yet seen. In this paper, I shall first attempt to sketch the structural changes in the mortgage market as they relate to the establishment of a greater role for governmental or quasi-governmental intermediaries,

and, second, to speculate on the functioning of the new system of housing finance toward which these developments are rapidly leading us.

Structural Changes in the Mortgage Market

Perhaps the most basic change in our attitudes toward housing and the mortgage market can be attributed to the establishment of a quantitative 10-year housing goal, calling for the production of 26 million new or substantially rehabilitated housing units in the Housing and Urban Development Act of 1968. Since 1949, the United States has had a statutory national goal of "a decent home and a suitable living environment for every American family." However, it was not until the passage of the 1968 Act that this objective was translated into a definite quantitative target. While the 1968 Act did not establish a set of policy instruments to be used to achieve the target, it did require the preparation by the Secretary of Housing and Urban Development of annual reports on national housing goals, and two such reports have thus far been prepared. The existence of a statutory quantitative national goal and the requirement of annual reports indicating the actions being taken to achieve that goal have, I believe, served to energize the activities of the Federal Government relating to housing and have led to innovations that would probably not otherwise have taken place. Whether it is desirable to have a specific national target for homebuilding alone among the many desirable activities that compete for our limited national resources is an issue on which I shall not comment.

In the wake of the Housing Act of 1968, a number of institutional and behavioral changes relating to the Federal Government's role in the mortgage market have already occurred, and a number of further innovations are in prospect.

First, the 1968 Act itself provided for an important reorganization of FNMA. FNMA was divided into two parts: A reorganized FNMA, which was constituted as a Government-sponsored private corporation to take over the responsibility for secondary market operations; and GNMA, which was established as an institution to be operated and financed by the Federal Government to continue the special assistance and management and liquidating functions of old FNMA. In May 1968, prior to the reorganization and in anticipation of it, FNMA changed its method of conducting secondary market

¹These two years were 1957 (13.2 percent) and 1959 (18.0 percent).

TABLE 1

NET INCREASE IN RESIDENTIAL MORTGAGE DEBT
AND PORTION ACCOUNTED FOR
BY FEDERAL SUPPORT ACTIVITIES
1966-1970
(AMOUNTS IN BILLIONS OF DOLLARS)

YEAR	(1) Total increase in residential mortgage debt ^a	(2) Net acquisitions by U.S. Govern- ment ^b	(3) FNM ^c	(4) Change in FHLB Advances to Savings and Loan Associations	(5) Total Federal Support	(6) Ratio of Federal Support to Total Increase in Mort- gage Debt [(5) ÷ (1)] percent
1966	\$13.5	\$0.9	\$1.9	\$0.9	\$3.7	27.4
1967	16.1	0.9	1.1	-2.5	-0.5	-
1968	18.8	1.1	1.6	0.9	3.6	19.1
1969	20.0	0.8	3.9	4.0	8.7	43.5
1970 ^b	15.5	0.7	5.5	2.6	8.7	56.1

^a Includes the categories, "home mortgages" and "multifamily residential mortgages" as shown in the Federal Reserve flow of funds accounts.

^b First six months, at seasonally adjusted annual rate.

^c Prior to September 1968, data relating to the special assistance and management and liquidating functions of former FNMA are included under U.S. Government while secondary market operations are included under FNMA. Beginning with the division of former FNMA into GNMA and new FNMA in September 1968, GNMA is included under U.S. Government.

Source: *Flow of Funds Accounts, 1945-1968: Annual Total Flows and Year-End Assets and Liabilities, March 1970; and Flow of Funds, Seasonally Adjusted, 2nd Quarter, 1970* (preliminary, August 13, 1970).

operations by substituting the so-called "free-market" system of making commitments to buy mortgages on the basis of weekly auctions for the previous system based primarily on outright purchases at posted prices.

These changes in the structure and operations of FNMA have permitted a substantial increase in the scope and effectiveness of FNMA's operations. The "free-market" system has enabled the organization to focus its support at the important commitment stage where it does the most good in sustaining residential construction. It has also permitted FNMA to determine the volume of the support it will provide while letting the market determine prices. The shift of FNMA to private auspices has taken its operations out of the Federal budget, thereby removing the budget constraint and enabling it to expand the scale of its operations substantially. FNMA's portfolio of mortgages has increased from \$6.5 billion in May, 1968, when the free market system went into operation to \$14.1 billion in July, 1970; and its outstanding commitments have increased from \$0.5 billion to \$4.7 billion over the same period.

GNMA has played an important role in the financing of the various Federal programs for providing housing to low- and moderate-income families, receiving important assistance from FNMA in carrying out this task.² In addition, the 1968 Act authorized GNMA, acting as an agent of the Federal Government, to guarantee principal and interest payments on securities issued by private institutions and backed by pools of FHA-insured or VA-guaranteed mortgages. Operations under this program have already begun and give promise of becoming more important in the years ahead.

² Since GNMA's operations fall within the Federal Budget, its lending activities add to the Federal deficit. In order to minimize the budgetary impact of the financing of Federal housing programs, a cooperative arrangement (referred to as the "Tandem Plan") has been worked out between GNMA and FNMA. The procedure works as follows: In the financing of multi-family projects of nonprofit sponsors which provide either rent supplements or interest subsidies for lower-income families, GNMA issues commitments to buy mortgages at par, while FNMA undertakes to buy them at a special price which is equal to the market price plus an adjustment for the fact that the costs of servicing these mortgages are lower than for single-family home mortgages. When the time comes for the financing to be carried out, if FNMA's special price has reached par, FNMA purchases the mortgages. If, however, FNMA's special price is below par, GNMA buys the mortgages at par and resells them to FNMA at the special price. Thus, GNMA's net cash outlay, which is a charge against the Federal budget, is limited to the difference between par and FNMA's special price.

No doubt as a result in large part of the commitment to a numerical national housing goal contained in the Housing and Urban Development Act of 1968, the Federal Home Loan Bank System has recently come to be much less dominated by its regulatory responsibilities and more concerned about supporting homebuilding through the medium of expanding its advances to member savings and loan associates. During the 10 months from March 1969 through January 1970, when restrictive monetary policy was imposing a severe constraint on net inflows of deposits to savings and loan associations, the Home Loan Bank System increased its outstanding advances by \$4.5 billion. This expansion of advances, together with a reduction of \$2.4 billion in holdings of liquid assets in part permitted by liberalization of FHLB requirements, enabled savings and loan associations to increase their holdings of mortgages by \$7.3 billion despite an increase of only \$0.6 billion in their deposit liabilities. When deposit inflows to associations began to pick up in the spring of 1970, the Federal Home Loan Bank System undertook a new program involving preferentially low interest rates on advances designed to encourage associations to postpone repayment of advances and instead to use the renewed inflows of deposits to expand mortgage loans. This program was undertaken in anticipation of the passage of the Emergency Home Finance Act of 1970, Title I of which authorized the appropriation of funds to subsidize a program of low-cost advances by the Home Loan Bank System. The Act was signed into law by President Nixon on July 24 of this year.

New System of Housing Finance

The Emergency Home Finance Act of 1970 contains two additional provisions, either or both of which may prove to be of major importance in the future development of the mortgage market. First, Title II authorizes FNMA for the first time to conduct secondary market operations in conventional mortgages. Second, Title III establishes a Federal Home Loan Mortgage Corporation (FHLMC), which is, in effect, a subsidiary of the Federal Home Loan Bank System; this new Corporation is also authorized to conduct secondary market operations in conventional mortgages, financing its operations by the sale of its own securities. The Corporation is also empowered to buy and sell FHA-insured and VA-guaranteed mortgages.

The developments I have been describing constitute the building blocks of a new-and, I believe, substantially improved-system of

housing finance in the United States which can be expected to come to maturity in the next decade or so. The essence of the new system lies in the development of a number of bridges connecting the mortgage market with the open securities markets. It is possible to sort out eight links of this kind which already exist or may develop under the new system.

1. The Home Loan Banks may make advances to savings and loan associations, enabling these institutions to expand their holdings of mortgages in excess of their inflows of deposits. These advances are financed by sales of securities in the open market by the Federal Home Loan Bank System. This link has existed and has been used to a limited extent for many years; its use has been expanded substantially in the last two or three years as a result of the aggressive attitude of the Federal Home Loan Bank Board. However, it seems likely that its use in the future as in the past will be largely confined to the offsetting of the effects of declines in inflows of deposits during periods of restrictive monetary policy. Any effort to expand the volume of advances secularly as a means of channeling additional funds into housing is likely to be unsuccessful, because of the traditional tendency of many savings and loan associations to eschew continuous indebtedness to the Home Loan Banks.

2. FNMA has the power to purchase FHA-insured and VA-guaranteed mortgages, financing these purchases by selling its own securities in the open market. As indicated above, it currently chooses to exercise this power largely through the "free-market" system of auctioning mortgage commitments, although it also purchases a much smaller quantity of mortgages to finance federally assisted housing, either directly or through GNMA. This link between the bond and mortgage markets has also existed for many years, but the scale on which it can be used has been vastly expanded since the Housing and Urban Development Act of 1968 changed the status of FNMA to a private corporation, thereby freeing it from a severe Federal budget constraint.

3. Instead of selling its own securities to finance its acquisitions of FHA-insured and VA-guaranteed mortgages, FNMA may issue mortgage-backed securities against pools of these mortgages, obtaining from GNMA guarantees of payment of principal and interest on the securities. This method of financing has already been used by

FNMA, which currently has \$1 billion of such mortgage-backed bonds outstanding. As yet, it is too early to tell whether it will prove to be less expensive for FNMA to finance its operations by issuing its own debt or by issuing mortgage-backed securities. FNMA securities are not guaranteed by the United States but are general obligations of, and are guaranteed only by, FNMA. However, FNMA has a high financial rating and has the power, in emergencies, to borrow directly from the U.S. Treasury to the extent of \$2.25 billion. Thus, it is not clear that the GNMA guarantee is capable of making mortgage-backed securities more attractive to investors than FNMA's own securities. Under some circumstances, however, there may be an advantage in the use of mortgage-backed securities, since these securities do not count against the debt limit of FNMA, which has currently been set by the Secretary of Housing and Urban Development at 20 times the sum of FNMA's capital and surplus.

4. GNMA may acquire mortgages in pursuance of its special assistance function, financing these purchases by selling its own notes to the U.S. Treasury, which obtains the necessary funds by borrowing from the public through the issuance of direct Treasury debt.

5. GNMA is prepared to guarantee mortgage-backed securities of the "pass-through" type--i.e., on which principal and interest are transmitted to the investor as collected--to be issued by mortgage lenders on the basis of pools of FHA-insured and VA-guaranteed mortgages. Indeed, an amount somewhat in excess of \$50 million of these securities has already been issued. The securities are sold on a negotiated basis to private investors in a manner somewhat similar to the private placement of corporate securities. Pass-through securities can be issued by, for example, mortgage companies on the basis of relatively small pools of mortgages (minimum \$2 million) and are intended to tap new sources of mortgage funds, such as private pension and trust funds and state-and-local government pension funds.

6. Under Title II of the Emergency Home Finance Act of 1970, FNMA may purchase conventional mortgages from private holders, financing its purchases by sale of its own securities in the market. The legislation includes safeguards designed to insure the maintenance of the quality of conventional mortgages included in

FNMA's portfolio and to assure that the funds disbursed by FNMA in purchasing conventional mortgages will go to lenders who are currently participating in mortgage lending activities.

7. The FHLMC created under Title III of the Emergency Home Finance Act of 1970 is specifically authorized to purchase, or make commitments to purchase, conventional mortgages from savings and loan associations or from other financial institutions (e.g., commercial banks) whose deposits or accounts are insured by an agency of the United States. It seems clear that the main activity envisaged for the Corporation is the purchase of conventional mortgages from savings and loan associations with these purchases being financed by issues of the Corporation's own debt. The Corporation provides, in effect, an alternative channel, in addition to the traditional advances mechanism, by which the Federal Home Loan Bank System can provide additional funds to savings and loan associations for mortgage lending, tapping the open securities markets to finance the operation. This new channel has an important advantage over advances by the Home Loan Banks as a means of adding permanently to the funds available for mortgage lending, because advances add to the liabilities of the savings and loan associations, which must, in principle at least, ultimately be repaid, whereas sales of mortgages to FHLMC do not increase such liabilities. The distinction here is somewhat akin to that between "owned reserves" and "borrowed reserves" in international finance.

8. FHLMC is also authorized to purchase FHA-insured and VA-guaranteed mortgages and to use these mortgages as a basis for issues of mortgage-backed securities with a GNMA guarantee. This provides an additional channel by which FHLMC can tap the bond market to obtain funds to be injected into the mortgage market, presumably in the main through savings and loan associations.

There are other possible channels through which the bond market might be tapped to obtain funds for mortgage lending. For example, under the provisions of the Housing and Urban Development Act of 1968 which established the mortgage-backed securities program, it would be possible, say, for a group of savings and loan associations to establish a pool of FHA-insured and VA-guaranteed mortgages, against which it would issue mortgage-backed bonds (as distinct from the pass-through type of mortgage-backed securities) with a GNMA

guarantee. However, all issues of mortgage-backed securities must have the approval of the Treasury, and it seems likely that the Treasury will want to avoid a great proliferation of small issues of these securities which would not be conducive to the development of an effective market for them. Thus, for the moment, it appears that the issuance of mortgage-backed bonds is likely to be carried out largely by FNMA as one means of financing its portfolio of mortgages. Whether it will even be important here depends upon whether experience demonstrates that FNMA can raise funds more cheaply by issuing mortgage-backed bonds than by issuing its own securities. FHLMC may also issue mortgage-backed bonds with a GNMA guarantee; indeed, as this is being written the Corporation is in the process of accumulating a pool of FHA-insured and VA-guaranteed mortgages in preparation for its first issue of such bonds. However, it seems likely that the Corporation will ultimately focus mainly on what appears to be its primary function, namely, providing support for the conventional mortgage market, financing itself chiefly by issuing its own securities.

Although thus far its extent has been quite limited, it is possible that the pass-through type of mortgage-backed security with a GNMA guarantee has the greatest promise for attracting new sources of funds, such as pension and trust funds, into the mortgage market on a significant scale. The reason is that it permits securities to be designed individually on a negotiated basis to meet to the maximum possible extent the preferences of these institutions.

Assuming that the secondary market facility for conventional mortgages under the auspices of FHLMC proves workable and develops on a substantial scale, I would expect the use of Federal Home Loan Bank advances to recede to its old function of meeting temporary liquidity needs of savings and loan associations resulting primarily from deposit withdrawals. Indeed, it might be desirable to "fund" a portion of the advances now outstanding through purchases of mortgages by FHLMC with the associations using the proceeds to repay advances. This approach seems preferable to the cumbersome procedure provided for in Title I of the Emergency Home Finance Act of 1970 of giving a Federal subsidy to the Federal Home Loan Bank Board to enable the Home Loan Banks to lower the interest rates on these advances as a means of persuading the savings and loan associations not to repay them.

Implications of the Emerging System of Mortgage Finance

By exploiting the linkages between the bond market and the mortgage market that are described above, I believe the financing of housing in the United States can be improved in some very important ways. The most far-reaching changes are likely to occur in the response of housing and the mortgage market to changes in credit conditions brought about by monetary policy.

There can be little doubt that restrictive monetary policy has a disproportionate--indeed, discriminatory--effect on homebuilding under the present institutional set-up. In part, the response of residential construction to changes in monetary conditions reflects the fact that the desired stock of housing depends upon mortgage interest rates. To the extent that housing demand responds disproportionately to changes in monetary policy on this account, there is nothing about the result that can be described as "discriminatory" toward housing. But it seems quite clear that during the postwar period, only a part--and at times probably a relatively small part--of the response of homebuilding to restrictive monetary policy can be attributed to the demand-restraining effects of high mortgage interest rates. Two other major sets of forces appear to be involved.

1. When credit tightens and market interest rates rise, commercial banks have an incentive to raise interest rates on savings deposits to attract or hold funds which they need to meet the burgeoning credit demands of their customers. If banks are permitted to raise savings deposit rates, they will pull funds away from savings and loan associations. Even if Regulation Q ceilings are used to hold down rates on bank savings deposits, as has recently been the case, the rise in open-market interest rates may induce savers to channel their savings flows away from savings and loan associations and toward direct investment in securities. Since savings and loan associations are heavily specialized in mortgage financing, such a process of "disintermediation" may drastically reduce the availability of mortgage funds. And since savings and loan associations engage heavily in the practice of "borrowing short and lending long," they often have such a large portfolio of old mortgages made at an earlier time when interest rates were lower, that they are slow to benefit from rising interest rates, making it difficult for them to raise rates on their deposits to keep them in line with market rates, even if the regulatory authorities will permit them to do so.

2. The existence of ceilings on mortgage interest rates under state usury laws--and, on occasion, of unrealistically low ceiling interest rates applicable to FHA-insured and VA-guaranteed mortgages--has at times kept mortgage interest rates from rising fully in pace with yields on competitive investments, such as corporate bonds, thereby causing investors who hold diversified portfolios, such as life insurance companies and mutual savings banks, to shift the direction of their investments away from mortgages and toward the bond market.

It seems clear that as a result of these forces, mortgage interest rates have not served to clear the mortgage market during periods of monetary restraint. Credit rationing has played an important part in matching demand and supply, with the result that some potential home buyers who would have been willing to pay the current interest rate for mortgages have been unable to obtain credit.

A great improvement in the functioning of our financial system would be accomplished if we could find a way to move from the present cumbersome and inefficient system of mortgage finance to a system in which mortgage interest rates moved in such a way as to clear the market. Under such a system all potential mortgage borrowers who were willing to pay the going interest rate would be able to find accommodation, and the elements of arbitrary rationing of mortgage funds that now exist would be eliminated.

A Market Clearing Arrangement for the Mortgage Market

The development of links between the bond market and the mortgage market of the kind described earlier in this paper provides, I believe, a mechanism which will make it possible to move toward a market clearing arrangement in the mortgage market. However, so many new institutional devices have been introduced into the mortgage market that it seems necessary to develop some kind of plan according to which they can be combined into a coherent system. Let me suggest one way of fitting together the pieces of the jigsaw puzzle.

First, every effort should be made to move toward a system in which mortgage interest rates are fully flexible. Title VI of the Emergency Home Finance Act extends through January 1, 1972, the provisions enacted in May 1968, which give the Secretary of Housing and Urban Development the power to set the maximum interest rates

on government-supported mortgages at any level he deems necessary to meet market conditions. As I understand it, the intention is to use the authority provided under this legislation to put into effect on a trial basis the dual market system for FHA and VA mortgages that was recommended by the Commission on Mortgage Interest Rates.³ This system should provide sufficient flexibility to enable the market to work effectively, and hopefully it may prove to be a transitory arrangement in the process of moving toward complete elimination of the rate ceilings. It is also necessary to continue the efforts to achieve liberalization of the usury laws applicable to mortgage interest rates in many states.

Second, I would like to see a vigorous development of secondary market operations in conventional mortgages by the new FHLMC. There are many problems involved in getting such a program under way--problems that arise mainly because conventional mortgages are not homogeneous with respect to risk and other investment properties. Assuming these problems can be solved, I would like to see the operations of the Corporation develop along the following lines. FHLMC would establish a schedule of purchase prices for mortgages having different maturities and bearing different interest rates. The yields corresponding to these purchase prices would bear a stable and consistent relationship to the current borrowing costs of the Corporation. The schedule of purchase prices would be changed frequently--perhaps once a month--as borrowing costs changed. The Corporation would stand ready to buy such mortgages as were offered to it by savings and loan associations at this schedule of prices.

Under such a system, potential mortgage borrowers should always be able to obtain accommodation, provided they were willing to pay the prevailing interest rate. Suppose restrictive monetary policy caused "disintermediation" with the result that inflows of funds to savings and loan associations were curtailed. In such circumstances, savings and loan associations could set interest rates on new mortgage loans which were above the interest rates at which FHLMC would buy existing mortgages by an amount sufficient to cover the costs associated with sales of such mortgages to FHLMC. The associations could then make new loans at these rates, selling mortgages out of

³Report of the Commission on Mortgage Interest Rates to the President of the United States and to the Congress (Washington: U.S. Government Printing Office, August 1969), pp. 63-73.

their existing portfolios to obtain the funds.⁴ If there was excess demand at the existing schedule of rates, FHLMC would experience an increase in its holdings of mortgages which it would have to finance by selling more of its own securities. As the volume of its outstanding debt increased, its cost of borrowing would rise, pushing up interest rates on mortgages until the excess demand for mortgages was eliminated and the market was in equilibrium. The adjustments to a marked increase in the demand for living space and an associated increase in the demand for mortgage credit with no change in the underlying credit situation would bring a similar set of adjustments into operation.

It would be possible to make the operations of the system symmetrical by having FHLMC sell mortgages out of its portfolio when market conditions warranted, using the proceeds to repay a portion of its debt. This could be accomplished by having it post a schedule of selling prices for mortgages that was somewhat higher than its schedule of buying prices. The yields corresponding to the selling prices might be somewhat lower than the current borrowing costs of the Corporation. Under such an arrangement, if housing demand should slacken at a time when inflows of deposits to savings and loan associations were large, instead of mortgage interest rates falling enough to insure that the entire inflow of funds to savings institutions found lodgment in the mortgage market, a different sequence of events would occur. As soon as mortgage interest rates fell enough relative to other capital market rates to be slightly below the yields corresponding to the posted selling prices of the Corporation, savings and loan associations would begin to buy old mortgages from the Corporation rather than new ones in the market. This would put FHLMC in possession of funds which it could use to retire a portion of its debt. This would serve to inject funds into the capital market generally, bringing down the general level of interest rates, rather than concentrating the downward pressure entirely on the mortgage market.

⁴It might appear that a problem could arise due to the reluctance of savings and loan associations to take capital losses on sales of old mortgages. However, this could easily be avoided by selling only recent originated mortgages to FHLMC. Indeed, the Emergency Home Finance Act of 1970 imposes strict limitations on the authority of FHLMC to purchase conventional mortgages which were originated more than one year prior to the date of purchase.

It should be recognized, however, that there are asymmetries in the system that make it less important to have FHLMC sell mortgages when interest rates decline than to buy them when interest rates rise. During periods of relatively low interest rates, the mortgage market clears under the present system. Moreover, if mortgage demand declines and interest rates fall, there is presumably some incentive for savings and loan associations to lower the interest rates on their deposits. Such a decline in deposit rates might divert funds away from savings and loan associations and help to cause a general decline in interest rates throughout the capital market. However, interest rates on deposits are notoriously sticky in a downward direction; consequently, there might be some benefit to housing over a full cycle of rising and falling interest rates if FHLMC operated asymmetrically, buying mortgages during periods of rising interest rates but not selling them during periods of falling rates. Under such a method of operation, the portfolio of FHLMC would (a) grow during periods when the private market experienced excess demand for mortgage funds because housing demand was strong relative to the volume of funds becoming available through private channels, and (b) remain constant under conditions in which the private market would clear without assistance.

Third, I would favor a continuation of the present FNMA system of weekly auctions of commitments to buy FHA and VA mortgages. This program has proved to be helpful not only in providing builders with a dependable basis for forward planning but also as a means of pumping a great deal of money into the mortgage market. I would expect, however, that the FNMA auctions would become a less important source of mortgage funds under a system in which interest rates moved consistently to clear the market. Under the FNMA auctions up to now, a very high proportion of the commitments have actually been taken up before the commitment period expired. To a considerable extent this is undoubtedly related to the fact that in periods when market interest rates are relatively high—as has been the case throughout the period since the auction technique was put into operation—the mortgage market has not cleared. That is, mortgage credit has not been available to many borrowers even if they were willing to pay the going interest rate. Under such conditions, many of the participants have undoubtedly used the auctions as a way of protecting themselves against lack of availability of mortgage funds, and auctions have helped to fill the credit availability gap.

Under a market clearing system in which borrowers could be assured of being able to obtain mortgage credit at a price, I would expect participation in the auctions to decline because borrowers would need to protect themselves only against the possibility of adverse movements of interest rates and not against the prospect of lack of availability of funds. Moreover, I would not expect as high a proportion of the commitments to be taken up as has been the case up to now. In some cases, interest rates would prove to be higher than the borrower anticipated and he would take up the commitment, but quite frequently rates should prove to be lower than he expected and it would be advantageous for him to borrow elsewhere.

I must confess that the FNMA auctions have some rather arbitrary aspects that do not really appeal to me. FNMA must decide each week the quantity of funds it is to make available. This involves an essentially subjective judgment about the amount of funds the market "needs." Second, not infrequently FNMA apparently finds that if it were to allot the full amount of commitments it initially announced as being available, it would be forced to accept offers it judges to involve "unreasonably" high prices. In such cases, the amount of funds actually allotted is cut back below that initially announced as being available. I would be happier if some way of conducting FNMA operations could be devised that was determined to a greater extent by objective market criteria and involved fewer subjective and, to my mind, essentially arbitrary decisions. It may be that in an environment in which interest rates moved to clear the mortgage market a different mode of operation involving less emphasis on quantities of funds supplied and more emphasis on mortgage interest rates as a guide to FNMA operations would be desirable.

Fourth, I believe it would be desirable to try to extend the use of the "pass-through" type of mortgage-backed securities with a GNMA guarantee. This program has not amounted to much yet in terms of volume, but it strikes me as the one element among the new instruments of mortgage finance that might be capable of attracting a significant amount of pension and trust fund money.

I view the arrangements I am suggesting primarily as a means of enabling housing to compete more effectively for its fair share of the funds available for investment in the face of the changing vicissitudes of the capital market. I do not think of these arrangements as a way of contributing--except possibly to a minor extent--to the process of

mobilizing the vast increase in mortgage credit that will be needed over the next decade to meet the housing goals set forth in the Housing and Urban Development Act of 1968. The necessary funds to meet these goals will only be forthcoming if we rearrange our fiscal and monetary policies in such a way as to achieve the necessary flows of funds through the capital market. The establishment of an arrangement under which interest rates would move to clear the mortgage market would merely mean that homebuilding would be able to obtain the share of total credit flows to which it was entitled. To the extent that it might be necessary to use restrictive monetary policy from time to time to curtail aggregate demand, the impact on homebuilding would reflect, as it should, the response of home buyers to high costs of financing. It would no longer be either appropriate or desirable to engage in frantic actions designed to cushion the impact of credit conditions on housing.

It should be noted, however, that it would be quite proper for the Federal Government to act to offset the effects of restrictive credit conditions on subsidized housing programs designed to assist low- and moderate-income families. The way to accomplish this would be to increase the subsidy payments to the extent necessary to offset the higher interest costs involved in financing such programs.

Finally, it should be recognized that the establishment of an arrangement under which interest rates moved to clear the mortgage market would almost certainly reduce the potency of monetary policy as an instrument of economic stabilization. Under the present system, the largest and fastest impact of monetary policy is on residential construction, and this impact is to a considerable extent attributable to changes in mortgage credit availability. If the availability effects on housing were eliminated, monetary policy would, I am convinced, be significantly weakened. It would take larger monetary policy actions and larger swings in interest rates to produce a given effect, and the lags of response would become longer.

DISCUSSION

HENRY KAUFMAN

I have read the drafts of Professor Smith's and Mr. Schwartz' papers with great interest. Federal agency financing deserves wide attention not only because of its increasing role in the capital market to date but also because it is time to ask whether or not this form of financing is the wave of the future and, if so, what are its implications for economic participants ranging from official policymakers to businessmen. Both papers are well-prepared statements, befitting the reputations of their authors. They argue their viewpoints exceptionally well. I find myself in accord with some of their views and I differ with others. However, it is perhaps largely the omissions in these papers which should be pondered seriously by those assessing the merits of this method of financing. I therefore want to cast in perspective the growth of Federal agency financing and thereafter call to your attention several basic issues which are definitely involved here.

The Growth in Agency Financing

Both Messrs. Smith and Schwartz emphasized the growth of the agencies involved in housing financing. This is understandable because FNMA, the Federal Home Loan Banks, and the newly organized GNMA account for a large part of the total volume of agency financing. There are, however, other agencies, some with aggressive expansionary objectives for the future. In addition to the housing agencies, there are the Banks for Cooperatives, the Federal Land Banks, the Federal Intermediate Credit Banks, the Export-Import Bank, the Farm Home Administration and TVA. These agencies have all issued their own obligations and most are "privatized" or "de-budgeted." In addition, other agencies have been proposed, including environmental authorities. I also want to mention the many guarantees which have been granted by the U.S. Government on various loan programs which I will omit from my calculations to avoid the problem of double counting.

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DISCUSSION

KAUFMAN

103

The net volume of new Federal agency financing has increased spectacularly in the past ten years. Their net new market demands averaged \$1.5 billion from 1961 through 1965 or 3.7 percent of the total net credit demands. They totalled \$4.8 billion or 8.6 percent in 1966, \$3.7 billion or 5.2 percent in 1967, \$5.4 billion or 6.3 percent in 1968, \$8.1 billion or 9.6 percent in 1969 and an estimated \$9 billion or 11 percent this year.

How does the net volume of new agency financing compare with other credit demanders? In 1969, it was nearly 60 percent of the net new corporate bond offerings, and it matched the net new offerings of municipals. Moreover, the net demands of the agencies have exceeded the new market demands of the U.S. Treasury in five of the last six years. Therefore, agency financing can hardly be considered a marginal participant in our credit markets.

At this juncture, let me turn to the issues which you should also consider in appraising agency financing. I shall name five. No doubt there are others worth evaluating.

The Problem of Enlarging Credit Demands

The Federal agencies transfer a regional or local demander of credit into a national demander of credit with efficient financing alternatives in the money market and national capital market. There is nothing wrong with this objective by itself. However, our problems in the credit markets during the past five years and perhaps in the 1970's is not really how to make demands more effective. Isn't the heart of the problem how to generate a larger supply of genuine savings in order to finance future requirements in a non-inflationary way?

Federal agency financing does not do anything directly to enlarge the supply of savings. Its main thrust is on the demand side. In contrast, as agency financing bids for the limited supply of savings with other credit demanders it helps to bid up the price of money. I suspect this is a rather costly way to redistribute savings flows. It causes considerable distortions and hampers monetary policy implementation as I shall explain later.

Who Will Be Rationed Out?

With the continued proliferation in Federal agency financing, there should be no doubt that agency demands will be large in absolute and relative terms. This is so even now, as I indicated earlier. Therefore, if the agencies will be accommodated in the credit market, you must ask, "Who will do without funds?" Who will be rationed out? Who will be the new disadvantaged in the credit market? How will they fare in their individual sectors as they are denied funds? It is unlikely to be the large well-known corporations or the U.S. Government. It is likely to be some state and local governments, medium-sized and smaller businesses, some private mortgage borrowers not under the Federalized umbrella, and some consumer sectors.

Impact of Federal Agency Programs on Economic and Financial Concentration

With the increase in agency financing, I feel that business will increasingly recognize that Government is harnessing financial resources to finance governmental objectives without adopting encompassing and meaningful national budgets. The failure to adopt meaningful national budgets will surely trigger another credit clash. This next clash, perhaps a few years off, will be a ferocious battle between the demands of Government and its powerful agencies on the one hand and those of private credit demanders on the other. In this confrontation, the credit demands of consumers, small business and lower-rated corporations, privately financed mortgages and local governments will be quick casualties. There will be no room for them in the capital markets as the Government and large well-rated businesses struggle for the limited volume of available funds. This is bound to contribute to additional economic and financial concentration in the United States.

The Problems for Monetary Policy

Professor Smith briefly touched on the impact of changing the procedure of housing financing on monetary policy. He stated in his concluding remarks:

Finally, it should be recognized that the establishment of an arrangement under which interest rates move to clear the mortgage market would almost certainly reduce the potency of monetary policy as an instrument of economic stabilization.

tion. Under the present system, the largest and fastest impact of monetary policy is on residential construction, and this impact is to considerable extent attributable to changes in mortgage credit availability. If the availability effects on housing were eliminated, monetary policy would, I am convinced, be significantly weakened. It would take larger monetary policy actions and larger swings in interest rates to produce a given effect, and the lags of response would become longer.

This problem should not be dismissed quickly. It deserves some additional elaboration. There are two conflicting objectives as the monetary authorities move to restraint under their current techniques. The seemingly laudable objective of the agency financing is to sustain the housing market and other programs. The objective of both fiscal and monetary restraint is to slow down or decrease overall economic activity. The result is a very costly delay in the economy's response to monetary restraint. Indeed, the credit demands of the agencies contribute importantly to a sharp escalation in interest rates and to the rising costs of housing.

This is quite evident by looking at the sequence of events as restraint unfolds. In the early stages of restraint, thrift institutions are encouraged to continue making a large volume of mortgage commitments by the Federal agencies even though the net inflow of savings is starting to slow down. At this stage, the net result is to intensify the competition for scarce real resources, to lift costs, to sustain inflationary expectations and to temporarily immobilize monetary restraint. Indeed, the high level of construction encourages additional business spending, thus complicating the task of the authorities. As monetary restraint persists, liquidity standards are lowered by the private sector. The decline in savings flows to thrift institutions accelerates. As the agencies provide funds to offset the savings outflow the situation is further aggravated by the attractive market rates on the issues of the Federal agencies, which further disintermediates the deposit institutions. In essence, the Federal agencies do not increase the total supply of funds in our financial system. They do, however, inflate the demand.

The Problems for Federal Budgeting

The de-budgeting or privatizing of Federal agencies brings these operations outside of the discipline of the Federal budget. To date, our leaders take credit in a political sense for the operations of these agencies. They disclaim them, however, in terms of the high interest

rates created by their credit demands. They fail to integrate them in official fiscal plans or in budgeting the wide-ranging demands of Government on economic and financial resources.

It would be highly beneficial if the Government adopted encompassing budgets including the Federally sponsored programs which are now excluded but still make demands on the economy and the credit markets. This is not to say that the programs outside the budget are not deserving, but by including them the priorities of the Federal Government will be well defined and ranked. It will also improve the alignment of the limited supply of new savings with the demand for funds, and thereby avoid much of the tension created by the current approach.

The current de-budgeting trend is surely decreasing the importance of the Federal budget as both an economic and financial document. "Privatizing" is a convenient political expediency for dressing up a faltering budget picture. As you know, it has continued even after the unified budget concept was officially adopted. Indeed, some time in the future, we may even de-budget the Defense Department. What a glorious moment--the achievement of a surplus in our Federal budget, even as defense expenditures are heading sharply higher and actually making greater demands on our resources. And then as you see displayed the new supersonic bomber of our Air Force you will be gratified to read on a highly polished equipment trust plate affixed to the flight deck, "Property of the First National-Chase-Hanover Chem Bank," and in smaller print, "Guaranteed by the Full Faith and Credit of the U.S. Government."

DISCUSSION

SAMUEL B. CHASE

I am always somewhat surprised when people argue, as Harry Schwartz does, that Federal credit programs aimed at reducing the impact of tight money on the mortgage market and the housing industry did a reasonably good job in 1969. Viewed from Missoula, Montana--a lumber mill town--things haven't looked that good.

Part of the problem is that although the aggregate figures for 1969 which both Harry and Warren Smith cite make these policies look quite effective, quarterly figures tell a somewhat different story. Between the first quarter of 1969 and the final quarter, home mortgage lending fell from a seasonally adjusted annual rate of \$17 billion to only \$13.5 billion; it dropped further, to only \$10.1 billion in the first quarter of 1970. Spending on one- to four-family houses dropped from an annual rate of \$23.6 billion in the second quarter of 1969 to only \$17.3 billion in the third quarter of 1970.

Nonetheless, I agree that these credit programs transferred real resources into housing--resources that would have been used in other industries in their absence. Harry contends that this reallocation was socially desirable--that "business overspending on capital in boom periods is endemic. At the same time, restriction on housing in such periods often leads to shortages." Thus, government intermediation, by pulling money from what would have been other uses and putting it into the mortgage market, prevented some or all of the misallocation. I don't doubt (and this gets to Warren Smith's paper too) that there are imperfections in the mortgage market, nor that there is excess demand that somehow gets arbitrarily rationed out during periods of tight money; I am sure that this happens any time a market is put through a severe wrench. But I'm not convinced that *arbitrary* rationing of mortgage credit is terribly pervasive on the basis of evidence that I have seen. Simply pointing to what most people would agree is a fact--that there was some credit rationing in the housing market during years like 1966 or 1969--does not reveal the significance of this rationing, nor the degree to which it is necessary to take steps to overcome it.

Another question that bothers me more than it does Harry is: to what extent did the government-sponsored intermediaries (FNMA and FHLBB) actually divert funds from other uses into the mortgage market, and to what extent did they simply capture funds that would have gone into the mortgage market anyway? The answer is not easily found. The fact that households acquired only \$5.3 billion of the agency issues in 1969 while they were acquiring \$8.5 billion of direct Treasury debt is not, by itself, evidence that the entire \$8 billion of Fannie Mae and FHLBB borrowing was not diverted from, say, savings deposits.

I do not seriously question that there was *some* rechanneling of money into the mortgage market, but I do question our ability to say much more than that. We simply aren't equipped to say anything definitive. Since we don't know how great a "gap" there was to fill, perhaps we ought not be upset by not knowing how much effect the programs had.

From Warren Smith's paper I learned a great deal about the numerous links between Federal programs, the mortgage market, and the securities markets. One of the things that interested me most was his discussion of the potential role of GNMA-guaranteed, mortgage-backed, pass-through securities, which may turn out to play a very important role in the portfolios of pensions and trust funds. The new programs, along with some other reforms that Warren has in mind would, as he sees it, provide a means of enabling housing to compete more effectively for its "fair share" of funds, especially in periods of tight money.

But Warren seems to discount the possibility that these government programs will add substantially to the stock of housing in the long run. While that may be correct, I am doubtful. A key question that neither paper addresses is the extent to which interposing Federally-sponsored credit agencies or Federal guarantees between lenders and borrowers provides a subsidy to housing. I suspect that the subsidy could be very substantial. For example, pension fund investment in GNMA-backed pools of mortgages might in part represent simply a breakthrough in the techniques of intermediation. But it may also represent the effect of a direct Federal guarantee or an implied or expected Federal guarantee, which goes beyond perfecting the mortgage markets. Such Federal support may be consistent with national priorities, but I suspect that if it works we will observe an enormous proliferation of Federal credit programs in other areas by the time we reach our housing goal. As more and

more programs are set up, still more will be needed to help borrowers whose potential sources of funds are being diverted into Federally-backed securities. Perhaps someday we'll all be borrowing from, or through, Uncle Sam.

Finally, I would like to raise a point that neither Harry nor Warren deals with, but that should not be ignored. That is the relation between the Federal housing finance programs and interest rate restrictions on time and savings accounts.

Without deposit rate ceilings the need for government credit programs to protect the housing industry in periods of tight money would be greatly diminished. The Federal credit programs mobilize funds to be invested in mortgages. Savings and loan associations, mutual savings banks, and commercial banks are also in the business of mobilizing funds. We restrict the ability of these private intermediaries to compete for funds in order to protect the "soundness" of the savings and loan industry. This causes disintermediation and a severe decline in the supply of mortgage credit. The greater is the resulting private disintermediation, the greater is the need for government intermediation. That is, the government programs are designed largely to raise money that could otherwise be raised by intermediaries. Under this system, as Bob Lindsay pointed out earlier, sophisticated investors are able to get out from under the ceiling deposit rates, although not without cost. So along come the government-sponsored agencies to recapture these funds and funnel them back into the mortgage market.

This procedure meets a lot of the political criticism of interest rate ceilings that would otherwise come from the housing interests. The small saver, who doesn't have an effective lobby in Washington to speak for him, takes the major beating. In effect, the savings deposit market gets segregated into two markets—one for big money and one for small money. Interest rate ceilings enforce monopoly pricing in the market for small money; the resulting profits enhance the net earnings of intermediaries, which is the object of the ceiling rates.

Given the rate ceilings, the Federal credit programs make a lot of sense. It is the rate ceilings that don't make sense. We should not, in our admiration for the way these programs helped housing in 1969, lose sight of the fact that what gave rise to most or all of the need for increased government intermediation was enforced disintermediation in the private sector. I fear that those who lose most from these rate controls are the ones who are least able to communicate with those who make the decisions.