Administration, is a step toward such integration, at least in the long run. But the bill also represents an attempt to enhance competition among savings intermediaries by extending the present network of mutual savings banks countrywide, and to enhance the flexibility of savings intermediaries by expanding their lending powers.

Ultimately, it may be desirable to have an integrated system of deposit intermediaries under a single regulatory authority, with the asset-liability structure of the member associations determined within broad regulatory limits by the individual association but with the details of regulation and any Government assistance dependent on the asset-liability structure adopted. However, that time seems far off.

Finally, it should be stressed that while the *Study of the Savings and Loan Industry* does consider the cost-benefit issues which are basic to any evaluation of the desirability of different changes in our financial structure, the analysis is limited by the state of arts. Neither the analysis carried out by the Study nor other available work provides definitive answers to a number of important questions relating to the effects of various institutional and market arrangements on economic efficiency or of different Government subsidies on housing and other demands. Much more work is required and should be carried out in these areas.

Structural Reform with the Variable Rate Mortgage

PAUL S. ANDERSON and ROBERT W. EISENMENGER

The disadvantages of interest rate ceilings on savings and small time deposits have already been outlined at this conference. In this paper we discuss a long-run plan and several shorter-run plans for eliminating these ceilings.

We conclude that the shorter-run plans are either unworkable or politically impossible. Even our longer-run plan, introducing variability in mortgage rates, entails many practical problems. These are so difficult that it is unlikely that rate variability will be widely adopted unless it is supported and actively promoted by financial institutions, their trade associations, and the Federal Government. We favor such support. Variable-rate mortgages would help low-income savers, bolster thrift institutions, and permit the elimination of Regulation Q as it applies to savings and small time deposits.

The Present Situation

The current problem of thrift institutions is often blamed on "borrowing short and lending long." However, if these institutions were using predominantly variable-rate mortgages, they would not need to match the maturity of their assets with the maturity of their liabilities.[1] The principal current problem of thrift institutions is their low yield on assets and consequently their inability to compete with commercial banks in free and open competition. In our

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judgment, thrift institutions are only able to survive because they are shored up by Regulation Q ceilings on savings and time deposits, by subsidized advances by the Federal Home Loan Bank System, and by mortgage purchase operations of the Federal National Mortgage Association.

Many economists have criticized this "jerry-built" protective system, particularly Regulation Q, because it discriminates against the low-income saver and it misallocates resources. However, those who criticize should also recommend an alternative system because no government can afford to permit large numbers of financial institutions to go into bankruptcy in any one year. If competitive forces had been given free rein in 1966, many thrift institutions would have gone under. And many which would have survived that year, would not have made it through 1969.

The Tobin Solution

In a recent article,[2] Prof. James Tobin suggests that ceilings on savings and small time deposits should have been raised 1 percentage point in 1966. He claims this would have brought a substantially increased volume of deposits to savings and loan associations and presumably to mutuals. We believe this is highly unlikely. From 1966 on commercial banks had a much faster rise in asset yields than did thrift institutions. Furthermore, as roughly half their funds come from interest-free demand deposits, almost the full benefit of their increased yields on assets could have been applied to interest on time deposits. Thus in 1966 commercial banks rather than thrift institutions could and would have taken the most aggressive advantage of higher ceiling rates. In this situation some depositors at thrift institutions would have shifted to commercial banks, and it is quite likely that deposit flows of thrift institutions would have deteriorated rather than improved.

[1]If a thrift institution has a temporary deposit run-off, a Federal Home Loan Bank, the Savings Bank Trust Company (for mutual savings banks in New York State), and the Savings Bank Trust Company Northwest (now being set up for mutuals in Oregon and Washington) can provide emergency credit. Unfortunately, the current solvency problems of thrift institutions cannot be remedied with doses of emergency credit; such credit, of course, is useful for liquidity problems.

[2]"Deposit Interest Ceilings as a Monetary Control," *Journal of Money, Credit, and Banking*, February 1970, pp. 4-14.

If thrift institutions had attempted to raise their interest rates by a full percentage point, many, if not most, would have paid out more than they earned, thereby reducing their book reserves. Prof. Tobin admits this but argues that the regulatory authorities should not be concerned about the "cosmetics" of balance sheets and income statements. He points out that the published figures for reserves and surplus of savings and loan associations increased steadily from 1966 to 1969. And he asks: Why wasn't the surplus used in this emergency to help depositors?

This reasoning overlooks the fact that published figures on reserves and surplus of thrift institutions mean little because the market value of their mortgage portfolios is around 8 to 10 percent, or about $16 to $20 billion, below book value. Thus their real reserves are already minimal. Losses on current operations would force them to sell off assets and, over a period of years, their real reserves could be pushed far below zero.

Thus, substantially higher interest rate ceilings and the resulting losses on current operations would have the following impact:

1. It would reduce the ratio of earning assets to deposits, thereby impairing the ability of these institutions to pay competitive interest rates.[3]

2. By prolonging the period of earnings weakness, it would postpone the time when Regulation Q ceilings can be lifted. In other words, excessive interest payments today are made at the expense of future payments.

[3]Some economists have suggested that thrift institutions might speculate on declines in mortgage rates in the future. If they could acquire additional savings deposits now, even at the expense of operating deficits, they could "lock in" a block of high-yielding mortgage loans. In addition to the current yield which is substantially above the cost of deposits, these loans would provide a large capital gain if mortgage yields decline. These two gains would, they claim, more than offset the operating deficit that results from the higher savings rates. What is overlooked, however, is that the higher rates on savings apply to 100 percent of deposits while only an additional, say, 10 percent of assets can be acquired with the new deposits. With this 10 to 1 adverse ratio, this type of speculation cannot possibly be profitable, with any conceivable interest elasticity of deposits (on an industry-wide basis) and any probable capital gains on only 10 percent of assets. In addition, there is the obvious point that current high yields on mortgages cannot be "locked in" since borrowers always have the option of refinancing with little or no penalty.

3. If the earnings position of a thrift institution were weakened sufficiently, deposit rates would have to be reduced, raising the threat of massive deposit withdrawals. Then the Federal Government would be forced to provide enough financial aid to induce a stronger institution to absorb the weakened one. An example of such a development is the recently well-publicized savings and loan case in California; this occurred even with present rate ceilings.

An Equitable Short-Run Remedy

Although there are clear dangers in raising depository rate ceilings under present conditions, such raising is certainly desirable. Rather than raising the ceiling and then providing the necessary Federal emergency aid on an *ad hoc* basis, it would be much wiser to devise a plan that would solve problems before the ceilings were raised. One such plan would be to have the Federal Government provide an annual subsidy which would enable thrift institutions to pay depositors, say, one-half of the interest income they forego because of interest rate ceilings.[4]

The cost of this plan would total around $10 billion over a 10-year transition period assuming that interest rates remain at present levels and that commercial banks would not require any aid. The first year's subsidy would amount to about $2 billion and would enable thrift institutions to pay 1¼ percentage points more on deposits. The required aid would decline each year with the increase in average yields on mortgage portfolios as the low-yielding mortgage loans gradually mature and are replaced with loans at current market rates. This rise in average mortgage yields would probably eliminate the need for any subsidy within 10 years if we make the assumption that interest rates do not change. If interest rates decline, the required amount and duration of the subsidy would be much less.

How could we justify this massive payment by Federal taxpayers? As will be shown later, the cost of subsidizing competitively weak thrift institutions is now borne by middle- and low-income savers. These people cannot invest in most U.S. Government and other similar securities and are forced by Regulation Q to earn a much

[4]Professor Edward J. Kane proposed a similar plan in an article, "Short-Changing the Small Saver: Federal Government Discrimination Against Small Savers During the Vietnam War" in the November 1970 issue of the *Journal of Money, Credit, and Banking*.

lower return on savings and time deposits. Thus Regulation Q imposes a substantial regressive tax on middle- and low-income people. It would be much more equitable if the tax were distributed among all taxpayers. The competitive weakness of thrift institutions results from past ineffective economic policies which generated inflation. Why should persons of modest means be forced to pay the entire tax?

Although our proposal makes economic sense, we realize that such an expensive and radical recommendation is probably not politically feasible. The plan also has difficult allocation problems. For example, should commercial banks be excluded? Should profitable thrift institutions be penalized for their good management by receiving a smaller subsidy than weak institutions?

A more feasible but longer-run solution would be to have a change in policy mix--a tighter fiscal policy and an easier monetary policy. The new mix should bring lower short-term rates and, with a given ceiling rate, a much larger flow of deposits to thrift institutions. At the same time the average yield on the assets of the thrift institutions would rise (as old mortgages were repaid) and the average yield on assets of commercial banks would fall as the prime rate declined. Within a few years this policy mix would create an entirely new competitive environment for thrift institutions.

What none of these policies would do, however, would be to prevent a recurrence of the serious competitive problem of thrift institutions in another period of escalating interest rates in coming years. Thus, we recommend the variable mortgage rate as a device which will permit the average asset yield of thrift institutions to move up and down with the market yield on long-term mortgages. Such a fluctuating yield should enable thrift institutions to survive in free competition during future periods of inflation and escalating interest rates.

Transfer of Income

A surprisingly widely held opinion even among bankers and economists is that variable rates are unfair to mortgage loan borrowers. This attitude implies that it is better for mortgage lending institutions to suffer a squeeze in their operating margins during periods of rising rates than for home mortgage loan borrowers to

have to pay higher rates on existing loans. The higher interest cost burden on a borrower is readily appreciated but the financial squeeze on a thrift institution seems to affect an impersonal organization, arousing no sympathy. As our previous analysis of ceiling rates has indicated, however, thrift institutions with their present level of real reserves do not have the capacity to absorb massive losses. As a result, Regulation Q ceilings have been imposed which keep thrift institutions viable but force depositors to bear the costs.

Under a regime of variable rates, these costs would not be borne by depositors but would be shifted to existing mortgage borrowers. The opposite income transfer would occur during periods of falling rates but the magnitude of this opposite transfer is likely to be much smaller because rates are, in effect, already variable on the downside since borrowers have the right to refinance when they wish. Thus, under fixed rates mortgage borrowers are in the pleasant situation of "Heads I win, tails you lose."

If most mortgage loans were on a variable basis today, the average yield on thrift institution assets would be around 8 percent rather than the actual 6 percent. Accordingly, thrift institutions could pay 7 percent rather than 5 percent on regular savings. Since total savings at depositary savings institutions amount to about $350 billion, a rise of 2 percentage points in savings rates would transfer $7 billion annually from existing mortgage borrowers to savings depositors. This is a substantial amount and would help savers considerably more, for example, than the elimination this year of the 10 percent Federal surtax.

How would this affect various income groups? The following table shows a percentage breakdown by income group of savings deposits owned by households and of mortgage loans owed by households. The interesting feature of this table is that families with below median incomes in 1962 held 28.8 percent of all savings deposits and owed only 11.1 percent of total mortgage debt of households. If variable rates had transferred $7 billion of income from mortgage borrowers to savers, families below the median would have received about $2 billion a year in additional savings interest but paid out only $0.8 billion in higher mortgage rates. Unfortunately the data in the table are for 1962. It is probable that in recent years many high-income households have pulled their savings out of thrift institutions. Consequently more recent data would undoubtedly show low-income families holding a substantially larger share of savings deposits but owing a somewhat smaller share of mortgage debt.

1962 INCOME	SAVINGS DEPOSITS	MORTGAGE DEBT
	(Percentages of Household Totals Accounted for by Income Class)	
0 - $2,999	15.8	3.4
$3,000 - 4,999	13.0	7.7
5,000 - 7,499	15.2	21.6
7,500 - 9,999	16.0	26.0
10,000 - 14,999	18.6	22.0
15,000 - 24,999	10.9	11.2
25,000 - 49,999	6.0	5.6
50,000 - 99,999	3.7	1.7
100,000 and over	.8	.7

Source: Projector and Weiss, *Survey of Financial Characteristics of Consumers*, Board of Governors of the Federal Reserve System, Washington, D.C., 1966.

*Median Income in 1962 was $5,200.

Help for Home Building and Other Impacts

What would be the impact of variable rates on home mortgage funds and residential construction? First, let us compare a variable-rate regime with one of fixed rates. And let us assume no ceiling rates, no FNMA purchases, and no subsidized advances by the Home Loan Bank System. In such a free market, commercial banks would attract most of the savings of thrift institutions in periods of escalating interest rates. This would be disastrous for thrift institutions, the flow of mortgage funds, and home building. In this comparison, therefore, variable rates show up very well.

Second, let us compare a variable-rate regime with the existing fixed-rate system which includes massive governmental intervention to sustain thrift institutions during periods of restraint. As we pointed out in an article in our Bank publication last spring,[5] Regulation Q and other protective devices have kept mortgage rates (in comparison to corporate bond rates) at very low levels in 1969 and 1970. Any further relative reduction in the level of mortgage rates would cause mortgage lenders other than thrift institutions to desert that market even more than they did in 1969-1970. Thus the introduction of variable rates in our existing institutional framework would not provide much additional insulation for the mortgage market and the home building industry from the effects of monetary restraint.

The variable-rate mortgage, however, would permit thrift institutions to weather periods of restraint and provide a more equitable rate to small savers. It would also accomplish these ends without our present jerry-built system of controls and subsidies. Thus, variable-rate mortgages would permit thrift institutions to create their own "free enterprise" mechanism for stabilizing home building.

Variable rates might have other beneficial social effects during periods of restraint. Most of the $7 billion transfer would be channeled to a population group with a high savings propensity. Therefore, it might serve to increase national savings. Also, the higher rates paid on savings and time deposits could conceivably encourage some people to increase their savings rate.

Encouraging Use of Variable Rates

In view of the advantages of rate variability on mortgages, particularly for the lenders, why has it not been used more extensively? Late last year, the Federal Reserve Bank of Boston surveyed mortgage lending institutions in New England. We found that about half of the lenders did make some loans with provisions for varying rates, but most banks included these provisions only in a minority of their loans. Furthermore, even in these cases, the right to raise rates was exercised only half the time. Inertia and fear of bad publicity were the chief reasons for lender reluctance to vary rates. In several cases where lenders began to exercise their rights to raise

[5] "Variable Rates on Mortgages: Their Impact and Use," *New England Economic Review*, March/April 1970.

rates across the board, a public outcry ensued. The most drastic repercussion was in Vermont where laws were passed which have virtually eliminated the use of variability. In Massachusetts a bill was introduced (although not passed) in the legislature which would limit increases in variable-rate mortgages to 50 basis points over 5 years.

All this New England experience shows that rate variability is unlikely to be adopted unless financial institutions, their trade associations, and the Federal Government provide strong leadership and encouragement.

Financial institutions and their trade associations could make variable-rate mortgages more attractive in several ways. First, they could promote tied-rate mortgages which move automatically down as well as up with national mortgage rates.[6] Too often in the past the power to change rates has rested solely with the lenders. A new state law in California requires all variable-rate mortgages to be of the tied-rate type. Second, lenders could offer an initial rate, say, ¼ to ½ percentage point lower than on fixed-rate mortgages to the borrower who chooses a variable-rate mortgage. A third inducement would be to incorporate a schedule of small reductions in the tie between the rate on each mortgage and the basic national mortgage rate. For example, if the initial rate were set equal to the national rate, the schedule could specify that in 5 years or so the rate would be reduced one-quarter of a point below the national rate with a similar reduction at the end of 10 years, and so forth. The procedure would serve to emphasize the concept of variability and should prove to be quite attractive.

The Federal Government could, of course, be most influential in promoting rate variability. Obviously, the VA and FHA should allow variable-rate mortgages to be included in their loan guarantee programs. Furthermore, the Federal Goverment could absorb the losses on these variable FHA and VA mortgages without requiring premium payments.[7] Regulatory agencies could also allow lower liquidity and capital reserve ratios if the mortgage portfolio of a

[6] We believe it would be best to have a tied-rate mortgage linked to a basic national series such as that of the Federal Home Loan Bank Board on conventional home mortgages. We agree with Mr. Puckett that use of a thrift institution's cost of funds or the bill rate would not be desirable. Nevertheless, it should be noted that some savings and loan associations are presently using their own cost of funds as the basic rate and they apparently have encountered no difficulty.

[7] This is the current practice on VA fixed-rate mortgages.

thrift instituiton consists entirely or largely of variable-rate loans. Such actions follow the spirit of the Federal Reserve System's capital adequacy formula which allows lower capital requirements against assets with less potential of decline in capital value.

If most thrift institutions offer variable-rate mortgages in the future, rate ceilings would be unnecessary. Without rate ceilings during periods of rising interest rates, thrift institutions with predominantly variable-rate loans, and, therefore, rapidly rising earnings, would be able to attract practically all the deposits away from thrift institutions with mostly fixed-rate loans. Thus, if a significant number of lenders began to use variable rates, others would be forced to follow suit in self protection.

Of course, many borrowers may continue to insist on fixed-rate mortgages. We believe they should be required to pay a higher rate for the right to escape the risk of higher interest rates in the future. Under our plan lenders who extend fixed-rate mortgages would be required to transfer this yield premium to reserves rather than paying it out to depositors. In this way higher reserves for fixed-rate mortgages would substitute for the protection provided by variable rates.

DISCUSSION

ELI SHAPIRO

The role of a discussant is, under the best of circumstances, an awkward one. This is also too apparent to me since there is much in the papers that I agree with; under the circumstances it is difficult for me to nit-pick. My earlier remarks are not intended to be criticisms of the Friend or Anderson-Eisenmenger papers. As proper authors they have addressed themselves to the topics assigned to them. I merely wish to make some general comments about housing, monetary policy and financial regulation before going on to comment specifically on both papers.

I thought I would start my comments by taking up Irwin Friend on the statement made in the first page of his paper. He talks about the justification for specialized savings institutions which get government assistance, and suggested that the restrictions on their asset and liability structures rest largely on a balancing of public policy and economic consideration. This balancing, says Irwin, requires first an appraisal of the importance of the public policy objectives involved on which, says he, economists have relatively little to comment. It is not clear to me in the context of the use of English whether he meant to convey that economists do not know very much about public policy objectives or they are concerned with means for any given ends and therefore do not talk very much about these policies. I, however, shall disabuse him on both counts very briefly.

Public Policies

In the first place we have a large number of public policies. We have a public policy in the sense that we have inflation which presumably was induced by the Congress of the United States and the Executive branch of the Government. We have a set of housing goals which were also enunciated by the government, both federal and state and local governments. We also have a series of public policies which deals with regulation of financial institutions. And so the issue really turns on how does this mixed bag of policies affect

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the outcome of one or the other of the ends that are desired. It seems reasonably clear from what I have heard transpired yesterday and certainly what has transpired today, that one of the major problems adversely affecting the housing field has been, in fact, the inflation that we have had since 1965. Very few people discussed difficulties in the savings and loan industry in the period prior to 1965, as Irwin remarked earlier. And it would seem to me that one of the major problems that we ought to address ourselves to, is that maybe it would be unnecessary to talk, as the two papers did yesterday, about the problems of housing, if we could achieve a public policy which provides a stable price level. I suspect it is not a silly hypothesis to suggest that in an environment characterized by a stable price level, housing would be supplied in quantities sufficient to meet the needs of the public.

I find it difficult to discuss the topic of changes in financial institutional structure because I am convinced that if we had gone further than Irwin did, as had the Commission on Money and Credit in 1961, and say in effect "eliminate all portfolio regulations and presumably also all ceilings on interest rates," and provide a stable level of economic activity, that the credit markets would have supplied a better end product relative to social aims. I happen to believe that, and I am concerned that somewhere in this conference a paper was not addressed to that subject. Had such a paper been discussed at this conference it might have made a lot of the other bits and pieces fit together in a better way.

Another topic I think should be discussed is the whole character of regulation of the housing industry in the United States. This regulation obtains not only with respect to the behavior of financial institutions but it is also a consequence of the variety of regulations that exist on the state and local government level. One such regulation is legislation designed to do great things for man, namely the usury statutes. Whatever their stated objective is, they have had the effect of impairing the ability of financial institutions to make mortgage funds available on terms competitive with other alternatives open to them. In effect, ceilings on interest rates on mortgages create serious problems to prospecitve home purchasers by rationing them out of the market for finance. The presence of usury statutes would create a serious if not fatal impediment to introducing variable mortgage rates as proposed in the Eisenmenger-Anderson paper.

The third thing that I would like to comment on before I talk specifically about the two papers is the rationale behind the widespread talk on the quantity of housing which is desired, i.e., 26 million housing units in the decade ending in 1978. I really do not know how much housing the American economy ought to have, and the fact that the Congress of the United States says in its wisdom that we ought to have 26 million housing starts in ten years is not really very specific from the point of view of any cost-benefit analysis in terms of what other expenditures have to be foregone if this level of housing starts is to be attained.

I, like most of us, can see a problem in connection with the desire to provide housing for the poor. You may on equity grounds desire to do something in this direction. It may take the form of rent subsidies; it may take the form of interest subsidies. I suspect it would be better handled by a guaranteed income, then let the consumer decide how much of his money he wants to spend for housing as opposed to other things. And I think that throughout the discussion of housing needs and goals there is a lack of clarity on whether you want to be concerned about housing for the middle income and the rich. My own particular view is that you may make a case for subsidizing the poor, but I see absolutely no reason why the middle income should have low cost or subsidized housing in order to retain four cars or any other combination of choices that they wish to make.

Allocating Real Resources

There is another sort of problem which I regard as really very important, which is not covered in the papers--and I do not wish to be interpreted by these remarks as criticizing the authors. We ought to worry about the whole question not only of allocational efficiency of financial resources, but also of the allocational efficiency of real resources. Let me state my proposition to you in the form of a hypothesis. In the long run it may be that the Congress of the United States and the public of the United States will really get adequate housing. And the reason they will get adequate housing is a consequence of the credit crunch, as a consequence of the growth of profitability of housing due to the fact that not much of it is being built by traditional builders and financed by the traditional mortgage lending institutions, i.e. savings and loan associations and mutual savings banks. There has arisen a disequilibrium in returns in housing, and this disequilibrium has led many corporations to go into

the housing field directly. Now, they have a great capacity to tap the capital market, and the presumption is that they also have a great capacity to expend money on research and development to develop optimum sized units for the production of housing in the United States. And I should not be surprised if when we look back at the so-called credit crunch period, it may be a turning point in the introduction of a much more modern technology in housing, a much more efficient stock of housing in the United States; it may also turn out that substantially fewer intermediaries are needed for the provision of this housing.

For a financial intermediary serves a particular purpose under certain sets of circumstances. It may be that we just have too many savings and loan associations, and too many mutual savings banks, or will have them in the latter part of the decade of the 70's as a consequence of what appears to be a very substantial interest on the part of corporations to go into the housing business directly. With their access to funds in the capital market they can avoid the regulatory restrictions that are imposed on housing finance through the regulation of financial institutions. Thus we may get more, better and cheaper housing in the United States in the future by reducing the scope of activity of the small builder-contractor and his dependence on traditional sources of mortgage finance.

The Need for Price Stabilization

Let me turn briefly to the Eisenmenger-Anderson paper which is really divided into two parts, as I think Irwin Friend's paper is also. One is a general discussion about monetary and fiscal policy, the presumption being that we want a combination of monetary and fiscal policy which in the first instance produces no inflation. Then there are some other elements to the advocacy of fiscal policy, in a combination of fiscal and monetary policy such that our stabilization policy mix will not affect the housing market unduly. I propose really not to discuss those parts of the paper for I am sure they have been discussed at earlier sessions of this conference. I would only say in passing, Irwin, that your comments on monetary and fiscal policy read as though they were written in 1960 or 1961 and that there had not been anything else written, about both monetary and fiscal policy, since that particular period which introduced a reasonable measure of uncertainty about our earlier beliefs in the relative importance of monetary and fiscal policy respectively. His preference is for heavy dependence on fiscal policy as the principal stabilization tool and his arguments read as though it were a proven instrument, and very evenhanded. I remind you of the evenhandedness of fiscal policy. In the last speech before the Congress of the United States by Joe Barr, then the Secretary of the Treasury, he pointed out the discrimination against middle income taxpayers by the revenue acts that we had passed. Thus I am not as sure as Friend about the evenhandedness of fiscal policy. Moreover, I never thought that advocates of monetary policy denied that monetary policy might not have some sectoral effects. The sectoral effects were the consequence of the sectoral effects of the market mechanism. That was the argument which was used to show the virtue of general controls rather than specific or direct controls.

Variable Interest Rates

I share the Anderson-Eisenmenger view with respect to the use of the variable rates on mortgages. I would simply repeat my earlier comment that one problem which arises is the effect of statutory limitations on interest rates which may impair the effectiveness of their proposals. I would say that if lenders have a reluctance to use variable mortgage rates then I do not see why they (the lenders) ought to be protected in their own best interests. If in fact they want to make fixed-rate mortgages and suffer portfolio imbalances and fail, then they deserve their fate. I would not protect them at all; if they wish to underprice their product, grand. The consequence is that they will probably not stay in business very long.

Now, on a purely technical level, it has been argued that a household has a certain amount of money which it allocates for housing. And in effect you would put them into a variable budget position by varying the rate, since they do not know whether they are going to have to pay ten bucks or forty bucks, depending upon the public policy which gives or does not give inflation. Well, I would say one way to get around that problem, which was not mentioned in the paper, is conceivably to lengthen the maturity of the mortgage so that, in effect, the households really have a constant out-payment. All you are doing in effect is to relax the terms to maturity to achieve that particular objective.

There are a number of alternatives, it seems to me, to the variable interest rate which I think might also be mentioned. First of all, there is the statutory requirement that lenders be able to prepay

their mortgages. Note what this does in effect. It is a one-way option which says that the borrower can always take advantage of falling rates. It seems to me, the simplest thing to do is to have the risk shared equally by lender and borrower, which is another thing which could be done in connection with a variable mortgage rate. And public policy, it seems to me, ought to move in that direction, but thus far it has not.

Another thing that I would suggest to deal with the problem of portfolio imbalance is that we are creatures of habit. We think of an amortized mortgage as being absolutely the greatest thing in the world, and it probably was a great innovation when it came in the 1930's. And it supplanted, as you know, the short-term mortgage with a balloon out at the end of a year, two years or five years. The fact of the matter is that I do not think that the amortized mortgage ought to be the sole mechanism for borrowing against real property. For the notion behind the amortized mortgage was that the lender's risk would be reduced by the amortization, and the borrower would be required to repay serially on the mortgage that he had taken.

I believe there is a lot of attractiveness to a non-amortized short-term mortgage. In the first place we seem to be generally convinced that major depressions are a thing of the past, and I think it was the fear of major depressions that led to interest in amortized mortgages. In the second place, when interest rates were low, and the typical maturity on a mortgage was 12 or 15 years, I think that it probably was true that the borrower repay a fair amount of his principal over a relatively early period of time. For example, a borrower under a 5 percent, 15-year mortgage would, under the terms specified, reduce his indebtedness by 25 percent during the first 5 years, and by 58 percent during the first 10 years. But today with interest rates at 8 percent and maturity terms of 30 years, the required reduction of principal during the first 5 years is only 5 percent and during the first 10 years only 12 percent. So that in fact, the amortized mortgage is not really reducing the principal amount by very much, and there ought to be some innovative lenders to say in effect, "You want mortgage money? Fine. We'll give it to you on an old-fashioned kind of instrument, namely a relatively short-term mortgage." And I suspect they are able to protect themselves against changes in interest rates, and therefore preserve their opportunity to remain in business in a world where they are in portfolio imbalance. These and related proposals seem to have more to offer than talk of the cosmetic effects of income and balance sheet statements of Jim Tobin. I find it sort of strange for a man who spends most of his

professional life working in portfolio theory and dealing with such variables as risks, returns, and liquidity, talking about the "cosmetic effect" of an unrealized capital loss.

Need to Improve the Mortgage Instrument

Irwin Friend enumerates the whole list of proposals which is very directly responsive to the title of his paper, and I must confess I have absolutely no objections to any of them. I think they are all desirable. They do not go as far as I would go, since I am a free portfolio man, and my only objection is, why not go a little bit further, Irwin? And I think also his comments about the necessity for the improvement of the nature of a mortgage as an instrument are extremely well taken, and here I think you are again subject to state regulation which really makes these mortgages infirm in the sense that foreclosure procedures and various other procedures differ from state to state. And here, too, we observe a case of government regulation impairing the quality of a mortgage in competing with other capital market instruments in tapping the savings of the public.

Now, whether we have ceilings on interest rates or not, the fact of the matter is that the Federal Government has in many ways protected the thrift institutions in the sense that they will not issue competing instruments in sizes that will drag money out of financial intermediaries. But what the government will not do, I assure you, A&T will; for one day they will offer 8 percent one hundred dollar bonds, easily available at every office of the telephone company. You are still going to have problems in the mortgage field, unless you permit the traditional mortgage lending institutions both to bid for funds, and to be able to earn rates of return on their assets that will be competitive with the alternatives that will be open to even small savers.

Impediments to Housing Construction

At one point Irwin goes through an attempt at a cost-benefit analysis, which being an honest man, he admits is very imprecise. The fact is I do not know whether you can talk about the cost-benefit analysis with respect to asset changes and liability changes in financial institutions alone, or whether you really have to talk about alternative ways of achieving the same purpose. Needless to say opening the choices gets to be even more imprecise. For I would submit to you, as an assertion not as a fact, that we would do

substantially more in the way of improvement of housing production in the United States, not by alterations in the credit machinery, but by alterations in the amount and extent of regulation on the federal level, state and local government level, including the labor union level, building codes, etc. These are really impediments, it seems to me, to the construction of an efficient housing industry in the United States. And while I do not mean to imply that either of the papers ignored this or would differ with me, I simply think we would get more mileage from my suggestions than would be the case if we only unbundled the asset and liability sides of financial intermediaries.

Equity Among Financial Institutions

There is one concern I have with Irwin's paper--he hinted at it, I would prefer to see it made very much more explicit. The argument about changing the domain in which savings and loan associations can operate would be, as I said earlier, a movement in the right direction in my estimation. The problem becomes one of interinstitutional equity, for I would hope that he would argue that the same sorts of treatment would be given to other financial institutions that have to compete with the savings and loan associations for the savers' dollars. I think this is a rather important problem in the implementation of any of these proposals for, ultimately I suppose, it boils down to which of the two groups of the financial institutions has the largest power bloc in the Congress of the United States, which is not always necessarily in the public's best interest. I suppose we would want to argue that if you are going to eliminate rate ceilings on S & Ls, you really ought to permit commercial banks to compete more effectively for demand deposits as well as for time deposits.

Now, again I do not personally have any major concern about giving checking rights to the thrift institutions, and Irwin's argument is that there is an advantage that you have in competing for savings if you have a full line of financial services which may be offered to the public. My only concern about the granting of that power to the savings and loan associations is that they should then be subject to all of the restraints of competing institutions on which Irwin was, I think, quite explicit. The problem, however, is if you are talking about the optimum number of checkeries in the United States, it is not clear to me that by giving all these institutions checkery rights that we will have the appropriate scale and number of check issuing

firms in the economy. Though I can raise the question, I certainly cannot answer it.

In conclusion most of my remarks are not directed at the papers, but are directed at issues that really should be raised in this conference for I think they are at least as critical as the issues which are being addressed to the financial machinery. I might say in closing that if it is true that our housing needs for the 70's are very largely conditioned by the need for multiple-family housing for the young and as I expect also for the poor, I am not at all sure that the savings and loan industry in its historic operations is really the one to worry about. Somehow or other there is a vast body of lenders that has historically done a great deal in the multiple-family business, and I suspect that what we ought to do is to give access to savings pools to all those institutions that are efficient in the financing of multiple-family housing--which I believe to be the major housing requirement in the decade ahead.