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THE OUTLOOK FOR HOUSING AND THE THRIFTS: 1980

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BEFORE THE

JOINT ECONOMIC COMMITTEE CONGRESS OF THE UNITED STATES

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WEDNESDAY, NOVEMBER 28, 1979

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, D.C.

The committee met, pursuant to notice, at 10:05 a.m., in room 1318, Dirksen Senate Office Building, Hon. Lloyd Bentsen (chairman of the committee) presiding.

Present: Senators Bentsen and Sarbanes; and Representative Heckler.

Also present: John M. Albertine, executive director; Deborah Norelli Matz, professional staff member; Mark R. Policinski and Carol A. Corcoran, minority professional staff members; Betty Maddox, administrative assistant; and Michael Nardone, research assistant.

OPENING STATEMENT OF SENATOR BENTSEN, CHAIRMAN

Senator BENTSEN. The hearing will come to order.

I am pleased to welcome our distinguished witnesses this morning to discuss the outlook for housing and thrift institutions.

At this point in time, both the housing and lending industries appear to be at crucial thresholds. The lending institutions are borrowing at record interest rates, and mortgage lending nationally has slowed and in some States has virtually dried up. In addition, housing starts are down significantly, and the high costs of houses and financing are turning the American dream of homeownership into a nightmare.

The duration and severity of this situation has significant ramifications for all potential homebuyers and sellers, as well as for our entire economy. The ripple effect goes through the entire economy.

One result of the skyrocketing inflation affecting the Nation and the ensuing high interest rates seems likely to be an end to the housing boom which we have recently been experiencing. In Houston, for example, we have already begun to feel the pinch—sales of existing homes are down 11 percent in the first 9 months of this year, and building permits for new housing units are off by 18 percent.

Now, that parallels the national trends. Housing starts in October were down 14 percent from a year earlier and building permits are off almost 16 percent.

In addition, the purchase price of new homes nationally continues to increase dramatically. In September, the median price of new homes reached an incredible $67,000. If these trends continue, homeownership for young couples will become a luxury for the privileged few in this country.

Tight monetary policy likely will further impact these trends—the average interest rate on new mortgages across the country has soared to 12 percent, and in some locales is even higher. Hopefully, the recent reduction in the prime rate will soon be reflected in reduced mortgage interest rates.

But a greater problem to home purchasers and developers appears to be the availability of funds—at any price.

In many States, mortgage lending has slowed down drastically or has virtually dried up as interest rates being paid by lenders has approached or overtaken allowable interest charges on mortgages. That means that in more and more States, houses simply cannot be purchased at any price—and mortgages are just not available.

Unfortunately, this is much more than a banking problem. The potential result of this situation could wreak havoc on the lives and the livelihoods of untold numbers of Americans.

I don't mean to minimize the problems confronting the thrifts. I realize that in recent months the high cost of borrowing has squeezed their profits and in some instances disintermediation has occurred and is accelerating.

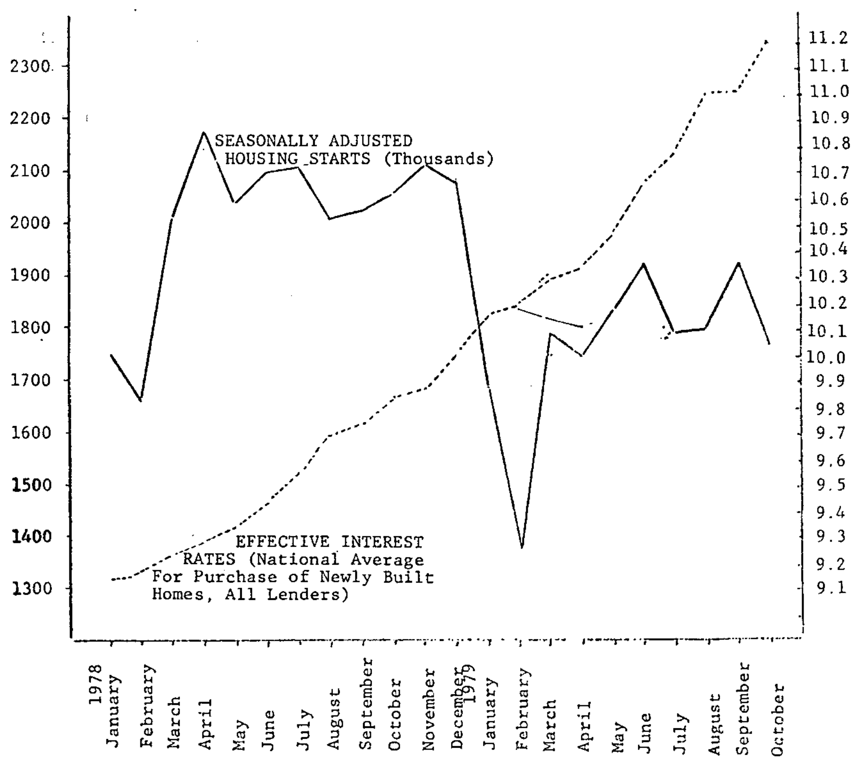
I am very concerned about the potential severity of these problems and about the future prospects for the thrifts. A healthy housing sector with an adequate supply of affordable homes depends, to a very large degree, on the soundness of the lending sector. Because these sectors are directly affected by and, in turn, significantly affect our national economy, their importance just cannot be overstated.

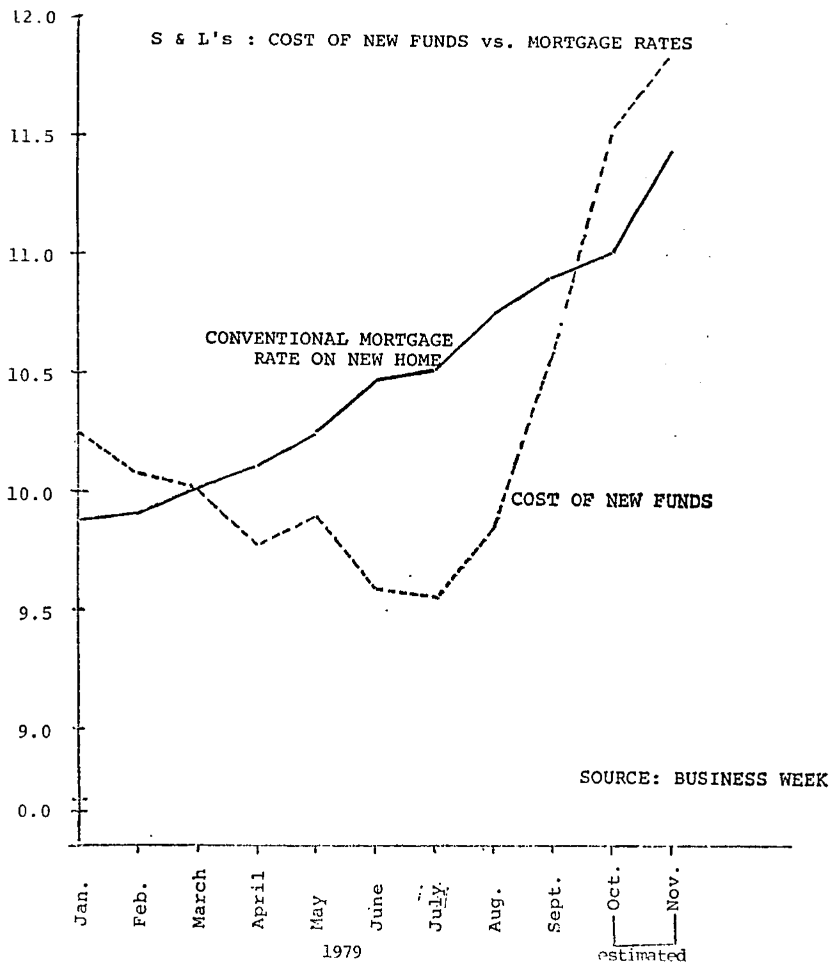
I look forward to hearing your analyses and projections as well as any recommendations you may have to sustain these sectors without exacerbating the rampant inflation in our economy.

I have two charts on easels behind me, prepared by the committee staff, which, without objection, we will place in the hearing record at this point.

[The charts follow:]

HOUSING STARTS AND INTEREST COSTS





Senator BENTSEN. Our first witness will be the Honorable Jay Janis, Chairman of the Federal Home Loan Bank Board.

Mr. Janis.

STATEMENT OF HON. JAY JANIS, CHAIRMAN, FEDERAL HOME LOAN BANK BOARD, WASHINGTON, D.C.

Mr. JANIS. Thank you, Mr. Chairman. It is a pleasure to be here with you this morning. I have a prepared statement that I would like to submit for the record, and with your permission I'd like to just summarize briefly the highlights of that statement.

Senator BENTSEN. All right.

Mr. JANIS. There is no question that the external environment in which housing and thrifts are operating in this year and the coming year is a very difficult one. The near-term outlook is extremely poor. It is poor because of inflation, generally, including the problem of escalating oil prices, because of general poor productivity in the U.S. economy, and because of the need to bolster the U.S. dollar abroad.

There is no question in my mind, Senator, that the Federal Reserve Board actions of this year and in particular of October of this year will have a significant impact—negative impact—on housing and on the thrift industry. But, nonetheless, I find myself in support of those measures in the hope that their action will lead to success in meeting inflation. And I find that, in my judgment, inflation is the No. 1 enemy of housing and the thrift industry.

With regard to the recent state of the housing markets—and now I am talking about essentially pre-Fed action in October—there is no doubt in my mind that based on normal circumstances we could have expected a much worse housing picture during much of 1979.

Housing has slowed somewhat. Starts are down in the range of 12 to 13 percent from 1978 levels. But that is better than what we might have expected. And I think housing starts of 1.76 million in October, which is the annualized rate, suggests a higher number than what is coming in the future.

I think the reason that housing has done better in the earlier part of 1979, despite the movement by the Fed to generally tighten rates, can be explained by several factors.

One is the demographic pressure, the fact that there are young families being formed in greater numbers today than there have been in previous years. There is that population bubble moving through.

Second, there is the so-called investment psychology, the fact that families are not just buying housing for shelter but they are doing so in some cases because they see housing as an investment in an inflating market.

Third. The creation of new liability instruments, the ability to borrow by the thrifts—I'm talking now about the money market certificates, the jumbo certificates, large certificates over $100,000 which are not regulated as to rate, and outside borrowings—has provided more funds for housing generally. In a normal period, we would be disintermediating more than we are at the present time.

Senator BENTSEN. Is that microphone turned on? I'm not sure everybody can hear what he's saying and it's terribly important.

Mr. JANIS. I can talk louder, if you wish.

Senator BENTSEN. We have some people who are interested in this hearing and want to hear what you have to say.

Let me get one thing straight. I am concerned about young couples and what they are going to be able to afford.

Let's look at the numbers on the charts our staff has prepared. When you say we have an increase in young married couples, you are assuming that this will mean an increase in the demand for housing, at the same time we are seeing the median cost of a new home escalating to what? $67,000, isn't it?

Mr. JANIS. That number is correct.

Senator BENTSEN. As we look at the first chart, we see interest costs escalating up to about 12 percent, and we see housing starts going down, and you tell me that we have an increase in the formation of families, young couples—what will it mean to a young couple that wants to buy a new home next year? How are they going to be able to afford it? What kind of monthly payments will they have? If you are talking about a $67,000 house and there is a 30-year mortgage, and the interest rate runs 12 percent, what kind of a monthly payment are we talking about? How much more is it if that monthly payment is based on a 12-percent interest rate as opposed to a 9-percent interest rate? What happens to the monthly payment?

Mr. JANIS. I don't have those figures with me, but it's approximately $135, Senator.

Senator BENTSEN. For what period of time?

Mr. JANIS. Per month.

Senator BENTSEN. Per month in additional cost?

Mr. JANIS. Oh, sure.

Senator BENTSEN. If the interest rate is 12 percent as opposed to 9 percent?

Mr. JANIS. Yes. What it does effectively is take a lot of people out of the market in terms of their ability to afford new housing and to afford a mortgage generally.

Senator BENTSEN. What you mean is that for young couples trying to buy their first home, only a privileged few will be able to buy one at those kinds of interest rates and those kinds of monthly payments.

Mr. JANIS. That's right. If you look at housing costs, base it on what incomes are today and compare the two, you have a significant drop in the number of people today that can afford a new house. I used to know that number and I will be happy to submit it for the record. But I think, depending on what assumptions you make, approximately 15 percent of the population today can afford a new home based on what assumptions you make. It is a dropping number.

Senator BENTSEN. I want that number for the record, because it shows what a serious problem this is.

Mr. JANIS. Yes, Senator.

[The following information was subsequently supplied for the record:]

Assuming a $65,000 sales price, a $52,000 mortgage (20 percent down) and a 30-year term, approximately 15 percent of American families can afford this home at today's interest rates (13 percent).

The monthly payment (principal and interest) would be $575. Add to that $215 per month in related housing expenses for a total monthly payment of $790. The annual income needed to afford this level of monthly payment is $37,920, assuming that 25 percent of income goes to housing expenses. Approximately 15 percent of American families had annual incomes of this level or more. Of course, if homebuyers decide to devote more than the traditional 25 percent of income of housing expense, as they have been doing in increasing numbers, the 15-percent figure would rise.

If the interest rates and other housing costs that prevailed 10 years ago were in effect today, the 15-percent figure would double.

Mr. JANIS. The importance of the number—comparing it with some years ago, with the same types of assumptions, where a much higher number of people could afford a new home, it was much higher than today. And I'll explain that.

Ordinarily, housing includes the existence of the secondary market and the fact that other lenders today, other borrowers, are coming into housing and housing's increased ability to tap capital markets.

What I mean is that as a result of such instruments as FHLMC, FNMA, and GNMA, for instance, and the use of mortgage-backed bonds, and mortgage pass-throughs which are available now to the thrift institutions, what we are able to do is tap the capital markets for housing-related certificates in ways we weren't able to in the previous recession. That has mitigated somewhat the availability of funds.

Another favorable factor over the earlier part of this year is that other lenders have gotten interested generally in real estate—life insurance companies, pension funds, and so on.

Also there is a lack of overbuilding as we had in the 1974–75 period. In that period we had much larger inventories than we have today, and apparently builders have learned a lesson. It has kept inventories generally low.

And finally, of course, subsidy programs have increased as compared to 1974, and that has helped housing somewhat.

And all those factors have made housing look better in 1979 than the economic conditions would seem to justify.

But, as a result of the Fed action in October, there is no question that there has been a falloff of activity, and this falloff will continue well into 1980.

Let me indicate some of the consequences of the October 6 action of the Fed.

For one thing, mortgage rates moved up as a result of that action by 1½ to 2 points nationwide. We are presently looking at mortgage rates between 13 and 14 percent, and I heard of a rate in Detroit just yesterday on a 30-year, 25-percent-down loan of 15.2 percent. That is the highest number I've heard.

Senator BENTSEN. That is a 30-year mortgage and you heard of one that was over 15 percent?

Mr. JANIS. Yes; 15.2 percent, with a 25-percent down payment, which is standard.

Senator BENTSEN. Twenty-five percent down payment?

Mr. JANIS. Yes, sir. And that's a high.

Senator BENTSEN. Let's try to relate this, because what people finally decide is based on what is my monthly payment? Can I really afford to buy a new house? This is my income, and this is what I have to pay for groceries, and how much can I pay for the house?

We used to think of 9 percent as being a very high interest rate. But, if it went up to 14 or 15 percent—I understand you to say we're talking about several hundred dollars a month more in payments?

Mr. JANIS. Yes, sir.

Senator BENTSEN. Several hundred a month more in payments?

Mr. JANIS. Oh, yes, when you go from 9 to 12 and 13 percent, sure. Maybe one of my economists could give us that exact number while we are talking.

Marshall, do you have that?

A VOICE FROM AUDIENCE. I don't have the exact number, but it's certainly at least a couple hundred dollars.

Mr. JANIS. Yes; it's got to be.

Senator BENTSEN. So it just means that we are going to end up with very, very few young people being able to afford their first home.

Mr. JANIS. Yes; that's right.

Senator SARBANES. Not just young people; anybody at all. Another couple hundred dollars a month——

Mr. JANIS. Let me tell you where we are right now on interest rates. As I say, I think we are dealing in the range of 13 to 14 percent—I'm talking about nonusury States now. And in those States, as I say, we are in a 12 to 13 to 14 percent range. It is instructive what happened in California just over the last couple of weeks. As short-term rates began to go up as a result of the Fed action of October 6, the S. & L.'s began to raise their mortgage rates about half a point a week. When they went from about 12 to 12¼ to 12½ to as high as 14, what they found out at 14 percent they had really cut out effective demand. In other words, people couldn't qualify at 14 percent. Builders wouldn't go ahead on that basis. They were worried about the ability of buyers to qualify.

So they dropped their rates down to 13 percent and then to 12¾—many of them. At 12¾ they were swamped. Demand started back again. In fact, at Home Federal Savings & Loan, the largest savings and loan in the country, it was reported to me the number of applications for appraisals went from about 20 per week, which was at a rate of 14 percent, to 200 per week when the interest rate got down to 12¾ percent.

I understand the rates in California have gone back up a little now to about 13. It seems to be, by and large in the rest of the country, when you reach rates of 13½ or 14 percent, you are cutting out effective demand.

A part of the problem, I think, is the rapidity with which rates increase. The market seems able, in my judgment, to be able to afford increases to 9, 9½, 10, or 10½ percent. When it was relatively gradual, there was a feeling on the part of the buyer and the part of the builder that people could adjust to this, that inflationary expectations were pushing and helping that concept. But the quick jolt of the October 6 acion was to increase mortgage rates almost overnight by a point-and-a-half, say, or almost two points. And that was more than I think the psychology of the typical buyer could take, as well as his pocketbook.

Senator BENTSEN. Well, what happens to points on the front?

Mr. JANIS. Well, points on a conventional loan approximate a point and a half across the country. That is conventional. On FHA and VA it's different.

Senator BENTSEN. What does the builder have to pay on the front?

Mr. JANIS. That's another thing, and that is hurting builder activity. A builder will usually pay about 2 percent over prime. The prime got up to 15¾ and it's back to 15½, although I understand Chase dropped yesterday to 15¼. But say you are paying 2 points over that for a construction loan, plus you are paying discount points——

Senator BENTSEN. You are paying discount points on the front?

Mr. JANIS. Construction loans to builders?

Senator BENTSEN. Yes.

Mr. JANIS. The coupon rate of a construction loan could be 17½ or 18, but with points the effective rate to a builder could be 18 or 19 percent, maybe 20 percent in a few cases. That means the cost of this construction money is in the 18- to 20-percent range.

Senator BENTSEN. And he has to add that to the cost of the home, and it's passed on to the consumer?

Mr. JANIS. That's right.

Senator BENTSEN. And it is a highly inflationary result.

Mr. JANIS. Yes. And there is no question that this does inflate the cost of housing. And it is one of the reasons builders by and large today are saying, "Maybe we should go fishing for a few months. I don't think as a builder that I can sell a house that is going to have that high an interest cost involved in it in terms of my construction money." I think that is the mentality of several builders. It certainly would be mine if I were a builder.

Senator BENTSEN. When you look at the charts you see what happens to these savings and loan associations. We see the cost of the new funds escalating above the conventional mortgage rate.

Mr. JANIS. Yes. That would suggest to me several things. First, if you look at the dashed line, the cost of new funds, and look at the rapid, almost vertical line from August through November, you can see the rapid rate at which the cost of new funds has gone up. I think the slope of that line is very significant.

Senator BENTSEN. And new funds are generally relatively short-term as compared to their assets, to their outstanding loan portfolio?

Mr. JANIS. That is exactly right.

Senator BENTSEN. So you are talking about an average portfolio with a—what? Maybe more on the order of an 8-percent return?

Mr. JANIS. Let me give you a national average. The national average is 8.7 percent. I am talking about the first half of 1979 which is the last period I have figures for. The cost of money is 7.23 percent. That is a pretty narrow spread to operate on. In fact, it is less than what it needs to be for sound operations, in my judgment.

But the significant factor is that that cost of funds, which is 7.23 for the first half of the year, is going to be very much higher when we get the numbers for the second half of the year, narrowing that spread even further.

The simplest way I can put it is that S. & L.'s and thrifts generally are in the business of borrowing short and lending long. That works in the normal economy with controllable inflation. But when you have inflation that is double digit or higher, what you have, first of all, is savers that aren't very interested in saving when the rate of return on their savings is not going to equal or exceed the rate of inflation. And you have lenders caught in a situation where they won't want to make a long-term, fixed-rate loan and get paid back in cheaper dollars over time.

Senator BENTSEN. Mr. Janis, I had before the Senate last week an amendment to the windfall profits tax to allow an exemption on interest earnings. Practically every nation in the world has some incentive for savings that would allow an exemption up to certain amounts, to encourage those kinds of savings. And we are going to be meeting with the Finance Committee tomorrow to consider my proposal.

But do you believe that if we had an exemption on interest from savings accounts to some reasonable level to try to encourage the small saver, it would have a very positive effect on the inflow of savings in this country?

Mr. JANIS. It depends. I would say that if we are talking about an exemption of $100 or $200—I know what your bill says, Senator, but I have seen some others—those kinds of levels are not going to really attract any new savings. That is not enough. I think that higher amounts, amounts in the range of $500 to $1,000, could well——

Senator BENTSEN. Well, I'm starting at those levels.

Mr. JANIS. I know you are.

Senator BENTSEN. And it feeds on up to try to attract the additional amount that you're talking about.

Mr. JANIS. Yes; and I think it's wise, if we are going to look at that kind of approach, that is to say a tax incentive, that we think about higher numbers. I think you are quite right in looking at higher numbers. Otherwise, at lower numbers all we are doing is having a substitutional effect.

Senator BENTSEN. Yes.

Mr. JANIS. I would comment further on your proposal, if I might. If I might suggest, you might want to consider the possibility of a tax credit rather than a tax deduction, for the simple reason that a tax credit would represent progressive taxation, whereas a tax deduction would regress in terms of those it helps.

One of the key things——

Senator BENTSEN. I have given consideration to that, and I am interested in that as a possibility. We run into the possibility of the 1976 tax where we went into percentage computations, and we had an incredible amount of errors in returns, so I'm trying to find some balance in that.

Mr. JANIS. One of the things I think we all need to look at is the cost-benefit question about whether that device is the best way in which to promote savings in this country, which is a very important goal in terms of the inflationary economy, in that it would certainly take some money out of inflationary buying.

I think that would be something that would need to be looked at carefully by your committee.

Senator BENTSEN. Senator Sarbanes.

Senator SARBANES. Mr. Janis, there is one question I am very much interested in asking. As I look through your prepared statement and listen to the questions, I see that most of it is directed to this point: Are we going to be able to balance supply and demand, whatever interest figures end up doing that? You use the California example, and you are talking about the inflow of funds into the housing market and so forth.

But I am really concerned with a much more fundamental and broader question, and that is: What does it imply in terms of national policy objectives if people find they have to pay 13, 14, or 15 percent for home mortgage money instead of 7, 8, or 9 percent?

You dealt with the fact that they weren't even coming in. You said the figures then dropped back a little bit and they began coming in again.

Mr. JANIS. Well, that is in California.

Senator SARBANES. That is in California only?

Mr. JANIS. Yes.

Senator SARBANES. But even if that is happening across the country, the fact remains that the people are taking on a much, much larger obligation to obtain housing, and therefore consuming a much larger portion of their budgets for that purpose. What is the implication of that as you look down the road in terms of housing policy?

You have been at HUD and have been the Under Secretary there, so you have the benefit of a somewhat broader view. What is the implication of that?

Mr. JANIS. Well, I have to answer that two ways—short term and long term—if I could. But just let me comment on the larger issue that you raised.

Some numbers I saw recently suggested that families are now paying about 35.7 percent of disposable income for their housing and housing-related expense. That compares with about 17 or 18 percent 10 years ago. I think you're dead right. The percent of disposable income going to housing has almost doubled in a period of a decade.

Senator SARBANES. Let me get that straight. Ten years ago the average was about 17 or 18 percent for housing?

Mr. JANIS. I will give you an exact figure for the record, but I know I'm very close on that. I know I was back in HUD in the 1960's as executive assistant to Secretary Weaver. And I remember we considered 17, 18, 19, maybe 20 percent for a renter and 25 percent for a homeowner as the absolute maximum that families ought to pay. And the national average in those days was running 18 or 19 percent.

Senator SARBANES. And it's now up to 35 percent?

Mr. JANIS. 35.7 percent is the latest figure I've seen. And that is a serious thing. What is happening is that people are reaching out.

First: There are more two-earner families. The wife or the spouse sometimes is working, and we are talking about two incomes, sometimes three incomes, in the family to make up the cost.

Second: We are talking about people reaching out and being willing to pay a higher percent because they look at housing partially as an investment in an inflating economy.

Now, I'm not sure that is a good idea, and people have asked me both professionally and personally whether they should buy a house as an investment and reach out and pay 35 to 40 percent of income. My feeling on that is it's not a good time, and it's not a good idea to speculate in housing. If people can afford a house and can carry it and need it, then in my judgment they should go ahead and buy it—perhaps not right at the moment, but in general over the coming year I think it's a good idea to buy a house if you need it. But to reach out and speculate might be a bad idea.

But you ask me about the national housing policy implications and I say this: I expect housing to improve substantially as we get out of this crunch in the 1980's, and I expect thrifts to get out of the crunch and experience better earnings as we get out of 1980 and into the rest of the decade. The demographic factors are that strong. The number of people that will reach the age of 30, which is a family-formation age, in the decade of the 1980's is 43 million Americans. This compares to only 32 million Americans in the decade of the 1970's.

So we've got that population bubble coming through that we are all familiar with.

Because of that, because of the productive capacity of the industry, and if we can get inflation under manageable proportions, if we can somehow get a handle on that, and if oil prices don't react too negatively, then I think the outlook for the 1980's is generally bright for housing. It is not so bright for the lower end of the spectrum, for the low- and moderate-income sectors of American young home buyers.

In terms of substandard housing issues today in America, I think the problem is serious. And I think there we might think about some kind of national commitment, say by the year 2000 or whatever other date is appropriate, to try to do away with substandard housing in this Nation. I think that is a laudable goal and one the leadership of this country should consider.

Senator SARBANES. Well, that doesn't quite answer my question. I can understand that if the demographics are moving in the direction you indicate for the 1980's that the demand for housing may be strong. But again, what is the implication of the portion of people's budgets given over to housing, which, as you have indicated, has already doubled—and that was before, I assume, we started dealing with the kind of mortgage interest rates that we are talking about here.

What is the implication if that portion of people's budgets is going to be consumed in the housing sector alone?

Mr. JANIS. The trouble is I guess we don't know how much of that sizable increase is due to investment psychology, the fact that people are in part investing in homes and willing to take a larger proportion of disposible income and devote it to housing, not just as a consumer item but as an investment item. There is that built-in aspect. I don't want to minimize it, but none of us, at least on my side of the table, understand how much of an investment factor is present. We haven't been able to isolate that but we know it's there.

Now, if inflation gets under control and the investment mentality about housing should diminish, the speculative aspect, and prices can hold at reasonable levels compared to income, and if rates taper off—and I think we have some indication that they will—then it's my prediction that certainly in the coming year or two we are going to get more back to normal or at least down to mortgage rates near 10 percent, which is better than what we've got now. Then I think that housing needs, at least for middle-income America, can begin to be met in the 1980's.

Senator SARBANES. Isn't it a case for most young couples that they really come to the housing market because they feel that they need a home for their family, then if someone experienced in investment psychology is present, that person can really push up the cost, but these couples are faced with the problem of whether to form an independent household or not. Isn't that the case?

Mr. JANIS. Yes.

Senator SARBANES. But if we push these rates up, won't we revert to an earlier generation where you cannot hold out the expectation to young people of forming an independent household, or at least not as early as they have come to expect? Is that what's happening? My concern about the long-run trend is that we will go back to saying to young couples, "You are going to have to continue to live with one or the other parent or continue renting an apartment for 8 or 10 or 12 years of marriage instead of expecting that as soon as you marry and start forming a family you are going to be able to have a home."

If that is the direction we are going in, what are the implications of that in terms of our society?

Mr. JANIS. The condition you are describing is exacerbated by present trends with respect to divorce rates and with respect to the number of singles looking for housing. We have those trends in our society which are increasing the pressures for housing even more than what would normally be the case.

I think there is some doubling up. We don't know quite how much doubling up there is right now. There is some work going on at HUD on that subject. I haven't seen the results of it.

One answer in part is more rental housing, because if homeownership is too expensive for some, a certain amount of rental housing can be helpful. Unfortunately, the outlook for rental housing at the moment is not good. That's because rental housing production is not adequate to meet the needs.

Part of the reason is that a number of communities, and I understand the number may be growing, have seen fit to enact rent control. Other communities have begun to ban condominium conversions. Those factors destroy the incentives for producing rental housing—

I'm talking about multifamily rental housing essentially. The fact that rents generally have lagged behind increases in consumer spending and in the CPI generally—and the cost of multifamily-highrise building rentals today is such that there is a coming crisis in the multifamily rental market. The GAO has confirmed this in a recent study.

If we could get over that problem, I think that might be a partial answer, and certainly a lower cost condominium-type unit may be an answer for the 1980's and maybe the 1990's.

Senator SARBANES. I think the Home Loan Bank Board had better pay some attention to this problem, and to another one that I see following along behind it. If we go to 14 and 15 percent interest rates as a normal state of affairs in the market, or even to 10 to 12, it will exacerbate the tensions created by the housing assistance programs which you had a large responsibility for when you were at HUD, because the ordinary person faces the prospect of not being able to get a home or pay very high rates for it and yet doesn't qualify for the assistance programs. It is one thing if the normal rate is running at 8 or 9 percent and the assistance rate makes it available to someone at 6 or 7 percent, and we're trying to get that little extra help but no one is precluded from obtaining housing. But if in an ordinary course you are precluded from qualifying for housing and you don't qualify for assistance, that is a problem. Don't you see that?

Mr JANIS. Yes. Also the Federal Home Loan Bank Board is limited in terms of its ability to affect these larger kinds of problems we're talking about. And I want to state that limitation because it's important to understand that.

We can work on a short-term basis in terms of pulling an industry through. We can work on the regulatory side, we can work through our supervision, we can affect advances, the supply of money generally for S. & L.'s within certain described limits. We can do a little bit of fine tuning. I don't know if we can meet the larger problems alone.

What I suspect is needed is some kind of national commitment to the idea that we are going to meet the housing needs of our Nation between now and, say, the year 2000. We are going to do it because it's important economically and important socially and important as a nation to have this kind of goal.

Senator SARBANES. I am not suggesting that the regulatory powers of the Home Loan Bank Board enable it to do something about the problems I'm talking about. What I am suggesting is that the Board, through its study and review role, might take a look at these problems and come up with an analysis and recommendations that might be very helpful. You are in a position at least to observe the entire situation and perceive some of the impending problems. Otherwise we are going to be here 5 or 10 years from now bemoaning the situation which we have allowed ourselves to drift.

Mr. JANIS. I agree with you, and I'd be happy to do that. I'd just add that my hope is that the Fed's policies will work and that we will get inflation under some kind of reasonable control. If we do. then I think housing will benefit and certainly the thrift industry will survive nicely.

Senator SARBANES. Well, that hope is premised on the proposition that hope springs eternal, I think.

Thank you, Mr. Chairman.

Senator BENTSEN. Thank you. Mr. Janis, as I look at the young couples out there, from what I hear from you also, unless we see some major changes in our economics, you are going to find the young couple putting off the purchase of a single-family dwelling. You are going to see, as Senator Sarbanes says, more and more young couples who today are married who are going to have to stay with their parents, are going to have to share the home, possibly for years to come, before they will be able to afford going into a single-family dwelling.

And you are telling me that the cost of an average home now is $67,000.

Mr. JANIS. The median. The average is about $78,000.

Senator BENTSEN. $78,000 is the average, and the median is $67,000?

Mr. JANIS. Yes, sir.

Senator BENTSEN. And with the interest rates that we have now as opposed to what we had 2 years ago, just on interest rates alone—not talking about the inflation on the house—the average payment has to be $200 or $300 a month more?

Mr. JANIS. Yes.

Senator BENTSEN. Did I also understand you to say that probably less than 15 percent of the people today will be able to buy a new home?

Mr. JANIS. Depending on the assumptions that you make about costs and interest rates, yes, that's right.

Senator BENTSEN. Well, obviously we need some changes in direction if we are going to be able to fulfill the dream of homeownership in this country.

Thank you very much, Mr. Janis.

[The prepared statement of Mr. Janis follows:]

PREPARED STATEMENT OF HON. JAY JANIS

I appreciate the opportunity to appear before your Committee to discuss the outlook for housing and thrifts over the coming year. Let me emphasize that housing markets and thrift institutions have become the victims of an inflationary economy and the policy measures that have been necessary to fight inflation. In this type of world, individuals don't save much and lenders find it barely profitable—if at all—to lend.

Interest rates remain high because savers and lenders can obtain a real rate of return on their investments only if interest rates exceed the expected rate of inflation over the life of the investments. Whether or not we are heading into a recession, the potential for output growth over the next year and possibly beyond is limited. This is because of the large transfer of resources from the United States to other countries implied by escalating oil prices, the poor productivity performances of the American economy, and economic measures necessary to bolster the position of the U.S. dollar abroad.

The actions of the Federal Reserve over the past several months surely will have a substantial adverse impact on housing activity over the coming months. Yet I support the Fed's actions, because I believe that if we are successful in reducing inflation, this is the best possible answer to meeting this nation's housing needs over the long-run.

My testimony covers each of the following points:

1. Recent State of the Housing Markets.
2. Federal Reserve Actions of October 6 and Likely Consequences for Housing.
3. Role of Bank Board Policies.
4. Sources and Uses of Funds for S&Ls for 1980.
5. Housing Outlook for 1980.
6. Financial Viability of Thrift Institutions.

RECENT STATE OF THE HOUSING MARKETS

I will turn initially to a discussion of the performance of the housing markets prior to the Fed's October actions. As this Committee knows, housing markets have remained much stronger this year than the very sharp rise in interest rates that occurred during 1978 and the first three quarters of 1979 would have implied, based on past experience.

The new mortgage loan commitment interest rate on prime mortgages, which was at 9.14 percent in January 1978 had escalated to 11.64 percent by early October of this year. Given this sizeable increase, past experience would have suggested housing starts currently at a level not much above an annual rate of 1 million units. However, housing starts were still at a seasonally adjusted annual rate of 1.91 million units this September, and declined only moderately to 1.76 million units in October. The recent continued strength in housing reflects loan commitments made some time ago when interest rates were lower and funds more plentiful as well as strong section 8 starts.

For this calendar year as a whole, housing starts are likely to be close to 1.75 million units compared to 2.02 million units last year, a moderate decline of 13 percent. Both new and existing home sales during the first nine months of this year were down even less. New home sales have been running only about 9 percent under that of last year and existing home sales only 4 percent under the all-time record of 1978.

This situation is now in the process of changing. However, let me review the reasons why housing activity was relatively insensitive to rising interest rates through at least October. The reasons are:

1. *Highly favorable demographic factors.*—There has been a large bulge in household formation in age groups that buy or rent housing. Household formation has been even stronger than the age composition of households would suggest because so many individuals are now setting up an independent household before marriage and the high divorce rate causes one household to be replaced by two.

2. *Investment psychology.*—Families have been purchasing homes at an earlier age, and even individuals have been doing so because of the perception that the potential price appreciation in homes more than offsets the negative impact of high mortgage interest rates.

3. *The ability of thrift institutions to raise substantial funds to lend in the mortgage market despite rising interest rates.*—The authorization of the money market certificate in June, 1978 gave thrifts a powerful tool for insulating savings flows to a considerable extent from rising interest rates. MMC growth has continued strong in October and early November and MMCs now constitute about 26 percent of accounts of all S&Ls.

Especially in recent months, S&Ls have also been raising money aggressively through jumbo CDs (negotiable certificates of deposit of $100,000 or over, which are not subject to rate control), and these now constitute 5 percent of total savings accounts. S&Ls have also been expanding their borrowings outside of the Bank System as an additional source of funds. The total net savings gain for S&Ls of $33.0 billion during the first ten months of this year occurred despite a $15.3 billion dollar decline in passbook accounts and a $33.3 billion decline in certificates other than MMCs. This is because the falloff in these two types of accounts was more than offset by an increase in MMCs of $71.3 billion and of $10.3 billion in jumbo certificates.

The strength in savings flows has ebbed since the first quarter of this year, in part because of the action by which the Bank Board and Federal banking agencies eliminated the compounding of interest on MMCs and also eliminated the rate differential of 25 basis points that thrifts had enjoyed over commercial banks on MMCs whenever the 6-month Treasury bill rate is at 9 percent or higher. Even so, without the general revolution in liability management by thrifts—by which I mean their use of high cost money in the form of MMCs, jumbo CDs, and borrowings and the way in which they are better able to manage their flow of funds through these types of liabilities, especially the latter two—we would normally have had savings outflows now continuously over quite a few months. If we eliminate jumbo CDs from our definition of savings accounts, since they are so clearly a managed form of liability more like borrowings, there have been savings outflows since August.

4. *Secondary mortgage market.*—Still another factor holding up the flow of mortgage money is a more highly developed secondary market in mortgages than during past tight credit periods. Not only is the Federal Home Loan Mort-

gage Corporation now a major factor in the secondary market, but the development of conventional mortgage pass-through securities as well as the use of mortgage-backed bonds by S&Ls have provided new sources of funds for housing so that real estate has been able to tap the capital markets as never before.

5. *Other lenders.*—A byproduct of the strong underlying demand for housing has been that mortgage interest rates have risen relative to interest rates on long-term open market securities. The result has been that life insurance companies, pension funds, and other investors that have not been active in the home mortgage market are now putting an increased flow of funds into this market, either through direct purchases of mortgages or through purchases of pass-through securities. Appreciation in real estate values in a generally inflating economy has tended to make real estate a somewhat more secure and, therefore, desirable investment alternative for these types of institutional investors.

6. *Lack of overbuilding.*—The housing market is now being aided by the much more conservative inventory policies on the part of builders. The inventory of unsold homes through September has continued well below what it was in 1974. Moreover, unlike the early 1970s, there has been a lack of overbuilding in the multi-family market, especially in speculative condominiums in Florida and California, which suggests that the lessons learned in 1974–75 have been remembered.

7. *HUD subsidy program.*—We also have substantial subsidy programs by HUD, primarily in the multi-family area, which have added to starts. The Section 8 program produced well over 150 thousand starts in the 1979 fiscal year compared to 40 thousand in 1976. This administration deserves a great deal of credit for its role in promoting subsidized housing for low and moderate income households.

FEDERAL RESERVE ACTIONS OF OCTOBER 6 AND LIKELY CONSEQUENCES FOR HOUSING

While some of the factors noted above will continue to help the housing market, the outlook for housing was changed radically by the Federal Reserve actions of October 6. Let me note first that interest rates were already moving up further before October 6 and that adverse impacts on the housing markets would have shown up even without these additional actions.

The most important step taken by the Fed on October 6 was to announce that it would put more emphasis on bank reserves than on short-term interest rates in its future monetary policy actions. Since the growth in bank reserves and in monetary aggregates was running above the Federal Reserve's range at the time it took its actions, the result of pulling back on bank reserves through Federal Reserve open market sales of securities was to escalate interest rates sharply.

The impact on mortgage loan commitment interest rates has been quite dramatic. Mortgage loan commitment rates have increased 1½ percentage points or more in non-restrictive usury states since October 6. The prime mortgage loan commitment rate in many major markets is now 13 to 14 percent. Although households had been fairly insensitive to mortgage interest rate increases over the last year, there is already evidence that these latest increases are having a significant impact on the ability and willingness of households to purchase homes.

The Bank Board has surveyed S&L commitment policy on mortgages of large associations twice since the latest Fed actions. As of October 26, nearly 85 percent of the associations surveyed had a more restrictive mortgage loan commitment policy than on October 6. Many of those that had not changed policy already were quite restrictive with respect to new mortgage loan commitments because of usury rate ceilings. Of those associations whose commitment policies became more restrictive since October 6, 28 percent indicated that they had ceased making commitments for at least the time being. As of November 15, commitment policies were, on balance, somewhat more restrictive for associations as a whole; but associations in some areas, notably California, eased commitment policies.

One impact of the recent sharp rise in mortgage interest rates is that it has triggered usury ceilings in a large number of states where these ceilings had not been restrictive before. According to information available to us, about 17 states currently have restrictive usury ceilings below the mortgage loan commitment rates being quoted in most areas that do not have restrictive usury ceilings. A number of additional states could be added to this list except that they have a floating ceiling rate that should be at market soon, depending upon the speed with which adjustments are made. Unless many of the states whose usury ceilings are restrictive change them soon, mortgage lending and housing activity in these states will be stifled. In this regard, the Bank Board fully supports the Federal preemption of state usury ceilings contained in the Senate version of H.R. 4986.

We have to face up to the fact that the Federal Reserve actions, in order to be effective, are going to have to exert some negative impact on housing. This is the price that we have to pay for dealing with the serious economic problems that our country faces. My concern, and it is shared by the Fed, is that housing not shoulder an undue portion of the burden.

Nonetheless, the longer-run impact of the new Federal Reserve monetary policy strategy is not necessarily adverse to housing even if housing activity declines sharply over coming months. The Fed's actions might well lead to a sharper decline in interest rates over the longer-run than would have occurred without these actions.

There are two reasons why this may be the case. First, the psychological impact of the Fed's action could reduce the inflationary premium in the interest rate structure. If the financial markets can be convinced that present economic policy is going to bring down the rate of inflation, albeit slowly, it could have a significant downward impact on interest rates at some point in time. Second, the new operating strategy that emphasizes reserve targets rather than interest rate targets will to more downward flexibility in interest rate if and as the economy weakens significantly. This is because the resulting decline in the demand for money will translate itself into a corresponding decline in interest rates that will not be constrained by the need for the Federal Reserve to take any overt act to reduce its Federal funds target. It is possible that the decline in short-term interest rates recently may already reflect this type of situation.

There is, of course, a calculated risk to the Fed's new monetary strategy, and I am not happy that the Fed had to take the actions that it did on October 6. However, external economic factors—both domestic and international—made restrictive policies inevitable. Since budgetary and tax policy are inflexible in the short-run, it was monetary policy that had to take the major burden of any policy response. Even if the Fed had not taken the dramatic actions that it did on October 6, we would probably have continued to see an upward creep in the Fed funds target and in other interest rates so that the Fed actions of October 6 accelerated what might well have occurred more gradually. And, without these actions, we would not be on the way to what I hope is a lower inflation rate in the future.

Ironically, the very rapidity with which interest rates escalated, which was so difficult for the housing markets to absorb, was precisely the jolt needed to break the inflationary psychology that was itself feeding inflation and putting constant upward pressures on interest rates. The key to the Fed's calculated risk is how long this tight money policy will have to persist. This issue of "duration" is absolutely crucial. For one thing, it affects the viability of thrifts because the longer the period of poor earnings the greater the erosion of the capital base of thrifts, which eventually affects their soundness as well as their ability to raise funds to put into housing. For another, it affects builders and their ability to withstand inactivity and still manage to survive. Perhaps most important, the duration of tight money and a housing slump is related to future demand for housing for much of the 1980s. If the downturn in housing activity is too severe and protracted, the resulting shortfall in production will cause a large pent-up demand for housing. This will result in a rebound in demand later on in the decade which will escalate housing costs severely and make it virtually impossible for young families and those with lower incomes especially to afford housing.

ROLE OF BANK BOARD POLICIES

Some reasonable decline in housing activity in 1980 may be desirable[1] and necessary as part of anti-inflation policy, especially as regards the desirability of curbing the speculative aspects inherent in some of the recent demand for housing. However, if it appears that housing will be unduly affected, the Bank Board is prepared to take actions to moderate the decline in housing activity.

[1] It is not easy for any professional housing person to speak of a decline in housing as being "desirable" at any time for any reason, given what we anticipate the short-fall in housing production to be in the 1980's for renters especially and for lower income families generally. But if a drop in housing starts for one year will lead to a significant drop in inflation over a reasonable period of time, the price is probably worth paying. This is because the biggest obstacle to meeting the nation's long-term housing needs is inflation itself.

The Bank Board and the Bank System have already taken actions designed to moderate the impact of tight money on housing. The major action was the authorization of the money market certificate in June, 1978 which has permitted S&Ls to continue to attract savings flows despite the very high interest rates. More recently, the Bank Board has proposed an increase in the ability of Federal savings and loan associations to engage in outside borrowings, i.e. borrowings from sources other than the Bank System itself. The present limit of 10 percent of savings (with an additional 5 percent for conforming mortgage-backed bonds) would be raised to an overall limit of 20 percent of assets.

Meanwhile, the Bank System has continued to provide advances in substantial volume to its member institutions as a source of housing credit. The increase in advances was over $12 billion in 1978. The increase could reach $9 billion or more this year despite the very large rise in jumbo CDs, which are a competitive source of funds with advance for S&Ls. Recently, the Bank Board made a point of reaffirming existing policy to take account of the fact that there was some uncertainty about the ability of the Bank system to raise adequate funds for advances. This was not an attempt to shut off or even reduce advances volume. We asked that each member institution consult with its Federal Home Loan Bank in advance of making mortgage loan commitments that they expect to fund in whole or in part with advances in order to ensure that the Bank would have funds for such advances.

Another important tool that we have is secondary market purchases of our affiliated Federal Home Loan Mortgage Corporation. Currently, the Mortgage Corporation is committing funds at an annual rate of $6 billion to the mortgage market. We could raise the commitment level rate if conditions warranted. However, the ability of the Mortgage Corporation to purchase mortgages in the secondary market is constrained by the same financing problems that affect the Bank System's ability to provide advances.

In addition, the Bank Board can continue to reduce liquidity requirements imposed on its member institutions to the statutory minimum of 4 percent. The present liquidity requirement is 5½ percent and was reduced from 6 percent effective November 1. This action released about $2.3 billion in funds that previously had to be held in the form of eligible liquid assets. However, it did not necessarily assure that all of these funds would go into mortgages since, under present conditions, S&Ls have been maintaining, on their own volition, a high liquidity ratio. Much of the impact of the latest reduction in liquidity requirements will probably be to reduce pressures for advances, which is desirable since the demand for advances could conceivably be greater than our ability to obtain funds in the open market at a reasonable interest rate. If and as mortgage and housing market conditions reflect the negative factors at work currently, the Bank Board is prepared to make further reductions in liquidity requirements. If savings outflows become serious, the Bank Board has the power to waive penalties on S&Ls whose liquidity falls below the minimum requirement.

Needless to say, the Bank Board is also thinking through other possible policy options if mortgage lending and housing starts should drop too sharply.

The Bank Board does not intend to simply let events in the housing markets drift out of control. However, I must return to the opening theme of my testimony, that there are basic economic problems in our economy that limit our ability to stimulate housing at the present time. Over the long-run, economic policy will have to deal with these basic problems if we are going to be able to provide housing to meet the long-run needs of the citizens of this country and meet the goal, first expressed in the Housing Act of 1949, to provide a decent home and suitable living environment for all Americans.

SOURCES AND USES OF FUNDS FOR S. & L.'S FOR 1980

Bank Board policies noted above will play a role in determining the source of funds available to savings and loan associations in 1980. The revolution in liquidity management of S. & L.'s noted above will continue to make for a more stable flow of savings than during past tight credit periods although some of this stability is misleading since jumbo CDs are more like borrowed money than the traditional savings and time account. It is not clear how much longer S. & L.'s will continue to issue more new jumbo CDs at a rapid rate, especially if housing demand drops off sharply.

In the current financial environment, savings flows, excluding jumbo CDs, are negative and should remain so through at least the early part of the next year. Money market funds and the newer 6-month unit investment trusts will continue to provide important competition for the saver's dollars even at lower interest rates than we have experienced recently.

Obviously, the outlook for savings for 1980 as a whole depends upon our projection as to when interest rates will peak; and it is possible that the recent decline in interest rates may indicate that we are past the peak. However, so many well respected authorities have predicted a peak in interest rates over the past year that we have little confidence in any projection (including my own). We hope that the Fed's action of October 6 have accelerated the timing of such a peak, although, as Chairman Volcker has stated, much depends on OPEC pricing policies, and this currently represents a major imponderable. As a cautious and careful regulator of the S. & L. industry, we have to assume the possibility that interest rates are likely to remain high through much or most of next year even if there is some decline.

While a significant economic recession could cause a fairly sharp decline in interest rates as a result of the Fed's new policy strategy, our best guess is that the continued high rate of inflation and international financial developments will still influence the Fed toward holding up interest rates. There is also a likelihood that we will have a moderate recession or weakness in the economy that may persist for a number of years rather than a serious recession. This is because the economy does not suffer from the same type of excesses that it did back in 1973–74. In particular, businesses have been much more conservative in their inventory policies so that, except for the automobile industry, most industries are operating with lean inventories; and it would take a very sharp decline in sales to convert lean inventories into significant excess inventories. As a result, we may not get a really sharp decline in the demand for money next year that would produce a sharp falloff in interest rates under the Fed's new operating strategy.

What is the implication of this for savings flows of S. & L.'s over 1980 as a whole? It would appear that savings flows will be constrained by the financial environment. Yet such flows will still remain higher than past experience would indicate because of the revolution in thrift liability management. The other side of this coin is that, even if and when interest rates decline sharply, the resulting recovery in savings flows will be less than we have experienced in the past. The major impact of a decline in interest rates will be to reduce the cost of funds of S. & L.'s rather than increase savings flows.

As a result, we expect the net savings gain in S. & L.'s in 1980 to be about $36 billion, not too much below the $38 to $40 billion that we currently project for this year. This, of course, obscures the fact that much of the net savings gain this year occurred in the first quarter and that much of the net savings gain next year will likely occur in the last half of the year. These savings forecasts, while high for a period of such high interest rates, are still down from the $44.2 billion of 1978 and $50.2 billion of 1977. Given inflation, the drop in savings flows translates into a sharper decline of housing units that can be financed.

While savings flows will probably drop only moderately in calendar year 1980 from 1979, we expect a sharper decline in loan repayments—an important internal source of S. & L. funds—as existing home sales slow down in response to high mortgage interest rates. Loan repayments could decline to about $42 billion in 1980 compared to $50 billion in 1979. Of course, the decline in loan repayments will reflect a weaker mortgage demand that S. & L.'s will have to finance.

What about mortgage lending of S. & L.'s? We expect this will be down to about $78 billion from the $99 billion that we are currently projecting this year. During the first half of early 1980, we believe that the decline in mortgage loans made will reflect primarily tight mortgage market conditions and very high mortgage interest rates. By the second half of the year, however, we expect that the general weakness in the economy and the declining real income of households will be pulling down the demand for housing. Thus, even though we expect savings flows to recover to some extent in the second half of 1980, we expect a weak demand for housing resulting from a poor economic climate to hold down the mortgage lending of S. & L.'s.

What are the implications of this for the external sources of funds that S. & L.'s will need? There will still be a strong demand for such external funds going into early 1980 although it is difficult to project the degree to which this will be met by advances or other borrowings or even by jumbo CDs, which are regarded by S. & L.'s as an alternative to advances. This demand will reflect the need to fund withdrawals of traditional savings accounts and the need to finance forward loan mortgage commitments made some time ago. However, by the second quarter of the year, housing demand will be dropping more sharply than implied by housing credit market conditions alone. As a result, we expect that S. & L.'s are likely to be repaying advances during the second half of next year or perhaps even earlier, a typical pattern during the latter stages of a decline in housing activity; and this environment should also produce a falloff in jumbo CDs that will offset some of the rebound in traditional types of savings accounts.

HOUSING OUTLOOK FOR 1980

Tying together the various pieces that I have put together, I believe that housing activity will decline fairly sharply in 1980 but not to the same degree as during 1974–75. We presently expect that housing starts in 1980 will average somewhat under 1.4 million units compared to 1.75 million units during the current year.

Some of the decline will occur in multi-family housing starts. However, the existence of substantial Federally subsidized programs in this area and the likelihood that construction of condominum multi-family projects will remain fairly strong will probably keep multi-family housing starts from declining more than a moderate amount. We expect that multi-family starts defined as starts in structures with 5 or more units will decline about 70 thousand units from 1979 to 1980 to a rate of 370 thousand units. This will still be well above the low rate of 1975, which was 204 thousand units.

We expect a sharper decline in single-family starts to a level only slightly above the low point reached during the housing trough of 1974. We expect that single-family starts will decline about 300 thousand units from 1.2 million units this year to about 900 thousand units in 1980, not much different from the 888 thousand units in 1974.

This decline would be sharper if we had the serious overbuilding that developed in the early 1970s. However, lacking this overbuilding in both the single-family and multi-family areas, builders will not be under pressure to reduce housing starts proportionately more than the expected decline in housing sales.

It is natural that there should be even greater pessimism about the housing outlook now among some individuals since we are still not that far removed from October 6. Most lending institutions reacted sharply in their loan commitment policies as a result of the October 6 actions, as I noted above. As time goes on, most lenders who have withdrawn from making new loan commitments probably will be back in the market, even though at a reduced commitment activity.

With respect to the time pattern of housing activity next year, we expect that the trough of housing starts is likely to be at about a seasonally adjusted annual rate of 1.3 million units in the second and third quarter of the year. Since these are quarterly averages, the trough could be below this figure for a number of months. Our housing forcecast for the year does imply a rebound in housing starts in the fourth quarter, reflecting an improved flow of funds situation that should be occurring by mid-year as well as the strong demographic factors underlying housing demand. In fact, given the extremely lean inventory of unsold homes and vacant apartments, we expect that housing starts may rebound much more sharply if and as credit conditions ease than during past similar periods following tightness in the credit markets. It is possible that housing starts in 1981 could rebound back to at least the level of this year. Peering ahead further into the 1980s, demand should be very strong and, if inflation is kept reasonably under control and Federal support for subsidized housing continues, there is no reason for starts rates not to exceed 2 million units per year for the rest of the decade.

FINANCIAL VIABILITY OF THRIFT INSTITUTIONS

The revolution in liability management of thrift institutions has had the salutary impact of supporting the level of housing starts and should continue to contribute to a higher level of housing starts next year than would be the case without the use of new type deposit and borrowing instruments. However, the other side of the coin is that this has resulted in a large percentage of funds in thrifts now being in very high cost short-term money.

These together constitute about 30 percent of the total liabilities of S&Ls although the percentage varies regionally. Thus, thrifts are in a highly leveraged position. The rollover of these high cost liability instruments at the higher interest rates now prevailing will have quite an adverse impact on earnings in at least the short-term. Conversely, if and when short-term interest rates begin to decline significantly, thrift earnings could improve sharply. However, as a regulatory body concerned with the soundness and solvency of S&Ls, we must be prepared for the worst contingency.

Let me comment on the earnings outlook for S&Ls. During 1978 the rate of return on S&L assets averaged .82 of 1 percent, the highest in many years. For the first half of this year, the rate of return on assets was .69 of 1 percent, which, while down from 1978, was about the average rate of return for this decade. During the third quarter of this year, we estimate that the rate of return on assets was probably .65 of 1 percent.

However, S&Ls are now in the process of rolling over MMCs, jumbo CD's, and other short-term liabilities at interest rates sharply higher than at the time these were originated. The fourth quarter rate of return on assets should be under .5 of 1 percent. We recognize that if current short-term interest rates remain at their present levels for some time, the rate of return on assets of S&Ls could decline to a very low level in the first half of next year. While we presently are projecting a rate of return on assets for the industry of .30 of 1 percent during the first half of 1980, a more pessimistic interest rate scenario would imply even a lower figure.

Rate of return on assets of S. & L.'s

1978:	
1st half	0.81
2d half	0.83
1979:	
1st half	0.69
3d quarter (estimate)	0.65
4th quarter (estimate)	0.45
1980: 1st half (estimate)	0.30

However, many of the S&Ls that will suffer poor earnings experience have an adequate net worth cushion and excess FIR. The S&L industry in general continues to have FIR and net worth well in excess of statutory and regulatory requirements. Therefore, unless interest rates continue to remain high beyond the first half of the year or even longer, most S&Ls will be able to absorb these losses without any reduction in their ability to remain viable competitors.

We recognize that there are S&Ls that do not have an adequate net worth and FIR cushion and that many of these are located in sections of the country where economic factors are unfavorable. Such S&Ls could well have a negative income for much of next year that will reduce an already low net worth. We have the regulatory tools to deal with these genuine financial stress situations that might arise.

If a really poor earnings situation materializes next year, this will not basically be the result of the ability of thrifts to use high cost short-term liabilities. Rather, it will be because of an inflationary high interest rate environment that *requires* thrifts to offer high interest rates to both retain and attract funds. While we would have preferred less reliance on short-term liabilities, the alternative, if S&Ls were to remain in the mortgage market, would have been to authorize much higher interest rate long-term certificates. But the latter would have locked S&Ls into a very high cost of funds for a prolonged period of time and made it difficult for S&Ls to operate profitably without an extremely high floor for mortgage interest rates for many years.

In my opinion, the only alternative to the current liability management of the S&L industry would have been for the S&L industry essentially to have gone out of the mortgage lending business for about 1½ years and to have done nothing except honor savings withdrawal requests and originate loans for others. Housing would have collapsed and the S&L industry would have shrunk in size.

Without the new liability management, S&Ls would not have been able to add high interest rate mortgages in substantial volume to their portfolios as they have been able to do. The mortgage portfolio yield of S&Ls would have remained close to what it was back in 1978. This would have created a situation in which the S&L industry might not have been able to operate profitably over the long run even if and as interest rates on savings instruments declined.

We need to recognize that rate control does not exist in a meaningful sense under current high interest rates given the fact that all new funds coming into S&Ls are in the form of MMCs, jumbo CDs, and borrowings. Once interest rates begin to decline, we hope that the recent trend toward the shortening in the liability structure of S&Ls can be reversed, and the Bank Board will consider steps to once again make long-term savings certificates more attractive, building on the present indexed long-term certificate under which S&Ls can already offer certificates of four years maturity or longer at an interest rate of 1 percentage point below that of four year U.S. Government securities. Matching maturities on the asset side also will be considered.

This would seem to be an appropriate time to consider some restructuring of the S&L industry as well as removal of the rigidities and inflexibilities that unnecessarily constrain competition and growth. The Bank Board will be doing all it can in this respect through its regulatory powers.

Let me conclude by summarizing the thrust of my testimony. I am certainly pessimistic about the near-term future for housing and thrifts but recognize that external events and policies necessary to deal with high inflation, poor productivity, and the weak position of the U.S. dollar abroad must take precedence. The Federal Reserve actions of October 6 were unavoidable under the general economic circumstances. I am hopeful that the Fed policies will make interest rates more flexible downwards, not merely upwards, and may prove beneficial to the housing market and thrift institutions over the long-haul.

In the short-run, the Bank Board will take whatever actions it can to prevent tight money from having a disproportionate impact on housing although these actions are, of necessity, constrained by external forces over which the Bank Board has no control. The Bank Board is aware of more pessimistic scenarios in which inflation does not come down and what such scenarios could mean for housing and thrifts, but we believe that extreme pessimism is not warranted. There is a good probability that both housing and thrifts will emerge from the current situation in good shape, not without bruises and scars to be sure, but better able to survive and cope in difficult economic and financial circumstances.

Senator BENTSEN. The remaining witnesses are Saul B. Klaman, president of the National Association of Mutual Savings Banks; Herman Smith, vice president and treasurer of the National Association of Home Builders; Kenneth J. Thygerson, chief economist and director of the U.S. League of Savings Associations; and Dwight Jaffee, professor of economics at Princeton University.

Mr. Klaman, since you are president of the National Association of Mutual Savings Banks, we'll let you start.

STATEMENT OF SAUL B. KLAMAN, PRESIDENT, NATIONAL ASSOCIATION OF MUTUAL SAVINGS BANKS, NEW YORK, N.Y.

Mr. KLAMAN. Thank you, Mr. Chairman. I have seldom been so royally treated as to permit me to lead off. I appreciate this opportunity to be before you.

I will be brief, Mr. Chairman, and will also request that my prepared statement be included in the record.

Senator BENTSEN. It will be.

Mr. KLAMAN. Mr. Chairman and Senator Sarbanes, the bombshell dropped by the Federal Reserve on October 6 left financial markets, in general, and housing and mortgage markets, in particular, in confusion and disarray. The shock waves are still reverberating. Interest rates have soared, credit availability has tightened, and the makings of a classic crunch in real estate finance and sales are now at hand. Prior to "bombshell day," by contrast, the continued strength in housing was wondrous to behold: Sales holding at near-record levels, prices still rising, and starts maintained at a very respectable 1.8 to 1.9 million annual rate. All of this, even though mortgage rates had reached previously unprecedented levels of 10 to 11 percent.

Much of the credit for that performance is typically given to the introduction of the 6-month money market certificates on June 1, 1978.

I would like to endorse what Mr. Janis said, that there were many other important factors, including, in my judgment:

The surge in mortgage lending from "nontraditional" lenders, such as life insurance companies and pension funds;

The strengthening and broadening of secondary mortgage markets led by FNMA and FHLMC;

The rapid expansion of mortgage-backed securities markets, both GNMA-guaranteed and conventional; and

The strong housing demand sustained, in large part, by inflation-hedging buyers.

But these factors, I'm afraid, will not sustain housing in the months ahead. And neither will the money market CD's, which have contributed to sharply higher mortgage loan costs while failing to stem disintermediation. A major housing downturn is in the making, as both buyers and sellers respond negatively to the new, restrictive financial environment in the post-October 6 climate. We have an effect which is hitting both the demand and the supply sides.

I think, briefly, as I see the chain of events, that the first impact will come in existing housing markets. There will not only be reduced sales volume but, in my opinion, some declines in prices, not a decline in the rate of increase of prices but actual declines of prices in selective markets. Some homeowners are going to find they have less equity in their homes than they originally thought.

The transmission effect then will go into new house markets. Fewer sellers of existing houses make fewer buyers of new houses. And as the Chairman of the Federal Home Loan Bank Board said, you have builders confronted with 17 to 18 percent construction loan costs up front, which are even higher when compensatory balances are considered. Faced with these costs, many builders will forego commitments, building plans will be temporarily shelved, and starts will decline sharply.

The rise in interest rates above inflation rates will also cause consumers and speculators to pause in their rush to buy houses in both new and existing house market. And certainly I think that this will have a favorable effect in reducing speculative buying.

So, on both the demand and supply side of the housing market equation, I think we can look for significant declines in sales and output, as well as price declines in selective markets.

In new housing starts, we are looking for a year-to-year drop of more than 20 percent, from 1.7 million units in 1979 to 1.3 million units in 1980. But I think more dramatic will be the decline from peak to trough. And in that respect we are looking for a 40- to 50-percent drop to a low approaching 1 million units in the early months of 1980, which is abnormally low, given the kind of demographics we have.

On the favorable side, I would say that this decline will not continue throughout 1980. I would expect some bottoming out during the year, and a modest recovery thereafter and through 1981. But housing markets face a year or more of subpar activity before we can anticipate any kind of a vigorous rebound.

My expectations are based, briefly, on four basic assumptions.

First, the rate of inflation is going to remain stubbornly high, regardless of all our best efforts to restrain it, lessening prospects for any marked easing of monetary policy.

Second, if the first assumption is correct, interest rates will not drop sufficiently next year to permit a vigorous turnaround in housing. I would look for short-term rates to decline. Our hope, as well as our expectation, is that we will see the prime rate by June—by late spring—down to the 10-percent area, and hopefully by yearend we may get below double digits in short-term rates. But the long-term rate is a stickier rate and will more clearly follow the rate of inflation. So, I don't look for anywhere near that kind of decline in mortgage rates from current peak levels.

Third, if the first two assumptions are correct, I expect only a modest improvement in the deposit experience of thrift institutions. As you know, these major mortgage credit suppliers, especially mutual savings banks, are currently having one of the worst deposit flow years in history. We are now experiencing rates of outflow which will probably result in a $6 billion net deposit loss over the counter in 1979, which means some 4 percent of our deposit base will have been eroded when the year is over. And in 1980, we expect another negative deposit flow year, excluding interest credits, perhaps half as large as in 1979. This hardly augurs well for mortgage credit availability from the savings bank industry over the short run.

Finally, the expected general business recession in 1980 will reflect, and in turn will be reinforced by, the housing downturn, thus lessening prospects for an early and vigorous turnaround. I expect the recession in general to be deeper than is currently anticipated by the administration. I think it will be reinforced by the sharp drop in housing, with its tremendous ripple effects throughout the economy. Housing has not been countercyclical for some time. It has behaved procyclically in 1978 and 1979, and will continue so in 1980, at least for much of the year. Once the recession gets rolling, housing demands will slip further as unemployment rises, consumer incomes fall, household debt levels press heavily, and consumers fall back from major new expenditures. Given such developments, the moderate decline in mortgage rates likely in 1980 will hardly be sufficient to trigger a sharp housing rebound.

All these things are forecasts of what is going to happen. What are we going to do about it?

I would suggest, very quickly, Mr. Chairman, that at least three actions be taken now to ameliorate our inflation and housing market problems:

First: Immediate enactment by the House and Senate of a tax incentive to promote increased private saving. And I wish you all the best in your pursuit of this objective, which is strongly supported by our industry.

Second: I think it is critically important that there be an immediate restoration of the thrift institution rate ceiling differential on the 6-month money market certificates.

Third: We need immediate action to study ways of addressing the serious problem of low-yield mortgage loans held by thrift institutions. We are faced with this problem because we have followed a mortgage lending policy almost dictated to us by the Congress, by the regulators, and by others, who say that we must make mortgage loans and that we must make them at fixed rates. We are living with the results of that policy now and have about 25 percent of our mortgage portfolio locked into 7 percent and lower mortgage rates. You cannot earn that kind of return on assets and pay market or near-market rates on savings for very long.

In commenting on the President's 1979 Economic Report earlier this year, this committee recognized the critical need to stimulate increased saving and productive investment in order to combat inflation and reverse the serious decline in our Nation's productivity. It is about time we implemented that by providing some kind of a tax break for savers. We clearly need to redress the imbalance that is inherent in our tax system, which favors borrowers by making Uncle Sam a partner with every borrower in the country and which literally makes Uncle Sam an adversary of every saver by taxing virtually every dime of interest that he earns. So in this regard, Mr. Chairman, I repeat my hope that you will achieve success in your efforts to get a tax break for savers.

Now, if we get this tax break for savers, we have to do this through legislation. But the other two actions I have recommended require no legislation, and I would urge that you and your colleagues, Mr. Chairman, impress upon the regulators the need to restore the differential on 6-month certificates when Treasury bill rates are 9 percent or higher. The elimination of the differential since mid-March of this year has clearly diverted a substantial amount of funds from mortgage-oriented thrift institutions and the housing market into nonmortgage-oriented commercial banks.

The thrift institution differential does make a difference for deposit flows and housing credit availability, and I hope this committee will urge its immediate restoration by the Federal regulatory agencies.

Mr. Chairman, let me just conclude by saying that, for the longer run, I think we have some hopeful expectations that inflation may be brought under better control. But for the short run, I would again urge prompt action: One, to provide a tax break for savers; two, to restore the thirft institution money market CD differential; three, to examine the operations of the money market mutual funds, which are draining away our resources; and four, to address the problem of frozen low-yield mortgage loans held by thrift institutions. If such actions were taken, it might make my 1980 housing forecast unduly pessimistic, and I'm quite willing to take that risk.

Thank you very much.

Senator Bentsen. Thank you, Mr. Klaman.

[The prepared statement of Mr. Klaman follows:]

Prepared Statement of Saul B. Klaman

Mr. Chairman and Members of the committee, my name is Saul B. Klaman. I am president of the National Association of Mutual Savings Banks, the national trade organization representing the $165 billion mutual savings bank industry. I am pleased to respond to your invitation, Mr. Chairman, to discuss the short-run outlook for housing and for savings banking, and the likely impact of developments in these sectors on the national economy in 1980.

Factors in the Sustained Level of Housing

The bombshell dropped by the Federal Reserve on October 6 left financial markets, in general, and housing and mortgage markets, in particular, in confusion and disarray. The shock waves are still reverberating. Interest rates have soared, credit availability has tightened, and the makings of a classic crunch in real estate finance and sales are now at hand. Prior to "bombshell day," by contrast, the continued strength in housing was wondrous to behold: sales holding at near-record levels, prices still rising and starts maintained at a very respectable 1.8–1.9 million annual rate. All of this, even though mortgage rates had reached previously unprecedented levels of 10 to 11 percent.

Much of the credit for this strong performance is often given to the introduction of the 6-month money market certificates on June 1, 1978, which kept funds coming into the mortgage-oriented thrift institutions despite high and rising open-market interest rates. But this is only partly true. It is increasingly clear that these instruments served only to postpone rather than to avert the classic pattern of disintermediation which is now hard upon us. More important to the sustained high level of housing activity, in my judgment, have been:

The surge in mortgage lending from "nontraditional" lenders, such as life insurance companies and pension funds;

The strengthening ad broadening of secondary mortgage markets led by FNMA and FHLMC;

The rapid expansion of mortgage-backed securities markets, both GNMA-guaranteed and conventional; and

The strong housing demand sustained, in large part, by inflation-hedging buyers.

SHARP DECLINE IN HOUSING AHEAD

But these factors will not sustain housing in the months ahead. And neither will the money market CD's, which have contributed to sharply higher mortgage loan costs while failing to stem disintermediation. A major housing downturn is in the making, as both buyers and sellers respond negatively to the new, restrictive financial environment in the post-October 6 climate. The 8 percent decline in housing starts to 1.76 million units in October and the 13 percent decline in new building permits are harbingers of the bad news to come. This is how I visualize the short-run sequence of events for housing:

First, in existing house markets, many sellers will withdraw from the market rather than take lower prices. Some "necessitous sellers," however, will have to take lower prices than expected, and price declines, as well as declines in sales volume, will occur selectively throughout the country. Clearly, some markets will be more adversely affected than others, reflecting the localized character of housing markets. Delinquencies may rise as well, as unemployment increases and the ability of some families to maintain high mortgage payments is strained—particularly in two-income-earner families where both incomes are needed to support the household.

Second, as existing house sales slow and prices decline, new house markets will be quickly affected. Fewer sellers of existing houses make fewer buyers for new houses. Many builders will forgo commitments, moreover, with construction loan rates as high as 17 to 18 percent (even higher when compensating balances are considered)—a situation which will squeeze out profits since weakening markets will not sustain further price increases to offset increased financing costs. Building plans will be temporarily shelved, therefore, and starts will decline sharply.

Third, in both new and existing house markets, the rise in interest rates above inflation rates will cause consumers and speculators to pause in their rush to buy houses either as an inflation hedge or for a quick profit. Some buyers will simply be priced out of the market. The increase in mortgage rates since the beginning of this year, for example, has boosted monthly payments on a 30-year, $60,000 mortgage by $125—or 25 percent. Downpayments will be increased and mortgage terms shortened, further adding to the monthly mortgage burdens of prospective buyers. For other prospective buyers, current astronomic mortgage rates, together with the fear of recession and unemployment, will lead to postponement of buying decisions until economic and financial conditions improve.

And some buyers will be unable to obtain mortgage credit at all, especially in low usury rate states.

So, from both the demand and the supply side of the housing market equation, significant declines in sales and output are in prospect, as well as price declines in selective markets. Homeowners may find that their real estate equity is smaller than they thought.

With respect to new housing starts, I expect a year-to-year decline of more than 20 percent, or a drop to 1.3 million units in 1980 from 1.7 million units in 1979. Within this overall annual decline, I anticipate a sharper peak-to-trough drop of about 40–50 percent from recent levels, to a low approaching 1 million units in the early months of 1980. This would still be a smaller decline, however, than the 60 percent peak-to-trough drop in 1974–75.

My judgment is that the coming decline in housing will not persist throughout 1980. Rather, it will bottom out during the year and recover modestly thereafter and through 1981. But housing markets face a year or more of sub-par activity before any sort of vigorous rebound can be anticipated.

UNDERLYING ASSUMPTIONS

My expectations are based on a number of short-run economic and financial assumptions:

First, the rate of inflation will remain stubbornly high, lessening prospects for any marked easing of monetary policy. This does not mean that some abatement in price pressures will not occur. I believe it will, as the Fed establishes more effective control over money supply growth and as weakening overall economic activity is reflected in reduced consumer and business outlays. But it would be wishful thinking to expect to break the back of inflation in one year. Inflation, and inflationary expectations, will yield only grudgingly to continued and coordinated private and government efforts.

Second, if my first assumption is correct, interest rates will not drop sufficiently next year to generate a vigorous turnaround in housing. Short-term rates may ease into the 10 percent area around midyear or so, and dip below the double digit level before year-end, as financial markets respond to a gradually worsening business environment. But longer-term rates, which are more sensitive to the rate of inflation, will decline less rapidly from current peak levels. This scenario suggests only a limited improvement in the supply and cost of mortgage funds and only a cautious return of marginal buyers to the housing market.

Third, based on my first two assumptions, I expect only a modest improvement in the deposit experience of thrift institutions. These major mortgage credit suppliers, especially mutual savings banks, are currently having one of the worst deposit flow years in history. Excluding the crediting of interest, savings banks will probably lose about $6 billion in deposits over the counter in 1979, some 4 percent of their deposit base. This would compare with the net outflow of $2.8 billion or 3 percent of deposits in 1974, the worst previous disintermediation year for savings banks. As a result, new mortgage commitments have been reduced sharply and net new mortgage acquisitions in 1979 have fallen well below year-ago levels. For 1980, our research and economics department is forecasting another negative deposit flow year (excluding interest credits), about half as large as in 1979. This hardly augurs well for mortgage credit availability from the savings bank industry over the short run.

Fourth, the expected general business recession in 1980 will reflect, and in turn will be reinforced by, the housing downturn, thus lessening prospects for an early and vigorous turnaround. Housing is no longer a countercyclical sector of the economy. It has behaved procyclically in 1978 and 1979 and will continue so in 1980, at least for much of the year. Once the recession gets rolling, housing demands will slip further as unemployment rises, consumer incomes fall, household debt levels press heavily and consumers fall back from major new expenditures. Given such developments, the moderate decline in mortgage rates likely in 1980 will hardly be sufficient to trigger a sharp housing rebound.

SOME SUGGESTED ACTIONS

In presenting this bleak forecast for 1980 housing activity, I am especially concerned that the extent of the decline will be much deeper than some observers now anticipate. An overall business recession in 1980 is probably now unavoidable. The danger is that the housing sector could experience far more than a recession, a development which could make the general business downturn more severe than it otherwise would be.

The key public policy question, then, is what can be done? Not just to mitigate the short-run pressures on the housing market in 1980, but also to address the underlying longer-run problems which have made housing one of the most cyclically vulnerable and unstable sectors of the economy.

Clearly, an effective, coordinated and persistently applied government program to bring inflation under control is the number one priority for overall economic health and healthy housing markets. In implementing such a long-run program, of course, the need to maintain employment and to avoid deep recession must also be addressed. Reconciling these objectives poses a major challenge for public policy.

A balanced program of fiscal and monetary restraint remains the best hope of bringing inflation under control over a period of years, and of restoring basic stability in housing markets. But in the meantime, there are other actions that can and should be taken now to meet our inflation and housing market problems. Let me suggest three:

First, immediate enactment by the Congress of a tax incentive to promote increased private saving;

Second, immediate restoration of the thrift institution rate ceiling differential on the 6-month money market CD's; and

Third, immediate action to study ways of addressing the problem of low-yield mortgage loans held by thrift institutions.

In commenting on the President's 1979 Economic Report earlier this year, this Committee recognized the critical need to stimulate increased saving and productive investment in order to combat inflation and reverse the serious decline in our nation's productivity. A tax break for savers should be a major feature of such efforts. And in this regard, Mr. Chairman, you deserve great credit for sponsoring legislation to achieve this critical objective.

I want to assure you that nothing has a higher priority for our industry than a tax break for this nation's inflation-battered savers. The savings bank industry has long been a lonesome voice in urging such action, and we are gratified that support for a savings-related tax incentive is growing so rapidly. We will do everything in our power to generate public support for, and enactment of, a tax break for savers.

The public-interest benefits of a savings-related tax incentive are manifold and too compelling to ignore any longer. It would be a major step in the fight against inflation, by promoting the increased saving needed to finance productive investment. It would strongly benefit housing, by promoting increased availability of mortgage funds. And it would be the most immediately effective means of providing increased real after-tax returns to all savers.

A major counter argument to tax incentives for savings, of course, is the loss of federal tax revenues. This is an important point at a time when federal budgetary deficits need to be reduced. Over the longer-run, however, an increased level of private saving and capital formation would provide more than offsetting economic benefits to the nation, particularly in its anti-inflationary impact. Increased real economic growth, moreover, would generate increased tax revenues and thus help offset any initial revenue loss.

It should also be recognized that reducing the federal budget deficit through inflation-induced tax collections is bad public policy and is ultimately self-defeating. Indeed, the effect of rapid inflation in pushing taxpayers into higher tax brackets, and a weakening economy, are generating pressures for another round of tax reduction. This situation provides a golden opportunity to tailor tax relief from inflation, and overall contracyclical tax reduction, to the critical longer-run need to promote noninflationary economic growth through increased private saving and capital formation.

Providing a tax break for savers will, of course, require legislation. The other two actions I have recommended, however, do not.

With respect to restoring the thrift institution differential on the 6-month money market certificates, the mid-March regulatory action which eliminated the differential whenever 6-month Treasury bill rates are 9 percent or higher clearly has diverted a substantial amount of funds from mortgage-oriented thrift institutions and the housing market into nonmortgage-oriented commercial banks. This can be seen in the fact that the commercial bank share of the total growth in these instruments jumped from only 31 percent in the first quarter of this year—before the differential was eliminated—to 51 percent in the April-September period.

The thrift institution differential does make a difference for deposit flows and housing credit availability, and we hope that this Committee will urge its immediate restoration by the federal regulatory agencies.

And in a related matter, we also hope that this Committee would urge the federal financial regulators and other relevant government agencies to undertake a close examination of the operations of the money market mutual funds. The phenomenal growth of these unregulated funds—which provide "banking-type" services—has drained a massive amount of money from the housing market and has been a major loophole in the Federal Reserve's anti-inflationary efforts.

Finally, as this Committee knows, the Senate-passed Depository Institutions Deregulation Act of 1979 (H.R. 4986) contains a provision directing the President to form an interagency task force to "conduct a study to determine the difficulties faced by depository institutions which have sizable portfolios of low-yield mortgages," and to report its findings and recommendations for action to the President and the Congress no later than three months after the date of enactment of this legislation. The large volume of low-yield mortgages held by thrift institutions has, in effect, frozen a substantial proportion of their assets in the present climate and this, in turn, has limited their ability to pay higher rates for savings and to make new mortgage loans.

We believe that ways to meet this problem—and to free up frozen assets for new mortgage lending—should be explored now, and we hope that this Committee will support such action.

IN SUM

All things considered, I believe housing and mortgage markets are in for a painful adjustment period in the months ahead. Thrift institutions have been in such a period for several months already. But as we experience the pain of short-run decline, we can be hopeful that the foundations for longer-run health and stability in housing and the economy are finally being put in place. I am hopeful for several reasons:

First, the American public seems at long last to have recognized inflation as our number one economic problem and is in support of broad-scale government efforts to combat it;

Second, the Federal Reserve has strengthened its ability to control the excessive money and credit expansion which has been a major contributor to inflation and inflationary expectations, and is demonstrating its intention to persevere in the anti-inflation struggle; and

Third, the nation's improved mortgage credit structure—secondary markets, mortgage-backed securities, alternative instruments, new sources of funds—will help the housing market recover from the 1979–80 downturn and provide continuing support as progress is gradually achieved in moving toward a more stable economic and financial climate.

Prompt actions to provide a tax break for savers, to restore the thrift institution money market CD differential, to examine the operations of the money market mutual funds, and to address the problem of frozen low-yield thrift institution mortgage holdings would provide even greater reasons for optimism. Indeed, such actions could well make my 1980 housing forecast unduly pessimistic—a risk I am more than willing to face.

Senator BENTSEN. Mr. Smith, if you will proceed.

STATEMENT OF HERMAN J. SMITH, VICE PRESIDENT AND TREASURER, NATIONAL ASSOCIATION OF HOME BUILDERS, WASHINGTON, D.C., ACCOMPANIED BY ROBERT D. BANNISTER, SENIOR STAFF VICE PRESIDENT, GOVERNMENTAL AFFAIRS; AND JAMES SCHUYLER, LEGISLATIVE COUNSEL

Mr. SMITH. Mr. Chairman, I am Herman J. Smith, vice president and treasurer of the National Association of Home Builders, and we are certainly privileged to be in your presence today.

Let me begin by thanking this committee for calling this timely and important hearing. I will present my prepared statement for the record and hit some of the high points, and then be open for questions if you desire.

Senator BENTSEN. It will be placed in the hearing record in its entirety.

Mr. SMITH. I think that what is most important to us today is the impact of high interest rates and other factors on housing starts. Let me put my remarks in perspective by giving you a brief idea of the impact of the housing industry on our Nation's economy. I will not get into details on this, but my prepared statement refers to the 2.5 million jobs provided by the housing industry.

Housing represents a productive investment which creates employment and increases Federal and local revenues.

Now, as we look at the short-term outlook for housing, frankly, it is sad to report the situation for the housing industry and the homebuying public doesn't look good at all. In fact, I think I could easily concur with the previous two witnesses today. In fact, the worst case economic scenario appears to be unfolding, particularly in the last 30 days.

We have heard previous testimony about average mortgage interest rates climbing to 13 or 14 percent, fluctuating by area. With the increase in the FHA rate to 11½ percent on Government-insured loans, we are looking at 6- to 10-percent discount points, so that even federally insured loans are well above the 12-percent yield. Throughout the country our builders are either completely out of the market or homes are so expensive the buyers cannot afford them. We know this has a significant effect on potential home buyers both in their actual ability to buy as well as the psychology of the market.

Homebuilders are laying off construction workers, trimming their own budgets, and drastically revising their plans for next year.

The construction unemployment rate in October increased to 10.1 percent from 8.8 percent in September. My prepared statement shows that if our predictions for next year do occur, we are talking about unemployment in excess of 20 percent in our industry.

Housing starts dropped 8 percent in October to an annual rate of 1.76 million units.

There are a number of observations to be made as we watch the reports coming out of the Census Bureau and HUD pertaining to housing starts. For example, in the last month of fiscal year 1979, HUD reported some 80,000 starts for September. We know the impact of section 8 commitments by HUD at the end of the fiscal year, and we know a lot of permits were taken out. But as we have checked with builders throughout the country, we have found that in a lot of cases, because of the high cost of financing, these starts are actually not underway. Permits might have been purchased and in most cases were. A ground-breaking ceremony was held that was featured in the local newspaper. But a lot of these projects are not now underway because of the high cost of money.

With the prime rate at 15½ percent, of course, we know that as previous testimony showed, builders today are paying in the neighborhood of 17 to 17½ percent for construction financing.

I might add, Mr. Chairman, on a $65,000 house—and that is a median-priced new home—we can readily see where the increase in the cost of construction based on interim financing alone has been a little over $3,000.

Senator BENTSEN. In what period of time?

Mr. SMITH. Over the period of the interim construction. Consider a $65,000 house. As we heard Mr. Janis' testimony a little earlier, including discount points, we are talking about 19 to 20 percent for interim financing. If we take the difference between what was charged 2 years ago on that interim financing during the 6 to 8 months of construction, we'd see an increase in the neighborhood of $3,000 which has to be put on the bottom line of the selling price of a house. This is then financed by the purchaser for 30 years, and the interest is compounded.

Based on those indicators and our economic assumptions, we are predicting a drop in new home construction in 1980 with a tremendous cost to our national economy. If current policies are not changed, we predict a deeper and more prolonged national recession and a drop of more than 50 percent in total housing starts by the second quarter of 1980.

I would like to turn to attachment A to my prepared statement, if you have it available, to show you how we project the scenario.

Please move down to 1980, on the middle of the page. In order to develop estimated starts for next year, we have to make certain assumptions in the area of interest rates. One thing we have learned as builders in the last year is that we cannot predict interest rates. But presuming the prime interest rates, as are outlined in each quarter of 1980, and presuming that the mortgage interest rate varies, as you will note, from 12.9 to 13.75 percent, you will see that the seasonal adjusted annual rate of starts would be, in the first quarter of 1980, 1,139,000; in the second quarter, 990,000; in the third quarter, 1,031,000; and in the fourth quarter, 1,111,000.

We could put another line on there and say that since there has been a slight drop in the last few days, in the event we looked at a 12-percent prime on the average next year and on a 12-percent mortgage rate next year, our econometric model would show about 1.4 million starts.

So we are presuming that those projecting 1.4 million are also projecting a decrease in the prime to around 12 percent on the average next year.

Now, as we look at the worst-case scenario as outlined here, we are looking at the layoff of more than 1.5 million workers in the residential construction and related industries. This results in a loss of $24 billion in annual wages, $6.4 billion in annual tax revenues, and the other bad effects outlined in my prepared statement.

We look at alternatives to the current economic policy, and we believe that the present program, of course, has its weaknesses. We see its inequitable impact on small business. And, by the way, the average builder in our association builds about 15 houses per year. Only about 20 percent are what would be considered volume builders. So we are talking about a large amount of small, private entrepreneurs who are very competitive out in the field nationwide. In a lot of cases the mother and dad and family are workers in the field.

We believe there are three fundamental principles regarding housing and housing cost which must be kept in mind if a responsible economic policy to restrain inflation is to be developed.

First: The underlying demand for housing is very strong and will grow substantially through the decade of the 1980's. We have heard previous testimony on that so I won't go into it.

Second: The boom-and-bust housing cycles are extremely disruptive and costly and are in themselves inflationary. In the 27 years I have been in the business, I have been through a half-dozen of these cycles. Each time we come out of the bottom of the cycle, the hiring and training of new workers to replace those who have moved into other businesses increases the cost of housing and decreases the quality of housing.

Senator SARBANES. Mr. Chairman, I don't want to interrupt Mr. Smith there, but I want to say this is an extremely important point that you are making, I think.

I would urge you to take an extra minute or two to do it in full rather than summarize it. Because we concern ourselves with efficiency and productivity, and I think if there is anything that attacks negative efficiency and productivity in the home-building industry, it is this boom-and-bust cycle.

Mr. SMITH. Senator, I think you are exactly right, and I appreciate your remarks. I will say that in testimony before the House Budget Committee, June 22, 1979, we elaborated on this point and I would be pleased to make this portion of the testimony available to you from our staff.

Senator SARBANES. I'd appreciate that.

Mr. SMITH. A study by the Labor Department showed the inflationary cost involved in the cyclical nature of the construction industry. And it is certainly easy to see that the situation creates particular problems for the manufacturers of building materials, such as insulation companies and siding companies. They cannot now plan capital expansion in order to generate more productivity if I come up here and the Federal Home Loan Bank Board Chairman and the savings and loan industry come up and say, "We are going to move from 2.1 million starts last year to 1.7 this year and 1 million next year."

Senator BENTSEN. You can't make any major capital commitments for things that will increase productivity when you have that kind of situation.

Mr. SMITH. Yes; and a consumer organization opposed to inflation agrees that the cyclical fluctuations have increased housing costs by 15 to 20 percent.

Third: We have discussed on many occasions Government overregulation in this field, including duplicative and overlapping regulations, so I won't get into that. But we had a housing forecast conference yesterday with a group of economists and builders in Washington. Mr. Chairman, it was interesting to note a story from one builder from the Baltimore area. He wanted to start 107 units in a HUD project, a planned unit development on the edge of Baltimore. In order to start 10 units—and that is all he was looking forward to in the near future because of the cost—he was required by the city to take out a permit for 107 units for the total planned unit development. Permits were required for every house to be built, whether they were actually going to be built or not.

First: It added to the cost of his fees up front on 97 units that might never be built. Second, it will be interesting whether the Census Bureau reports 10 starts or 107 starts since these permits were taken out although 97 units might not be built.

We would suggest for your consideration and review three legislative items we are very much concerned about.

The first is a tax exemption for interest on savings. I wish I had more time to discuss it but your interest in this area is clear. We think this is a must this year. We need to encourage the American people to get back into a savings posture that not only will help our industry but the entire economy as well.

Second: We think that the continuing use of tax-exempt revenue bonds as outlined in a bill to be introduced by Senator Williams this week, is necessary.

Third: We believe, as we look at the horrendous and tremendous downturn in starts for the second quarter of 1980 to 990,000. Starts, that we should look forward to the reactivation of the Brooke-Cranston program. We don't think either of these programs are a substantial revenue drain for the Treasury. We think in the long run this will provide additional money to the Treasury.

In conclusion, let me ask you to turn to attachment B, the housing affordability table, in my prepared statement, Mr. Chairman. It answers some of the questions you asked previously about housing affordability and interest rates.

If we look at the 10-percent interest rate of a short time ago—and in previous testimony today you heard of rates of 13 percent on a conventional loan—you will note, in the housing affordability table, the difference the increase makes in a house payment on a $65,000 house with a 5-percent down payment and a $61,750 mortgage. You are talking about an increase—just in the last few months—in a monthly payment of $141 in interest alone. That increase amounts to about $1,692 a year, or about $50,760 over the life of a 30-year loan. And you have not taken into consideration the $3,000 we discussed earlier resulting from the additional interim construction financing that is part of the $61,750. Our industry just does not understand how this type of inflation and interest rate will hold down the price of a house and cause a downturn in the cost of housing.

Furthermore, if you look across to the right column of that same table, you will see the number of families priced out each time the interest rate increases. If you will look at the total figures there between 10 percent, with 686,000 families priced out of the market, and then go down to 13 percent by percentage half-points, 4,748,000 American families have been priced out of affordable housing in this Nation.

Mr. Chairman, that concludes my remarks.

Again, we appreciate the importance of your committee's looking into this, and we hope to see some changes next year.

Senator BENTSEN. Mr. Smith, it has been tremendously informative and can't help but cause a great deal of concern. While I note it evokes a lot of questions from the members here, I am also concerned about what is happening on the floor and a possible vote. Therefore, I think we should go on and we'll ask questions when we have finished.

[The prepared statement of Mr. Smith, together with attachments, follows:]

PREPARED STATEMENT OF HERMAN J. SMITH

Mr. Chairman and Members of the Committee, My name is Herman J. Smith, and I am a home builder from Fort Worth, Texas. I am testifying today on behalf of the more than 120,000 members of the National Association of Home Builders (NAHB). NAHB is a trade association of the home building industry, of which I am Vice President and Treasurer. Accompanying me today are Robert D. Bannister, Senior Staff Vice President for Governmental Affairs, and James Schuyler, Legislative Counsel.

We appreciate the opportunity to appear before this distinguished committee today to discuss the short-run outlook for the housing industry and the likely impact of a housing downturn on the national economy in the coming year.

Mr. Chairman, let me begin by commending you for calling these most timely and important hearings. There is no question that the actions of the Federal Reserve Board on October 6 have focused national attention on our economic policy to combat inflation, particularly its impact on certain sectors of the economy, such as housing. I believe that we must examine the impact of this policy on the national economy in the coming year, and that we must develop less painful alternatives to the current policy which will achieve the result we all desire—a slowdown of inflation. At the same time, we must avoid a catastrophic collapse of the housing industry with its attendant loss of jobs, loss of federal revenue, and devastating impact on the homebuying public.

IMPACT OF THE HOUSING INDUSTRY

Let me put my remarks in perspective by giving you a brief analysis of the impact of the housing industry on our nation's economy. Mr. Chairman, as you are aware, the housing industry is one of the largest contributors to the Gross National Product, and new residential construction will account for about 4.7 percent of the GNP in 1979, representing $108 billion. Housing production has a powerful ripple effect throughout the economy, creating jobs and stimulating sales and demand for goods and services. The total economic impact of the 1979 production rate of an estimated 1.73 million new housing starts has been estimated to be in excess of $210 billion. The production of 1.73 million new homes has generated more than 2.5 million full-time jobs; some $45 billion in wages; over $5 billion in federal income tax revenue; about $2 billion in local real estate tax revenue; and an additional $850 million in state income taxes. I think that the members of this Committee would agree that this represents a tremendous contribution by an industry whose members are predominantly small businessmen and women who build an average of about 15 new homes a year. Mr. Chairman, housing represents a productive investment which creates employment and increases federal and local revenues. And I believe that a healthy housing industry is an important element in providing the impetus to help lead the country out of its current inflationary climate.

SHORT-TERM OUTLOOK FOR HOUSING

Now what about the outlook for housing in 1980? Frankly, it is sad to report that the situation for the housing industry and the homebuying public doesn't look good at all. In fact, almost overnight, the worst-case economic scenario appears to be unfolding.

Mortgage interest rates have climbed to over 14 percent in the past month.

A number of savings and loan associations, mutual savings banks and mortgage bankers have virtually closed their mortgage windows, honoring existing commitments but holding off on making new mortgage loans.

Other lending institutions have severely tightened their credit requirements and substantially increased downpayment requirements.

Many potential homebuyers have postponed their decision to buy a new home because of their inability to qualify for loans at today's record high interest rates or because of fear of a deep general recession. Others are backing out of contracts on new homes when they find that they cannot sell their existing home or their mortgage commitment has fallen through. This is leaving homebuilders stranded with growing inventories of unsold homes.

Homebuilders are already laying off construction workers, trimming their own budgets and drastically revising their plans for next year.

The construction unemployment rate in October increased to 10.1 percent from 8.8 percent in September.

Housing starts dropped 8 percent in October to an annual rate of 1.76 million units. It represents a sharp decline of 300,000 starts at an annual rate compared with October 1978 activity. And these numbers grossly overstate the number of multifamily starts because of the impact of Section 8 commitments by HUD in the last month of fiscal year 1979 which will continue to be reflected as "starts" by the Census Bureau until the end of the year. HUD reported some 90,000 "starts" in September. As you know, some of these starts may actually be permits and may never result in housing starts at all due to inability to obtain financing. But they will all continue to be reflected as Census Bureau "starts" over the next few months and the multifamily figures could remain distortedly high through the end of the year.

With the prime rate at 15½ percent, interest rates on construction financing have risen to over 17 percent. This serves to increase the carrying costs for homebuilders by thousands of dollars and will lead to a sharp increase in business failures and bankruptcies.

Based upon those indicators and our economic assumptions, Mr. Chairman, we are projecting a catastrophic drop in new home construction in 1980 with tremendous costs to our national economy. If current policies are not changed, we predict:

A deeper and more prolonged national recession.

A drop of more than 50 percent in total housing starts by the 2nd quarter of 1980—to an annualized rate of 990,000 starts. (See Attachment "A".) We predict housing starts for 1980 at about 1.1 million units.

Mortgage interest rates of 14 percent which will slam the door on homeownership for millions of potential homebuyers and families of moderate income. At 14 percent interest rates, only 8 percent of American families could afford a median-priced new home. (See Attachment "B"). A family would need an annual income of over $45,000 to afford the $732 monthly mortgage payments on a $65,000 home.

Lay off of more than 1.5 million workers in the residential construction and related industries resulting in loss of $24 billion in annual wages; loss of $6.4 billion in annual tax revenues; and substantial additional government expenditures for unemployment compensation and other governmental assistance programs.

A sharp increase in the unemployment construction rate (residential and non-residential) to at least 20 percent next year.

Mr. Chairman, we would be pleased to provide this committee with our assumptions and updates of these projections over the next few months based upon our econometric model. As you are aware, Mr. Chairman, our projection of about 1.1 million starts in 1980 represents the lower end of the range which has been projected by most housing economists. I believe that Mr. Klaman of the National Association of Mutual Savings Banks projects starts dipping as low as 1.1 million. But even Administration projections which are probably at about 1.4 million have been steadily revised downward over the past few months. And I think that all projections assume no drastic changes in our national economy, such as could occur with major increases in oil prices.

ALTERNATIVES TO CURRENT ECONOMIC POLICY

Mr. Chairman, I believe that the Fed's tight money approach is riddled with weaknesses. It is inequitable. It favors big corporate America and big government who have access to credit and can pass on the higher costs to the consumer. It does this at the expense of those who have the most to lose—working people and small businessmen who will be driven out of the marketplace and out of business by sky-high interest rates. The tight money approach penalizes those who are most vulnerable in our society—the young and the elderly, the poor and the disadvantaged, and millions of working families who are pinched first by the hidden tax of inflation and then by the misguided attempt to cure it.

The Administration has stated that we all are going to have to make some sacrifices in this fight against inflation. But it certainly appears that, as in the past, some of us are being forced to make far greater sacrifices than others.

I believe that there are three fundamental principles regarding housing and housing cost which must be kept in mind if a responsible economic policy to restrain inflation is developed.

First, the underlying demand for housing is very strong and will grow substantially through the decade of the 1980's. Projections indicate that during the 1980's, 42 million Americans will reach the prime homebuying age of 30. This compares with about 30 million who will have reached the age of 30 during the 1970's. The Census Bureau estimates that by 1990 there will be 22 million households with only about 10½ million households in that age group in 1970.

This increased rate of family formation is largely the result of the postwar baby boom and the number of increased single person households. We predict that there will be no significant drop in housing demand until the 1990's, when the "baby bust" generation of the 1960's enters the housing market.

When combined with the number of families currently occupying substandard housing and the number of housing units removed from the market each year by demolition, disaster or other means, an additional 12.5 million to 14 million housing units could be needed during the next five years. The demand for housing would not even be met by a level of production of 2 million units per year, which has traditionally been considered a "very good year" for housing. And any lower production levels will almost certainly result in increased upward pressure on home prices due to the simple facts of supply and demand.

Therefore, a policy of tight money which is designed to dampen consumer demand is doomed to failure, just as it failed in 1973 and 1974. Inflation won't be brought under control by restraining credit and pushing up interest rates. Inflation might be cooled temporarily, but it is bound to surge back at even higher rates during the next recovery. And the pent-up demand will lead to even higher home prices as purchasers bid up the prices of an inadequate supply of new housing.

As this Committee so wisely recognized in your mid-year report in August 1979, the major cause of inflation is an inadequate supply of goods, not excessive demand. The best way to bring about a more stable economy, your report concluded, is to provide incentives to strengthen the capability of businesses to produce needed commodities, thus allowing increased productivity and a moderation of inflationary pressures. Policies to increase savings and investment would lead to a more stable flow of mortgage finance and growth in productivity.

Second, the "boom and bust" housing cycles are extremely disruptive and costly and are in themselves inflationary. The roller-coaster which the housing industry has traditionally been riding has contributed substantially to increased home prices. It has reduced productivity in housing by disrupting management and decimating the supply of skilled construction labor. In addition, it makes rational planning by suppliers extremely difficult.

During periods of slack construction, plant and equipment stand idle; the capacity for manufacturing materials and components used in housing construction is underutilized; and construction workers are not employed. During periods of high construction activity, workers demand higher wages to provide reasonable annual incomes (considering periods of unemployment); returns on plant and equipment must be higher to make up for losses during idle periods; and the demand for resources used in housing is increased sharply, resulting in higher land prices, higher material prices, higher interest costs, and higher wage costs.

A broad coalition of public interest groups—Consumers Opposed to Inflation in the Necessities (COIN)—has estimated that the cost of cyclicality in housing production has increased housing costs by 15 to 20 percent. And a study by the Department of Labor released in April of this year has found "cyclical and seasonal fluctuations in employment and output of great magnitude." The study stated: "These wide swings (in employment and output) exacerbate inflation and unemployment. The unemployment rate in construction is typically twice the national average, and this industry accounts for a tenth of the total number of unemployed. Increases in construction costs have contributed substantially to general inflation."

Third, Mr. Chairman, as you are well aware, government over-regulation including duplicative and overlapping regulations and regulations promulgated without regard to costs or benefits, are a major contributor to inflation in the housing industry. I need not dwell on this subject because I know that this Committee has been in the forefront of a Congressional effort to begin to attack these unneeded and substantial costs. You have all heard the figures—the cost of excessive government regulation at all levels could add as much as 20 percent to the cost of a median-priced new home.

Mr. Chairman, I think it is clear that the same old prescription of tight money and high interest rates will not succeed in restraining inflation. It holds enormous risks for the national economy: for unemployed workers in the construction and related trades; for the first-time homebuyer who will be priced out of the market; for the young, the elderly and the poor who are least able to cope with inflation; and for the small home builder who will lose his lifelong dream and years of hard work in bankruptcy court.

There are alternatives to this current policy which are far less disruptive which I believe would do a better job in bringing inflation under control and would also spread the burden of fighting inflation more evenly across the entire economic spectrum.

Instead of trying to restrain demand for essential goods such as housing by imposing tight and expensive money policies, the Administration and the Congress should pursue the appropriate mix of fiscal tax and monetary policies that would reward increased productivity, encourage investment by business and saving by consumers, reduce unnecessary and costly government regulations, and eliminate reckless deficit spending policies that have saddled our country with a national debt of more than $800 billion, costing taxpayers more than $50 billion a year to finance.

Such actions would lower inflation by restoring business and consumer confidence in the economy and by increasing production, employment and competition in the marketplace. It would mean more choices, better products, and lower prices for consumers.

Mr. Chairman, I am most impressed that this Committee, with its representation from the leadership of both Houses of Congress, Majority and Minority, was able to reach a consensus regarding the importance of productivity and economic expansion to our economy in the 1980's.

In that spirit of cooperation, I would urge your review of a number of specific legislative proposals which I believe are consistent with your philosophy that "we must and we can produce our way out of our economic problems" and which would help to reduce inflation in the 1980's.

We would suggest for your consideration and review:

Reactivation of the "Brooke-Cranston" GNMA tandem program which increased the supply of below-market mortgage credit to help stimulate the purchase of new homes during the 1974–1975 recession.

Continuing use of tax-exempt revenue bonds as an essential source of mortgage finance for low income, moderate income and middle-income families both for rental and ownership, as will be proposed in a bill expected to be introduced by Senator Harrison Williams (D–NJ) within a week.

A tax-exemption for interest earned of up to $1,000 on passbook savings to induce greater savings and productivity as proposed by the Chairman.

A statutory requirement that government regulations meet their objectives at the least possible cost and exploration of a "regulatory budget" to encourage federal agencies to limit the cost of compliance with their regulations, as proposed by this Committee.

Because of the urgency of the crisis in housing, the National Association of Home Builders convened a Housing Economic Summit Conference on November 7 and November 8. We invited representatives of the Administration, Congress, including your distinguished Chairman and Chairman Reuss of the House Banking Committee, labor, financial institutions, low-income groups, consumers and the elderly to present their recommendations for actions which can be taken by the Administration and the Congress to reduce inflation without catastrophic cost to the housing industry. I would be pleased to share with this Committee the written presentations and substantive actions recommended by the participants in the Conference.

Thank you for giving us the opportunity to present our views before you today. I wish that I could present a more optimistic picture of the outlook for housing in the near term, but the recent actions by the Federal Reserve Board force us into a gloomy assessment. Mr. Chairman, I would be pleased to answer any questions which you or the members of your distinguished committee may have.

Attachment A

COMPARATIVE HOUSING ECONOMIC VARIABLES

Year/quarter	Prime rate (percent)	Mortgage interest rate, percent (effective rate)	Total housing starts—SAAR (thousands)	Single family starts	Unsold inventory—SAAR (thousands)	Months of inventory at end of period
1973:						
1st quarter	6.11	7.69	2,378	1,336	425	7.4
2d quarter	7.04	7.74	2,139	1,181	437	8.4
3d quarter	9.13	7.99	2,016	1,101	453	10.2
4th quarter	9.81	8.40	1,642	918	448	11.3
1974:						
1st quarter	9.26	8.59	1,586	925	452	9.9
2d quarter	10.94	8.75	1,515	964	436	10.7
3d quarter	11.99	9.08	1,203	861	414	10.3
4th quarter	11.00	9.25	1,024	779	400	12.1
1975:						
1st quarter	8.98	9.17	976	734	395	10.5
2d quarter	7.32	8.94	1,071	848	379	8.8
3d quarter	7.56	8.91	1,250	950	384	8.4
4th quarter	7.58	9.01	1,342	1,033	378	6.9
1976:						
1st quarter	7.03	8.95	1,442	1,141	389	8.3
2d quarter	6.90	8.93	1,450	1,099	406	8.6
3d quarter	7.09	9.02	1,557	1,176	415	7.5
4th quarter	6.54	9.07	1,691	1,250	431	6.6
1979:						
1st quarter	11.75	10.23	1,615	1,119	424	6.8
2d quarter	11.72	10.50	1,834	1,264	431	7.4
3d quarter	12.12	10.94	1,823	1,236	418	7.4
4th quarter	15.50	[2] 12.25	1,402	928	450	10.2
1980:						
1st quarter	[1] 16.00	12.90	1,139	784	443	11.9
2d quarter	[1] 15.50	13.25	990	691	434	12.3
3d quarter	[1] 15.25	13.75	1,031	703	417	11.3
4th quarter	[1] 15.00	13.50	1,111	731	409	10.7
1978:						
July	9.00	9.57	2,104	1,455	417	6.4
August	9.01	9.70	2,004	1,431	418	6.4
September	9.41	9.73	2,024	1,432	417	5.9
October	9.94	9.83	2,054	1,436	407	5.5
November	10.94	9.87	2,107	1,502	512	6.5
December	11.55	10.02	2,074	1,539	413	6.2
1979:						
January	11.75	10.18	1,679	1,139	412	6.7
February	11.75	10.20	1,381	953	410	7.1
March	11.75	10.30	1,786	1,266	424	6.6
April	11.75	10.36	1,745	1,278	425	6.8
May	11.75	10.47	1,835	1,226	431	7.2
June	11.65	10.66	1,923	1,288	418	7.4
July	11.54	10.78	1,788	1,220	417	7.4
August	11.91	11.02	1,806	1,240	417	6.5
September	12.90	11.02	1,881	1,249	NA	NA

[1] Estimate.
[2] Commitment rate.

Source: Federal Reserve Board, Federal Home Loan Bank Board, Bureau of the Census, estimates by NAHB.

Attachment B

HOUSING AFFORDABILITY

[$65,000 house, $61,750 mortgage amount (5 percent down), 30-yr term]

Interest rate	Monthly payment	Related housing expenses[1]	Annual income needed to afford[2]	Number of households who can afford (thousands)	Percent of households who can afford	Number of families priced out (thousands)
7½ percent	$432	$215	$31,056	13,274	23.3	
8 percent	453	215	32,064	12,645	22.1	629
8½ percent	475	215	33,120	12,015	21.0	630
9 percent	497	215	34,176	11,386	19.9	629
9½ percent	519	215	35,232	10,756	18.8	630
10 percent	542	215	36,336	10,070	17.6	686
10½ percent	565	215	37,440	9,440	16.5	630
11 percent	588	215	38,544	8,754	15.3	686
11½ percent	612	215	39,696	8,067	14.1	687
12 percent	635	215	40,800	7,381	12.9	686
12½ percent	659	215	41,952	6,694	11.7	687
13 percent	683	215	43,104	6,008	10.5	686
13½ percent	707	215	44,256	5,321	9.3	687
14 percent	732	215	45,456	4,577	8.0	744

[1] Real estate taxes, hazard insurance, utilities, maintenance and repairs.
[2] Assumes ¼ of income goes to housing expenses and constant underwriting criteria.

Source: National Association of Home Builders.

Senator BENTSEN. Mr. Thygerson, will you proceed, please.

STATEMENT OF KENNETH J. THYGERSON, CHIEF ECONOMIST AND DIRECTOR, ECONOMICS DEPARTMENT, UNITED STATES LEAGUE OF SAVINGS ASSOCIATIONS, CHICAGO, ILL.

Mr. THYGERSON. Mr. Chairman, thank you very much.

There always tends to be a lot of agreement among forecasters in times like this, and I think this year in particular there is unusual unanimity of opinion.

The United States League, nevertheless, appreciates this opportunity to present our short-term outlook for housing and thrift institutions. I will summarize my prepared statement, dwelling on what I think to be the major factors affecting the housing market for 1980, and then, most particularly, on some recommendations for congressional and governmental action next year.

Certainly the October 6, 1979, Federal Reserve Board action, which was designed to strengthen the dollar and lower inflation, has thrown many an economic forecast into disarray and mine is no exception.

Available housing statistics do not yet reflect the consequences. They really mask the potential housing problems looming for 1980.

Despite the ambiguity concerning current statistics, it is our opinion that residential construction will experience a severe contraction in 1980—proportionately as bad as the average contractions of previous postwar housing cycles. We do not, however, anticipate a repeat of the collapse in housing starts which took place between 1972 and 1975.

Our forecast, however, is predicated on the assumption that the oil problem that now faces our Nation does not reach crisis proportions in late 1979 or 1980. A further escalation of oil prices could substantially upset the U.S. economy and bring about both a more severe recession and a more severe inflation problem. Housing could be expected to perform very poorly in such an environment.

Barring such a calamity, we estimate housing starts in 1980 will fall 20 percent to about 1.4 million units from 1979's estimated level of 1.75 million units.

Let me review briefly the negative and positive factors for next year. I think, Senator Sarbanes, you hit on the major one, the cyclical nature of it.

I would like to call to the attention of those that have not had a chance to read it, to the statement that was in the "Midyear Review of the Economy: The Outlook for 1979," the report of the Joint Economic Committee this year, because it is most appropriate for this occasion. And I read:

> Even if expansionary policies are adopted during the 1980's in order to prevent major economic downturns, a change in the policy mix can help control inflation by providing incentives for individuals and businesses to save and make new investments, thereby expanding the capital stock and productive capacity of the economy. The investment spending would expand demand, just as consumer spending does, but it would also expand the supply side of the economy and thus reduce inflationary pressures.

That says it much better than I can. If we are to avoid the pains and the suffering and the costs of the cycles that we have had in housing, we've got to develop a better balance between monetary and fiscal policy the next time around.

Another area of concern is usury ceilings. We have 18 States, in our estimation, that have usury ceilings at 12 percent or less. The homebuilder and home buyer have found that their ability to compete for funds in these States has been seriously impaired. In effect, a credit crunch is in effect.

Another major jolt to the housing market alluded to by Saul Klaman—and I want to emphasize it very particularly—was a decision to eliminate the savings rate differential in the popular money market certificates whenever the index to which that is tied, the 26-week Treasury bill rate, goes over 9 percent. As a result of the loss of the differential, savings and loan associations—the Nation's major supplier of home mortgage credit—have experienced a substantial reduction in retail savings. In the last 6 months, retail savings flows have been negative, though negotiable certificates of deposit offered to corporate and governmental treasurers have kept overall net savings positive in some months.

And I call the attention of this committee to the release by the Federal Home Loan Bank Board that showed a $1.2 billion increase in net new savings in the month of October, which goes on to report that $1.6 billion of that increase was due to rises in jumbo certificates or in large CD's.

In the retail savings market we have, as the mutual savings banks have, been losing deposits.

Exhibit 2 of my prepared statement shows that when the differential was in effect from June 1978 through March 15 of this year, the savings and loan share of the MMC market was 52.6 percent as between commercial banks, savings and loan, and mutual savings banks. After March 15 our share of the MMC market dropped to 35.9 percent. And since we expect Treasury bills will remain over 9 percent at least through the middle part of next year, we think our ability to attract deposits will continue to be impaired.

Real personal income of home buyers has been falling since late 1978, the Department of Commerce reports. I need not dwell on that problem at this point.

Despite the predominance of these major negatives, there are a few positives. Saul Klaman highlighted the fact that savings and loan business and other mortgage lenders have been very successful in attracting so-called nontraditional sources of funds. Mortgage-backed bonds, conventional passthrough securities will help somewhat cushion the housing cycle next year.

Another reason the dip in this housing cycle can be expected to be more moderate stems from the better inventory balance of the housing market today, as contrasted with that which preceded the housing decline in 1974. Certainly we do not have a record-high inventory of unsold and unrented multifamily units that was so prevalent back in 1972, 1973, and 1974.

It might also add that with housing having the investment attributes which are perceived by so many Americans, there is no doubt that this inflationary aspect of the home purchase will continue to force families and really persuade families to reach into their family budgets to a greater extent in order to attain home purchase.

So these positive factors, I think, will temper somewhat the housing cycle next year.

Another major consideration, going back to the problems of the thrift institutions, shown in exhibit 2, relates to the fact that the high cost of funds is having a significant detrimental impact on earnings of profitability and net worth of thrift institutions.

I want to point out very specifically that savings and loan associations under law are required to maintain a reserve position, called a Federal Insurance Reserve, which is related to the amount of savings they have. So to the extent that next year—and we fully anticipate that next year will be a difficult year for earnings and net worth—to the extent that we have these pressures on the net worth of associations next year, this may cause many savings and loans to pursue what we call no-growth or slow-growth policies. As their net worth goes down, their ability to attract savings goes down with it. That may be another negative for the housing picture next year.

Given these factors, let me review a few recommendations for this committee.

First, I think the Federal Home Loan Bank Board should be encouraged to authorize renewable mortgages for all federally chartered associations, as well as modify their existing regulations for variable rate mortgages for institutions consistent with the rises and falls in interest rates that we have seen in this economy over the last 15 years. They should do so without artificial restraints.

Next, we strongly urge that the language of H.R. 4986 as recently passed by the Senate, which provides a Federal exemption from anachronistic State usury ceilings for home loans, be retained and accepted by the House this year.

Another important amendment found in that legislation again passed by the Senate would give the Federal Home Loan Bank Board the discretion to adjust Federal insurance reserve requirements for all FSLIC-insured S. & L's. Again we are hopeful that the House will agree to this important provision of the Senate version of H.R. 4986.

We would further recommend the savings rate differential should be preserved or reimposed for all retail-type savings accounts offered by housing-specialized institutions.

Mr. Chairman, your committee's midyear review recited the critical need to encourage savings. I understand tomorrow the Senate Finance Committtee at your initiative, Chairman Bentsen, is meeting to consider a very important amendment which will reverse the long-standing bias in our tax code against savings and provide a new tool to combat inflation. This is most important to reverse the "buy now" psychology which has affected us, and thus the home buying and home sales market. I understand, Mr. Chairman, there is some concern in the Congress that this not be put into effect immediately. We wish that were not so with inflation at today's double-digit rates, that it be available as soon as possible, for example. In any event, we wish you all succcess tomorrow.

I have left my most important recommendation to the last, and it relates specifically to the comments of Mr. Smith and Senator Sarbanes a few minutes ago.

The 1980 economic slowdown should not be used as an excuse for rapidly enlarging our Federal deficit. It would be a mistake to use force-fed spending programs to buy us out of a recession. A longer term, less inflationary policy would be to rely more on a monetary policy—unhampered by the need to finance Treasury borrowing—to bolster the economy. I firmly believe that growth would occur at the same overall rate but that it would be a more balanced growth with capital spending, making a larger contribution and less inflationary growth and the kind of growth that may avoid the kinds of problems that we are confronting today.

The United States League appreciates this opportunity to participate in your hearing, and I, too, look forward to your questions.

Thank you.

Senator Bentsen. Thank you very much, Mr. Thygerson.

[The prepared statement of Mr. Thygerson follows:]

Prepared Statement of Kenneth J. Thygerson

My name is Kenneth J. Thygerson. I am chief economist and director of the Economics Department of the United States League of Savings Associations.[1] The United States League appreciates this opportunity to present its views on the current state of the housing market and our forecast for 1980.

Mr. Chairman, you and members of your committee are to be commended for having the foresight to review conditions in the housing market at this very critical stage of the housing cycle. The October 6, 1979 Federal Reserve Board action, which was designed to strengthen the dollar and lower inflation, has thrown many an economic forecast into disarray. Nowhere is this more true than with respect to residential construction. With inflation and interest rates already at or near all-time record high levels, it should come as no surprise that the outlook for housing in 1980 has taken a definite turn for the worse.

[1] The United States League of Savings Associations (formerly the United States Savings and Loan League) has a membership of 4,400 savings and loan associations representing 99⅔ percent of the assets of the $510 billion savings and loan business. League membership includes all types of associations—Federal and State—chartered, insured and uninsured, stock and mutual. The principal officers are: Ed Brooks, president, Richmond, Va.; Rollin Barnard, vice president, Denver, Col.; Lloyd Bowles, legislative chairman, Dallas, Tex.; Norman Strunk, executive vice president, Chicago, Ill.; Arthur Edgeworth, director-Washington operations; and Glen Troop, legislative director. League headquarters are at 111 E. Wacker Dr., Chicago, Ill. 60601; and the Washington office is located at 1709 New York Ave., N.W., Washington, D.C.

Because housing policy is frequently born out of emergency conditions, some suggestions with respect to how Federal Government might respond to the unfolding housing conditions for 1980 may be useful to the members of this committee. Before doing this, however, I will turn to the housing outlook for next year.

THE HOUSING OUTLOOK: ANOTHER MAJOR CYCLICAL DECLINE

Current trends which indicate a continuation of double-digit inflation, together with the sharp rise in open-market interest rates since October 6, 1979, certainly represent a dark cloud hanging over the residential housing market. It's rather like being in the eye of a hurricane: Current conditions appear calm, but experience tells us that the storm clouds and violent winds will soon be upon us.

Since September the prime rate has risen from 13.25 percent to 15.75 percent. Mortgage interest rates have also risen sharply to levels of 13 percent and 14 percent in nonusury States from 11.50 percent prior to the Federal Reserve's action. Such a sharp rise in interest rates has historically been the prelude to a marked softening of activity in the housing markets. This is also true today.

Recent housing statistics do no yet reflect the October 6 action. October housing starts registered a preliminary 1.76 million units (SAAR). This is roughly on target with the beginning-of-the-year forecasts which predicted 1.7 to 1.75 million housing starts for 1979 as a whole.

Moreover, mortgage loan commitments outstanding at savings and loan associations, an indicator of future lending, remained at an all-time high in September. Since commitments outstanding relate to future residential construction activity, they suggest that housing starts and mortgage loan closings will remain relatively high for several more months at least.

Thus, available statistics really mask the potential housing problems looming for 1980.

Despite the ambiguity concerning current statistics, it is our opinion that residential construction will experience a severe contraction in 1980—proportionately as bad as the average contractions of previous post-war housing cycles. We do not, however, anticipate a repeat of the collapse in housing starts which took place between 1972 and 1975. The decline in housing for 1980 will contribute to a recession which can be expected to last at least through the first half of next year.

This forecast, however, is predicated on the assumption that the oil problem that now faces our nation does not reach crisis proportions in late 1979 or 1980. A further escalation of oil prices could substantially upset the U.S. economy and bring about both a more severe recession and a more severe inflation problem. Housing could be expected to perform very poorly in such an environment.

Barring such a calamity, we estimate housing starts in 1980 will fall 20 percent to about 1.4 million units from 1979's estimated level of 1.75 million units. This is a less severe drop than that experienced in 1974. We base this assessment on the substantial differences in the composition of housing starts and inventory levels between 1974 and at present. Multifamily starts accounted for a much higher proportion of total starts in the early 1970's than they do now. In 1974 the multifamily market was overbuilt and vulnerable to collapse, which occurred. Housing markets are simply not as exposed today as they were earlier in this decade.

However, like the 1974 collapse, usury ceilings again pose a problem. Thus, there will be a marked disparity in home construction activity in markets across the nation depending upon whether the local jurisdiction is burdened by an anachronistic usury ceiling.

And, as in earlier tight money periods over the past 15 pears, inverted yield curves (where short term investments command higher rates than long) will place the financial institutions specializing in long-term, fixed-rate mortgages at a disadvantage in holding deposits and attracting new funds from the savings public.

FACTORS AFFECTING OUR HOUSING OUTLOOK

Forecasts, while interesting, do not really provide the substance for developing recommendations. Rather, it is necessary to review the many factors that will affect housing next year. Let me, therefore, review the negative and positive factors that we expect in 1980. Because the negative influences will be dominant, we begin by looking at five major factors that will contribute to next year's decline in housing. These include: (1) The impact of high inflation and resulting high interest rates; (2) the impact of below-market usury ceilings; (3) the impact of the March 15, 1979 loss of the regulation Q savings rate differential on the money market certificate; (4) the impact of lower or negative real income gains in 1980; and, (5) the impact of our Nation's lack of savings incentives—that has resulted in a low savings rate for the American economy.

(1) *Inflation and high interest rates.*—Clearly the dominant negative factor affecting the housing outlook next year is the substantial increase in inflation and interest rates. It may be worthwhile to consider the current situation from the historical perspective of the last decade and a half. A short review of this period shows that there is a close correlation between the level of housing starts activity, inflation, and short-term interest rates. This relationship is shown in exhibit 1.

The exhibit indicates that periods of high inflation are also associated with periods of high interest rates and low, or declining housing starts. High inflation in 1969–70 resulted in high interest rates and weak housing starts activity. The situation recurred in 1973, 1974, and 1975. Conversely, the strongest housing starts—1971, 1972, 1976, and 1977—were generally characterized by lower or declining rates of inflation and interest rates. Although the relationships shown here are less than perfect—primarily as a result of the long "lead" and "lag" times inherent in the residential housing market—they are strong enough to make the case that inflation is the major nemesis of home finance and home construction. This is the case in 1979 and 1980.

The problem in 1980 appears to be that Federal budget deficits have continued far too long. We are now in the fifth year of economic expansion and the fiscal 1980 Federal budget deficit is estimated to be over $30 billion.

Exhibit 1

RELATIONSHIP BETWEEN HOUSING STARTS, INFLATION AND INTEREST RATES

Year	Total housing starts (thousands of units)	Annual average 3-mo Treasury bill rate (percent)	Annual Consumer Price Index increase (percent)
1965	1,509.7	3.954	1.7
1966	1,195.8	4.881	2.9
1967	1,321.9	4.321	2.9
1968	1,545.4	5.339	4.2
1969	1,499.5	6.677	5.4
1970	1,469.0	6.458	5.9
1971	2,084.5	4.348	4.3
1972	2,378.5	4.071	3.3
1973	2,057.5	7.041	6.2
1974	1,352.5	7.873	11.0
1975	1,171.4	5.838	9.1
1976	1,549.7	4.989	5.8
1977	1,988.8	5.265	6.5
1978	2,020.3	7.221	9.0
1979	[1] 1,750.0	[1] 9.96	13.5

[1] Estimate.

Source: Department of Commerce, Federal Reserve Board.

The dilemma we face, then, is that even with major efforts to try to pare Federal spending and lessen the red ink, we are again faced with having to resort to restrictive monetary policies as the primary inflation-fighting tool in our economic arsenal. It may be that the best we can do is learn an important lesson from this experience: We must work toward a more balanced monetary/fiscal policy stabilization mix in the future than that which we have used in the past; we should not rely so heavily on consumption-oriented Federal spending—and resulting budgetary deficits—to promote economic expansion during periods of recession. The results have always been the same: the deficits last too long; the temporary spending measures become permanent; and we are left to rely on monetary policy to slow the inflation forces that are ignited in the process.

This observation is entirely consistent with the excellent discussion of the problem found in the Joint Economic Committee report "Midyear Review of the Economy: The Outlook for 1979." In the report the following important point is made:

"Even if expansionary policies are adopted during the 1980s in order to prevent major economic downturns, a change in the policy mix can help control inflation by providing incentives for individuals and businesses to save and make new investments, thereby expanding the capital stock and productive capacity of the economy. The investment spending would expand demand, just as consumer spending does, but it would also expand the supply side of the economy and thus reduce inflationary pressures."

(2) *Usury limits.*—Usury ceilings in a number of States also represent a significant negative influence on the housing outlook in 1980. Our estimate is that there are 18 States that have usury ceilings of 12 percent or less. However, market interest rates for mortgages are at 13 percent to 14 percent in States without below-market usury limits. In combination with portfolios filled with long-term, fixed-rate loans originated years ago, these usury ceilings mean uneconomic returns on home loans for institutions. The home builder and home buyer in these 18 States have found that their ability to compete for funds has been seriously impaired. A credit crunch is in effect.

(3) *The impact of the loss of the savings rate differential on the money market certificate.*—A major jolt to the housing market in 1979 has been the March 15, 1979 elimination of the savings rate differential on the money market certificates (MMC) when the index to which they are tied—26-week Treasury bills—yield over 9.00 percent. As a result of the loss of the differential, savings and loan associations—the Nation's major supplier of home mortgage credit—began to experience a substantial reduction in retail savings. In recent months, retail savings flows have been negative resulting in disintermediation. As a consequence, the residential housing market has been hurt.

This fact is evident from a review of the statistics provided by the financial institution regulators covering the net increase in money market certificate balances for savings and loans, commercial banks, and mutual savings banks. Exhibit 2 shows the net increase in MMC dollar balances for commercial banks, savings associations, and mutual savings banks for the period when thrift institutions had the differential (June 1978 through March 1979) and after it was eliminated (April through June 1979). This exhibit also shows the market share of the total MMC increase going to each of the three depositories.

For the period when the differential was in force, the exhibit shows that attracted 52.6 percent of the MMC market, while commercial banks captured 31.5 percent. After the loss of the differential (April-June 1979) the savings and loan market share fell to only 35.9 percent, while the commercial bank share rose to 53.3 percent. The loss of the differential is the only creditable explanation of the market share decline in MMCs for thrifts over this period.

Exhibit 2

SHARE OF MMC INCREASES

[Dollar amounts in billions]

MMC increases	Commercial banks	Savings associations	Savings banks
With rate differential, July 1978–March 1979	$38.1	$65.2	$19.7
With differential, July 1978–March 1979 (market shares)	31.5	52.6	15.9
Without rate differential, April 1979–June 1979	$17.8	$12.0	$3.6
Without differential, April–June 1979 (market shares)	53.3	35.9	10.8

Source: Federal Reserve Board, Federal Home Loan Bank Board.

(4) *Slower real income growth.*—Current high rates of inflation, together with the prospect for slower economic growth in 1980, also increase the probability that "real" personal incomes of potential home buyers will not be growing in the year ahead. This impact, too, is likely to negatively affect the housing markets in 1980.

Generally speaking, growing real incomes have contributed to the strong housing markets we have experienced in the past. Real incomes have been falling since late 1978, the Department of Commerce reports. Moreover, prospects in 1980 are that real incomes will be declining early in the year. This will add another "negative" to the housing picture next year.

(5) *Savings disincentives.*—Our inability to generate a high level of personal savings in our economy is another negative. Much has been said about the gener-

ally low level of savings as a percent of disposable personal income in the U.S. economy as compared to other major industrial powers. Preliminary estimates for the third quarter of 1979 show that personal savings as a percent of disposable personal income dropped to only 4.1 percent—the lowest level in nearly 30 years.

This low rate of savings has obvious implications for capital-intensive sectors of our economy such as homebuilding. A low rate of personal savings puts added pressure on the capital markets and on interest rates as the various economic sectors compete for a limited dollar pool.

Despite the predominance of these major negative factors there are a few positive elements in the housing outlook which suggest that the impending housing decline will be more modest than what we faced in the 1972–74 cycle. These factors include: (1) The impact of new financing innovations represented by mortgage-backed securities; (2) the impact of a more favorable inventory situation in housing; and (3) the public continues to view homeownership as an inflation hedge.

(1) *Recent mortgage-backed instrument innovations.*—One development which shows promise in maintaining a better supply of mortgage credits is the use of mortgage-backed bonds and mortgage pass-through securities issued by savings and loan associations and other lenders. Since mid-1975, well over $2.5 billion of mortgage-backed bonds have been issued by savings and loan associations. These long-term securities have provided savings and loan associations with access to major long-term investment funds managed by pension plans, trusts and insurance companies.

In addition, thrift institutions and commercial banks have augmented the supply of mortgage money through the issuance of pass-through certificates backed by a pool of mortgages. The first such issue was offered in 1977; through mid-1979, a total of $1.927 billion of pass-through certificates have been issued by savings and loan associations and commercial banks across the country. The ready acceptance of these new mortgage instruments by nontraditional mortgage investors will be a factor in cushioning a decline in mortgage credit availability for 1980.

(2) *Better housing inventory balance.*—Another reason the dip in this housing cycle can be expected to be more moderate stems from the better inventory balance of the housing market today, as contrasted with that which preceded the housing decline in 1974. In particular, during the current cycle we do not face a record high inventory of unsold and unrented multifamily units that we faced prior to the 1974 decline. At that time, multifamily housing starts peaked out at over 1 million units in 1972. During this cycle, we have yet to reach an annual rate of 500,000 starts for such units. In large part, the excess inventories of 1974 were the result of speculative building of not only rental and owner-occupied, but also second homes. Fortunately, we do not face this sort of excess inventory situation during the current housing cycle. As a result, the decline in multifamily construction which is likely next year can be expected to be far more moderate than that witnessed in the previous cycle.

To a lesser extent, this more favorable inventory/sales balance is also reflected in the single-family home market. Unsold units have remained relatively stable at approximately 425,000 throughout most of 1979. The important thing is that the sales rate for single-family homes today is substantially above levels reached prior to the 1973 housing recession. As a result, the Nation's supply of unsold single-family homes has not reached critically high levels.

(3) *Homeownership as an inflationary hedge.*—The remarkable price escalation in housing over the past 4 years has convinced many Americans that homeownership is one investment which may outperform cost-of-living increases. Thus, they are willing to reach as far as the family budget will permit to attain homeownership.

In summary, negative factors will outweigh these positive factors in terms of the housing outlook for 1979. Housing starts can be expected to fall next year—but not as far nor as abruptly as they did during the last cycle. Our forecast calls for 1.4 million units in 1980.

OUTLOOK FOR THRIFTS

A major consideration for next year's housing outlook is the impact that current record high interest rate levels is having on thrift institution earnings and net worth. This situation has taken on ominous proportions since the October 6 Federal Reserve action.

We don't know, of course, how long interest rates will stay at current or higher levels. The picture has become clouded as a result of recent oil tensions in the Middle East. What we do know is that, should short-term interest rates remain at or above current levels, the earnings and net worth position of the savings and loan business will be diminished in 1980.

This situation has a secondary negative impact on mortgage credit availability. Savings and loan associations are required by law to maintain specified levels of net worth in relation to savings balances. This Federal Insurance Reserve requirement effectively limits the extent to which savings and loans can attract savings and leverage their capital. Thus, as net worth and earnings suffer next year due to a continued sharp rise in savings costs (especially from the money market certificate), and while mortgage portfolio yields stay relatively fixed due to the substantial volume of fixed-rate mortgages, some savings and loans may be forced into a type of "no or slow growth" savings promotion policy. This would lead to an additional tightening in mortgage credit availability and a more severe decline in housing construction and sales.

RECOMMENDATIONS

Given these short-term factors influencing the housing market today, we offer this committee the following recommendations:

1. Expand the selection of alternative mortgage instruments

The Federal Home Loan Bank Board should be encouraged to authorize renewable mortgages for all federally chartered associations, as well as adjust their existing regulations for variable rate loans to market realities.

The Federal Home Loan Bank Board regulations which authorized variable rate mortgages on July 1, 1979 for federally chartered savings and loan associations represented a long-overdue action toward partially correcting one of the most significant problems facing the mortgage market. We recommend that a renewable mortgage option also be authorized as soon as possible. Institutions should be permitted to offer these modern options without artificial restraints—such as the 50 percent of originations limit—which currently discourage Federal associations from introducing new mortgaging methods in their local markets.

It is important for this committee to recognize that these new types of mortgage instruments will contribute to economic stabilization in the future (though their contribution may be modest for the rest of the current cycle). One major distortion created by fixed-rate mortgages results from the fact that during periods when a higher rate of personal savings is desired, mortgage lending institutions do not have the capacity to pay higher interest rates to generate a greater volume of savings. As a result, inflation tends to be exacerbated by both the continued high level of consumption by those mortgage customers who happen to have been lucky enough to have a low, fixed-rate mortgage and by the inability of mortgage lenders to pass on to savers a higher rate of return on their savings dollars.

Of course, the most persuasive case for renewable mortgages results from the recent authorization of the T-bill, moving-rate, money market certificates. As we noted earlier, savings and loan associations overwhelmingly remain long-term, fixed-rate mortgage lenders. As such, associations, unlike commercial banks, are unable to keep pace with sharp increases in the level of market interest rates on most of the assets they hold. At the end of September 1979, associations held $459 billion in mortgage loans which accounted for 101 percent of their total savings balances. Except for a few billion VRMs, these investments are fixed-rate mortgages with maturities of up to 30 years. Any increase in market interest rates does nothing to improve the yield on these assets. Thus, the recent rise in short- and long-term interest rates has had no impact on the interest revenue received by associations on these mortgages. To the contrary, the rise in rates has resulted in substantial market losses for associations which desire to sell these loans from their portfolios to the secondary mortgage market.

These interest-rate insensitive investments highlight the serious and growing dilemma currently facing savings and loan associations which are competitively offering the moving-rate, money market certificates to protect themselves against deposit losses to commercial banks and direct market investments. Simply, short-term, moving rate deposits invested in long-term, fixed-rate mortgages make for a very dangerous asset/liability mix. Associations which have offered the moving rate MMC have done so at the risk of immeasurable increases in their cost-of-funds. Associations have paid a high price to keep housing going.

2. Support a mortgage usury exemption

The first session of the 96th Congress could add measurably to the housing outlook for 1980 by passing the amendment in the Senate version of H.R. 4986 which would provide a Federal exemption from anachronistic State usury ceilings for home loans.

The impact of below-market-level usuary ceilings has become a critical problem since October 6, 1979. States with usury ceilings on mortgages below 13 percent are now suffering the worst form of credit allocation—a credit crunch Legislation passed recently by the Senate, H.R. 4986, provides a Federal override of State statutory, constitutional and regulatory usury limits, while permitting States to reimpose such ceilings if they act within 2 years. We urge the House to adopt the Senate's important initiative.

3. Lower the statutory Federal insurance reserve for savings and loan associations

The House should agree to an amendment in the Senate-passed H.R. 4986 to give the Federal Home Loan Bank Board the discretion to lower the Federal Insurance Reserve for savings and loan associations.

The expectation of severe earnings pressures on thrift institutions in 1980 could result in many associations being forced to pursue "no or slow growth" savings acquisition policies. Such action would severely diminish the availability of mortgage credit in 1980. Again the Senate-passed H.R. 4986 contains language to relieve this problem and we urge the House to accept this important provision.

4. The problems of tax-exempt money for mortgage investment

The use of tax-exempt funding for mortgage subsidies should be restricted.

In July of 1978, the city of Chicago made history as a result of a $100 million industrial development revenue bond issue, the proceeds of which were used for mortgage investment. Similar tax-exempt revenue bond issues have been developed in a number of other cities around the country and are currently being discussed in over 100 cities and counties. (The Wall Street Journal recently reported that over $10 billion are "in the pipeline.") These programs, which have received considerable publicity in the news media, highlight the need for the Congress to take a constructive and broad look at the use of tax-exempt money for mortgage investment. The fact that these programs are largely untargeted and, therefore, reach the broad mass of moderate- and high-income people, suggests that there is a major problem concerning the thrust of mortgage credit policies in this country. In particular, it highlights the problem relative to the potential inflation-generating impact of providing low interest rate mortgages to the public in these inflationary times, while adding to the financing burden of other municipalities and States which must compete with these bond issues for their own essential funding needs. H.R. 5714, recently cleared by the House Ways and Means Committee, is an important beginning: we strongly urge the 96th Congress to promptly process legislation to control abuse of the tax-exempt bonding privilege.

5. The need for savings incentives

Tax incentives for personal savings should be developed.

Public and private discussions of the existence of major disincentives to savings and the need for savings incentives have taken place regularly in this country for over a decade. The urgency of these discussions has remained at peak levels since the 1974–75 recession. This committee has also addressed this major issue in its mid-year report. In the report, Chairman Bentsen wrote in his introduction: "We need to save more, invest more and train more disadvantaged."

Thus, I do not need to review before this committee the numerous points involved in this major issue. It is sufficient for me to say that savings and loan associations, whose business it is to promote thrift as well as homeownership, continue to urge and support Federal efforts to develop savings incentives, reverse the longstanding bias in our tax laws against savings and provide a major contribution to fighting through increased savings and capital formation.

6. Retain the savings rate differential on all time and savings deposits at savings and loan associations

The savings rate differential should be preserved or reimposed for all retail-type savings accounts offered by housing-specialized savings and loan associations.

Recent savings experience since the loss of the differential on the money market certificate March 15, 1979, clearly points out the primary importance of the differential to the residential housing market. While a number of policymakers and those in the commercial banking business have questioned the need for the differential, recent savings trends demonstrate again its importance.

7. Affordability: A growing problem

Inflation has cut deep into the ability of many first-time home buyers to afford today's housing. Housing programs should be more narrowly focused to channel assistance to this specific buying group.

The sharp rise in market interest rates since October 6, 1979, has resulted in a marked increase in the number of first-time home buyers who are finding it impossible to afford today's housing.

The average existing home financed by savings and loan associations during 1979 averaged approximately $60,000. Using a 25 percent down payment, at an average interest rate that prevailed in September 1979, this required a $437 monthly principal and interest payment. The subsequent rise in mortgage rates to 14 percent has brought that payment to $533, a $96-per-month increase. Using the old rule of thumb of 25 percent of income for housing expenses, this would necessitate a $384-per-month rise in the buyer's income to afford the same house Needless to say, many first-time buyers who are without benefit of equity buildup in an existing home will be unable to meet this rise in costs. Consequently, housing assistance programs, if needed, should be targeted to first-time buyers.

8. Develop a better balanced monetary/fiscal economic stabilization policy

An economic slowdown should not be used as an excuse for rapidly enlarging the Federal deficit.

I have left my most important recommendation until last. To repeat, we must develop a new discipline to control our country's Federal budget. We have had the tendency to try to spend our way out of nearly every economic slowdown or recession rather than putting the emphasis on monetary policies and capital formation.

If indeed, as some economists warn, we have already entered a recessionary period, it would be a mistake to use force-fed spending programs to buy us out of a recession. A longer-term, less-inflationary policy would be to rely more on a monetary policy—unhampered by the need to finance Treasury borrowing—to bolster the economy. I believe that growth would occur at the same overall rate, but that it would be a more balanced growth with capital spending contributing to a larger percentage of the growth.

In this context, let me note that current Federal Budget pressures have led to new financing gimmicks—the growing use of off-budget Federal credit agencies. A study of the inflationary impact of Federal credit agency borrowing should be initiated. It makes little sense to make major efforts to reduce Federal deficit spending while rapidly expanding the ability of agencies to borrow with Federal backing.

Mr. Chairman, the United States League has appreciated this opportunity to participate in your housing forecast hearings. I hope that our comments have been helpful and look forward to your questions.

Senator Bentsen. Professor Jaffee.

STATEMENT OF DWIGHT M. JAFFEE, PROFESSOR OF ECONOMICS, PRINCETON UNIVERSITY, PRINCETON, N.J.

Mr. Jaffee. Thank you. Mr. Chairman and members of the committee, I appreciate the opportunity to discuss with you the outlook for housing and the thrift institutions during the coming year. I believe we are now at a key juncture concerning housing and thrift institution policy and will direct some of my comments to a longer term view as well.

Let me start with the outlook for housing in 1980.

For the second year in a row, residential construction activity is exceeding most forecasts made a year earlier. The unexpected strength in housing has been related to a number of factors—and these have already been described by Mr. Janis so I won't go into them in detail. However, there is one element I'd like to discuss a bit.

I have just recently completed a study with a colleague, Prof. Kenneth T. Rosen, that explores the contribution of the money market certificates. These are the certificates that thrift institutions can offer with yields equal to Treasury bill bonds.

Our study finds these MMC's account for the predominant part of this unexpected strength in housing this last year. The reason they are so important in housing is that approximately 50 percent of the cyclical variation that we have experienced in housing is due to disintermediation and deposit-flow-related phenomena. The others are simply related to general economic conditions. The money market certificates have been an incredibly effective way to allow the thrift institutions to maintain deposits that they otherwise would have lost, and on the basis of historical ratios they would have lost much more money in the last year-and-a-half than they actually have lost.

I am delighted to tell you about the success of the money market certificate because it represents an excellent example, an outstanding example, of the benefits that are available from deregulation, in this case phasing out of regulation Q type requirements.

I testified about 5 years ago before several congressional committees, arguing that deregulating or phasing out regulation Q would have a favorable effect on housing.

Unfortunately, at that time the predominant view was that housing would be hurt by such deregulation. And, in fact, the moves toward removing regulation Q were beaten back at that time in important part because of the fear for future housing construction activity.

I think the money market certificate experience provides an excellent starting point in that I think we no longer have that fear. I think that one can perceive the phasing out of regulation Q without concern about housing. In fact, I think housing will do better under those circumstances.

I indicated 5 years ago—and it is clearly evident now—that the financial situation of the thrift institutions, as you deregulate, could be a serious area of concern, and in just a moment I'll return to this.

I am stressing these money market certificates because in my view they are the key factor for forecasting residential construction activity in 1980. My baseline is that the thrift institutions will be able to maintain their current position in competition for savings dollars during 1980, with the result that thrift deposit flows during 1980 will be roughly in line with the experience of 1979. And I think that is roughly also in line with the projections of the other panelists here.

This assumes, however, that the money market certificate regulations are not made more restrictive and we always have reference to the restrictive changes that were made last March. And it also assumes that the thrift institutions continue to pay and to be able to pay the ceiling rates allowed on these certificates.

With respect to economic conditions more generally, I anticipate an extended period of slow macroeconomic activity, but without a deep recession. I expect that inflation rates and short-term interest rates are unlikely to rise much higher, but that the decline of both will be very slow.

Under these conditions, I foresee housing starts during 1980 at close to 1.5 million units, which is, I suppose, slightly more optimistic than the other panelists, but we are in the same ballpark. But the risk is on the down side, and I can imagine starts of 1.2 million, with a serious disintermediation. Translating these housing start numbers into macroeconomic growth rates is interesting. A decline of approximately 300,000 housing starts between 1979 to 1980 translates into approximately 1.5-percent growth rate in GNP. In other words, this decline in housing itself with a standard macroeconomic multiplier will cause growth next year to be 1.5-percent lower. Were my more pessimistic scenario to come through, the decline in macroeconomic growth on this account alone could approach 3 percent. I think that is important because obviously 3 percentage points could spell the differences between a slow-growth economy and a serious and deep recession.

Looking beyond next year, the decade of the 1980's, it looks very positive for housing demand. The impact of the emerging baby-boom cohort into home-buying ages is very positive, with annual housing starts in the area of 2 million units not overly optimistic. The bottlenecks are likely to arise on the supply side in terms of providing the necessary mortgage finance and in terms of rent controls and acceptable land-use sites. I am reasonably optimistic that the mortgage market will adapt to these needs quite well, and I will turn to this topic in a moment. I am much less sanguine that solution will be found in the escalating land-use problems, and I suspect this will be the housing issue of the 1980's.

Turning to the mortgage market developments, I am just completing a second study with Kenneth Rosen that analyzes recent trends in the availability of housing finance and projects the likely future developments.

We find strong evidence of something we call a "mortgage gap," which is a large and increasing excess of demand over supply in the mortgage market. This gap is a theoretical concept, and what it analyzes is the difference between likely demand for mortgage funds by borrowers and the supply of funds that could be available from traditional lenders. What we find is that there is a gap that's already large, and it is increasing and likely to increase over the coming 10 years.

The gap arises because mortgage demand has been rising very fast due to high construction rates and surging house prices, while the supply of mortgage funds from traditional lenders has been very sluggish due to factors that have been mentioned here, the low savings rate and the difficulty of thrift institutions to maintain even their normal share of these savings.

The markets will adjust to this gap, and there are two sets of factors that will attempt in a market economy to reduce this gap. The first is an internal pricing mechanism in the mortgage market. This excess demand will cause mortgage interest rates to rise relative to the rates on other capital market instruments. Already in the last 5 years we have seen mortgage rates rise relative, say, to the AAA corporate rate by 150 basic points, by 1.5 percentage points. So even putting aside capital market developments, the mortgage market has been rising very rapidly relative to them, and I can easily foresee another

1 percentage point change in the mortgage rate above the AAA rate in the coming 5 years.

So this will reduce the scale. Because a high mortgage rate will on the one hand reduce demand somewhat and on the other hand tend to increase supply.

A similar mechanism occurs in down-payment ratios. In the same fashion we have seen that down-payment ratios have been rising in the mortgage market in the last 5 years by several percentage points, and again I anticipate this will continue for the following 5 years.

The second area I want to emphasize in terms of adaptation of the market to this gap concerns the increased supply of mortgages that can be realized from secondary market activity in the mortgage market. This works in the following form: Traditionally the thrift institutions have financed the bulk of mortgage lending by making mortgages and holding them in a portfolio. This is sometimes called a make-and-hold principle.

What we are now starting to see more and more is thrift institutions making the mortages but selling them immediately on secondary markets. We think of this as a make-and-hold principle. This is occurring through a number of mechanisms. The most important is the Ginnie Mae passthrough program, but there are also important programs at the Federal Home Loan Bank Board in their Freddy Mac program, and there are a number of private industry initiatives doing it.

I think this notion of the traditional lenders continuing to originate mortgages but not hold them but sell them to nontraditional final holders is tremendously important for analyzing the likely gap that will be realized in the coming 10 years. And my calculations provide grounds for optimism in that I think this sort of innovative activity will solve a fair bit of the potential mortgage problem.

I don't think there is a lot required of public policy to make this come through. I don't think an aggressive public policy stance is necessary, although I am sure there will occur a number of instances where accomodating policy will allow these developments to proceed. And one example that has already been mentioned are these net-worth requirements that are placed on the savings and loan associations. They limit to some degree the extent to which these institutions can participate in the secondary market, and I would advise that the Bank Board change the regs to accommodate these needs a little more.

The last topic I want to discuss is the financial situation of thrift institutions.

The financial condition of the thrift industry is now a serious concern, just as it has been in each of our previous periods of high interest rates and tight monetary conditions. Accurate analysis of the problem becomes difficult because the industry is in reasonably good condition on average. Of course, it is little consolation to the captain of a ship capsized by huge waves to be told that on average the ocean is smooth and his ship is still sailing. And similarly with the thrift industry, the issue concerns the number and condition of those institutions that are below average.

Unfortunately, disaggregated data at the institution level are not readily available, and I have not had the opportunity to work on this recently. So I cannot offer precise quantitative appraisal of the actual state of these institutions, but I would like to mention in closing two aspects of this problem which I think require careful attention.

The first is that the problem is distinctly regional. The institutions that tend to get into trouble have the following characteristics:

They tend to be older institutions that have been in existence for a long time.

They tend to be slow-growing institutions.

They tend to be inefficient institutions.

And they tend to reside in States where there are constraining usury ceilings.

Unfortunately, all of these conditions tend to come together and point to particular regions of the country where the problems are clear and apparent and other regions of the country where there are really very few problems.

I think this regional aspect of the problem is a serious question in terms of providing equitable Federal help under such circumstances.

Finally, I'd like to suggest that in terms of solutions to this that much more attention should be paid to the Federal Savings and Loan Insurance Corporation as a potential mechanism for solving it rather than HUD, FHA, and its Ginnie Mae components. I think this is important as a matter of principle because help to these institutions is a matter of safeguarding the depositors, not the institutions, and FSLIC is obviously the regulatory agency that has this.

Second, FSLIC has both the expertise to evaluate individual institutions and their problems and has the insurance reserves as one potential source of funds to solve it.

Third, I believe that merger should be a frequent solution to this problem in part so as not to perpetuate inefficient management, and again FSLIC is set up to try to answer such a merger or other solutions in which the institution itself probably does not survive.

Thank you.

[The prepared statement of Mr. Jaffee follows:]

PREPARED STATEMENT OF DWIGHT M. JAFFEE

Mr. Chairman and members of the committee, I appreciate the opportunity to discuss with you the outlook for housing and the thrift institutions during the coming year. I believe we are now at a key juncture concerning housing and thrift institution policy, and will direct some of my comments to a longer-term view as well.

THE OUTLOOK FOR HOUSING IN 1980

For the second year in a row, residential construction activity is exceeding most forecasts made a year earlier. The unexpected strength in housing has been related to a number of factors including:

High rates of household formation associated with the aging of the post-war, baby-boom, cohort;

An investment motive for home purchase that extrapolates the recent surge of home prices into the future;

High rates of activity in secondary mortgage markets using both the facilities of Government Agencies and innovative private facilities; and

The Money Market Certificates (MMCs) that have allowed thrift institutions and commercial banks since June, 1978, to offer interest yields on time deposits competitive with money market asset yields.

I have just recently completed a study, with Professor Kenneth T. Rosen, of the University of California, Berkeley, that explores the contribution of these factors to housing construction in recent years.[1] We find that the MMCs account for the predominant amount of this unexpected strength. Some of the other listed factors are important, but have had easily anticipated effects, while the role of

[1] See Dwight M. Jaffee and Kenneth T. Rosen, "Mortgage Credit Availability and Residential Construction Activity," forthcoming, Brookings Papers on Economic Activity.

other factors appears to be exaggerated. The critical role of the MMCs arises because about 50 percent of the cyclical variation in housing construction activity is due to a corresponding variation in the flow of funds to thrift institutions. The other half of housing's cyclical fluctuations is due to the business cycle pattern of income and interest rates that affects the demand for housing. The MMCs have stabilized housing by maintaining deposit flows at thrift institutions well above the levels that would have been expected in this economic environment on the basis of historical relationships.

I am delighted to report this success of the MMC to you, because it represents an excellent example of the benefits available from deregulation, in this case with respect to regulation Q ceiling rates. Indeed, I had testified about five years ago before several Congressional Committees that the phasing out of regulation Q would provide a boost to construction activity, together with the obvious benefit to small savers. Deregulation was beaten back at that time in part because the dominant view was that housing would suffer with the phasing out of regulation Q. I hope the MMC experience has eliminated that fear. I indicated then, and it is clearly evident now, however, that the financial condition of the thrift institutions could well be a serious area of concern. I return to this below.

I stress the importance of the MMCs because deposit flows to thrift institutions are, in my view, the key factor for forecasting residential construction activity in 1980. My base line is that the thrift institutions will be able to maintain their current position in competition for savings dollars, with the result that thrift deposit flows during 1980 will roughly equal those of 1979. This assumes that the MMC regulations are not made more restrictive and that thrift institutions continue to pay and to be able to pay the ceiling rates on these certificates. With respect to economic conditions more generally, I anticipate an extended period of slow macroeconomic activity, but without a deep recession. I expect that inflation rates and short-term interest rates are unlikely to rise much higher, but that the decline of both will be slow.

Under these conditions, I foresee housing starts during 1980 at close to 1.5 million units, a decline of about 15 percent from the likely 1979 level. The distribution between single-family and multi-family units would then be very similar to the 1979 proportions. The risk, in my view, is on the downside, and were more traditional thrift deposit disintermediation to unfold, or were a deep recession to develop, housing starts under 1.25 million units would not be surprising. Translating these housing start numbers into macroeconomic growth rates, the decline in residential construction activity during 1980 translates into reduced GNP growth, relative to 1979, of about 1.5 percentage points. Were the more pessimistic number of 1.25 million housing starts to occur, then the impact would be close to 3 percentage points. It is clear from these numbers that the actual result for housing starts can easily spell the difference between a slow growth macroeconomy and a deep recession.

Looking beyond 1980, the outlook for the decade of the 1980's as a whole is very positive for housing demand. The impact of the emerging baby-boom cohort into home-buying ages is very positive, with annual housing starts in the area of 2 million units not overly optimistic. The bottlenecks are likely to arise on the supply side in terms of providing the necessary mortgage finance and in terms of rent controls and acceptable land-use sites. I am reasonably optimistic that the mortgage market will adapt to these needs quite well, and I will turn to this topic in a moment. I am much less sanguine that solutions will be found to the escalating land-use problems, and I suspect this will be "the housing issue" of the 1980s.

MORTGAGE MARKET DEVELOPMENTS

I am just completing a second study with Kenneth Rosen tha analyzes recent trends in the availability of housing finance and projects the likely future developments. We find strong evidence of a rising "mortgage gap" with a large and increasing excess of demand over supply in the mortgage market. This gap is the outcome of both fast rising demand and sluggish supply growth from traditional mortgage holders. Demand rises fast due to high levels of construction activity and the inflating prices of the units. The supply of traditional mortgage holders rises slowly because of the low savings rate in the economy generally and because of the difficulty thrift institutions have in even maintaining their traditional share of these savings.

This gap can be offset, and perhaps even eliminated, by developments within the mortgage market, and I foresee a variety of specific changes that are likely to reduce the major part of the problem. Specifically, as an internal mechanism, excess demand should cause the mortgage interest rate to rise relative to the rates on other capital market instruments and to cause loan to value ratios—the proportion of the housing value that is financed—to decline. Concerning the interest rates, and using the spread between the effective mortgage interest rate and AAA corporate bonds as an example, this spread has already increased by about 150 basis points from near zero levels in 1975, under the pressure of a rising gap. A rise of another 100 basis points would not be surprising. Loan to value ratios have followed a similar pattern, already having declined by several points since 1975, and with a comparable decline still in prospect. Rising mortgage interest rates and declining loan to value ratios should reduce mortgage demand and stimulate mortgage supply, thereby reducing the gap.

I anticipate that a critical part of the increased mortgage supply will be the result of secondary market sales of mortgages originated in the traditional fashion (by thrift institutions, for example) but held in the portfolio of "non-traditional" lenders (pension funds, for example). These sales become feasible because the rising yield on mortgage instruments will make them competitive with other assets in investor portfolios. An important link in this process is the issue of mortgage-backed securities, including mortgage pools, by thrift institutions and other lenders. Using these instruments, the thrifts and other depository lenders can maintain their traditional position as mortgage originators, even if they lack the deposit funds to hold all of the originated mortgages in their long-term portfolios.

I expect that the mortgage market will adapt in these ways to its excess demand gap, and thus carry out its functions without any major problems. Public policy toward the market and its institutions need not take the lead in generating these changes, but certainly should encourage such changes and not place obstacles in their way. As an example, the net worth and related requirements of Savings and Loan Associations could be eased to make the issue of mortgage-backed bonds a more attractive secondary market vehicle for these institutions.

THE CURRENT STATUS OF THE THRIFT INSTITUTIONS

The financial condition of the thrift industry is now a serious concern, just as it has been in each of our previous periods of high interest rates and tight monetary conditions. Accurate analysis of the problem becomes difficult because the industry is in reasonably good condition on average. Of course, it is little consolation to the captain of a ship capsized by huge waves, to be told that on average the ocean is smooth and his ship is still afloat. And similarly with the thrift industry, the issue concerns the number and condition of the institutions that are below average.

Unfortunately, disaggregated data at the institution level is not readily available, and I have not had the opportunity to work on this recently. So I cannot offer a quantitative appraisal of the actual state of these institutions.

Rather, I would like to suggest some factors and issues that should be considered in any discussion of the appropriate policy action to help these troubled thrift institutions. A key point is that the problem is likely to be distinctly regional in character. The following list indicates some frequently observed characteristics of "problem" institutions:

Old institutions; slow-growing institutions; inefficient institutions; and usury ceiling states. Unfortunately, these characteristics tend to accumulate in specific regions of the country, and there is a serious question of how to provide equitable Federal help when this is the case.

Finally, I would like to suggest that the Federal Savings and Loan Insurance Corporation (FSLIC) probably should play a key role in any plan of Federal help to ailing institutions. First, as a matter of principle, help to these institutions is really for the safeguard of the depositors, not the institution, and this is the domain of the FSLIC. Second, FSLIC has both the expertise to evaluate individual cases and the resources to solve them. Third, merger should be a common part of the help package for ailing institutions—in part so as not to encourage inefficient management—and again FSLIC is experienced with such matters.

Senator BENTSEN. Thank you very much, professor.

There are about 13 States, as I understand it, that have the problem you are talking about; that of maximum interest rates that originally were set up to try to protect the consumer. Now they seem to be working just the other way. They seem to be denying the consumer funds to build a home. What do you think we ought to do about it?

Mr. JAFFEE. You are speaking of the usury ceilings?

Senator BENTSEN. Yes, you were talking about that. You were trying to profile those thrift associations that were having more trouble than others, and one of the problems, as I understood you, was that there are a number of States that have a limitation on interest to be charged. They were set up originally to try to protect the consumer, but now it's apparently working against the consumer in those States. What do you suggest?

Mr. JAFFEE. There is no question these usury statutes are working against the best interests of the consumers. Most were set up on the order of 100 years ago at a time when communications were poor and when there was really a serious problem that some borrower out in the countryside might be unfairly taken advantage of by some lender.

I think this is just not credible today. All borrowers have access by all kinds of communications media to a pretty good notion of what interest rates are, and a usury statute, I think, isn't going to protect them against unscrupulous lending policies.

It is very frustrating for me. I come from New Jersey which I think at the moment probably has the lowest usury rate in the country. Saul Klaman is going to claim New York. I think we are about tied. And they won't budge. And I think they are wrong. And I hesitate to suggest that Federal aid be used to support legislators and commissioners that just don't quite see the truth.

Senator BENTSEN. I have had my experience with one State. In this particular State I'm talking about, the State legislature held very tough on the usury legislation in the last session, and I had several legislators call me up and say, "We really wish you fellows at the Federal level would take this out from under us." [Laughter.]

Mr. JAFFEE. I think one has to protect the depositors of these institutions because they have made all these low-rate mortgages, but I don't think I would protect the institution because they just haven't petitioned hard enough with their State legislatures.

Senator BENTSEN. Professor Jaffee, I want to interrupt. Congresswoman Heckler has a vote in the House and I'd like to defer to her.

Representative HECKLER. Thank you very much, Mr. Chairman. We have a vote and I will only be able to ask one question.

Mr. Klaman, your prepared statement raises a most unique possibility in your reference to the unregulated funds, the vast amount of money flowing from the housing market and into money market mutual funds which provide banking-type services. Well, I don't know of any mutual fund that actually funds housing or funds student loans or deals with the personal loans and personal banking services that your industry must deal with.

Now, what kind of comparisons or comparative regulations do you think should be placed on money market mutual funds?

Mr. KLAMAN. Congresswoman Heckler, this has been one of our most frustrating issues. The savings bank industry, by tradition, has never inveighed against any other industry and asked it to be overregulated or indeed to be restricted in its activity. But we believe very strongly, and have so written to every regulator, with copies to every member of the Senate and House Banking Committees, that something clearly needs to be done about these money market funds which are clearly operating in the banking field without regulation. They are heavy buyers of commercial bank CD's and, as you say, are not putting any of their funds into housing or other consumer-type credit. And they are not being limited by Community Reinvestment Act regulations, or by other regulations which apply to depository institutions. I think one clear thing that can be done is to discuss restrictions against the issuance of checks by the money market funds.

We have talked to Federal Reserve Chairman Volcker and to FDIC Chairman Sprague and others, and I think they feel equally frustrated in trying to achieve some balance of regulation between those of us in the financial institution area and these new money market funds, which are draining away our deposits at the most rapid rate. I think they are the single most important source of our deposit losses, and they have grown from some $4 billion to some $40 billion in an incredibly short period.

And restrictions against the issuance of checks—or perhaps the imposition of reserve requirements—these are the kinds of things that must be looked at by the Banking Committees and by the regulators.

Representative HECKLER. Obviously they are not investing in student loans and housing and personal loans, et cetera.

Mr. KLAMAN. No; they are mainly intermediate between jumbo commercial bank CD's and other money market instruments, in effect fragmenting them and selling them to individuals. And I think that is a clear frustration of a monetary policy that is trying to bring the supply of funds under control to combat inflation. But they aren't even measured in the money supply data, and it is a total frustration.

Representative HECKLER. Can I ask if the panel can show by a show of hands, because that is all the time I have, those who agree with Mr. Klaman? [Show of hands.]

Mr. JAFFEE. I didn't raise my hand.

Representative HECKLER. Three out of four. It is something to be pursued.

Senator BENTSEN. I am sorry I have to leave. Senator Sarbanes will chair the hearing in my absence.

Senator SARBANES [presiding]. Professor Jaffee, I want to question you. First of all, I am not going to allow you to put yourself in the same ballpark as the other panelists when you give me a housing start figure 36 percent higher than they do. I was a Princeton undergraduate, and if I ever came in and told you a 36-percent discrepancy put two figures in the same ballpark when we are trying to draw some important predictions for policy formation, you would have flunked me. They say 1.1 million housing starts and you say 1.5 million housing starts, and you say that puts you in the same ballpark. I won't accept that characterization.

Mr. JAFFEE. My understanding was several of the panelists, or at least one or two, had mentioned numbers on the order of 1.4 million. Mr. Klaman, I guess, had 1.3 million. And my range was 1.25 to 1.5

million. Again I am on the high end, but I don't think by 30 percent or 50 percent.

Again, to be clear, I think we are assuming slightly different conditions. If we assume the same conditions——

Senator SARBANES. If you are going to make a more optimistic prediction, you ought to go on the line for doing it. You may be proven right. But we can't fuss and hedge around here that way. We have to take the burden of our calls, and you ought to. I am not going to allow you to get in the same ballpark with the others on their expectation of what the economy is going to do.

Mr. JAFFEE. 1.5 million it is then. [Laughter.]

Senator SARBANES. Now, on this question about your assertion of the elimination of regulation Q and what has happened in the money market certificates—first, I want to distinguish what I consider to be two very important elements involved in regulation Q.

One is the interest ceiling, in other words, that sets a level of interest; and the other is the interest differential, whatever the level is, between different types of financial institutions.

Now, putting to one side a moment the ceiling question, since the money market certificates were outside of that ceiling, and addressing the second aspect, the interest differential, how do you respond to exhibit 2 of Mr. Thygerson's prepared statement showing what happened? Did you see exhibit 2?

Mr. JAFFEE. I am familiar with those numbers, yes. I know what you are referring to.

Senator SARBANES. What happened to money market certificates in terms of the financial institutions to which the funds were going when there was a rate differential of a quarter percent—only one-fourth of 1 percent—and what happened when the rate differental was eliminated?

That is not the ceiling question but the differential question.

Mr. JAFFEE. I think that is a very important distinction, and I'm glad you are stressing it. I am very familiar with those data which indicate how sensitive the flow of funds between the thrifts and the commercial banks are to even a quarter-point differential. And I think there is no question that has very strong ramifications for housing policy because of the intensity with which the thrifts invest in mortgages relative to the commercial banks.

I think the question of the differential is very important and worth stressing. I think if one is going to use regulation Q ceilings as a means of effecting policy, the differential is the point to key on, and I think the recent experience with the money market certificates has indeed indicated that maintaining a differential is likely to increase the flow of funds to the thrift institutions and thereby the mortgage market.

So I would agree with those data and with the conclusion you and Mr. Thygerson want to draw from it.

Senator SARBANES. Then let me ask you the following questions since you said:

> Indeed, I had testified about 5 years ago before several congressional committees that the phasing out of regulation Q would provide a boost to construction activity, together with the obvious benefit to small savers. Deregulation was beaten back at that time in part because the dominant view was that housing would suffer with the phasing out of regulation Q.

At the time you testified, did you make the distinction with respect to the elimination of regulation Q as between the ceilings and the differential?

Mr. JAFFEE. Yes, indeed. That was an issue at that time. It is one that is frequently lost sight of.

Senator SARBANES. And at that time you were in support of maintaining the differential although you wanted to get either the ceilings off or at a much higher level; is that correct?

Mr. JAFFEE. I would certainly want to get the ceilings at higher levels. I think that even if——

Senator SARBANES. When you testified 5 years ago, did you testify to eliminate regulation Q altogether, or did you propose in effect to eliminate it except for holding onto the differential for the financial institutions primarily involved in housing?

Mr. JAFFEE. I testified to eliminate it entirely and would do so today.

Senator SARBANES. You would? How do you square that position with what Mr. Thygerson's exhibit 2 seems to indicate is the consequence of such a policy?

Mr. JAFFEE. Well, because I don't think that the outcome for housing is negative by removing the ceilings entirely. I think it would be even more positive if you retained the differential. That is point 1.

Point 2 is I think there are many other benefits to removing the ceilings beyond the effects on the housing market. Most notably, and I think critical, is the equity consideration of small savings, and it is for that reason I wouldn't raise my hand in answer to the question.

Senator SARBANES. But the money market certificates were up at a high rate. They just maintained a differential for a certain period, which resulted in the commercial banks getting about 30 percent of the share. And then when it was eliminated in the immediately succeeding quarter, that share jumped close to 55 percent and the savings associations' and the savings banks' shares went down accordingly.

Mr. JAFFEE. Yes.

Senator SARBANES. Does that concern you?

Mr. JAFFEE. It certainly does concern me.

Senator SARBANES. Then why don't we maintain the differential?

Mr. JAFFEE. I have no great problem with that. If you asked me which I would prefer, given these two——

Senator SARBANES. Given which two?

Mr. JAFFEE. Whether to completely remove the ceilings or whether to raise the ceilings but maintain a differential. If I had to make a choice, I would come down with total removal. But I don't view those two as totally separate boxes. I would be quite happy if we could come to a definite plan which would have the raising of the ceilings so that they were virtually at market levels but somehow managed to administer it in such a way that you managed to maintain a slight differential.

Senator SARBANES. If you could do that, would that be your preferred position?

Mr. JAFFEE. It wouldn't be my preferred position.

Senator SARBANES. Why wouldn't it be your preferred position?

Mr. JAFFEE. Because——

Senator SARBANES. If you could do that, which would in effect give the small saver the market, why would this not be your preferred position?

Mr. JAFFEE. What you'd be doing in that case is to still have the thrift institutions offering them a third or a quarter of a percentage point beyond the market yield.

Mr. KLAMAN. No.

Mr. JAFFEE. Sure, you do. If you post the thrift rate at the market rate, above the market rate, and the commercial banks at the rate, they are effectively the same. You are not going to get a benefit from the differential. You get a benefit from the differential only to the extent that the commercial bank rate is slightly below the going rate. And I think there is a social cost to that. It may be small.

Senator SARBANES. What is the social cost? To the saver?

Mr. JAFFEE. Yes.

Senator SARBANES. Let's assume that what the savings institutions pay is at the market rate. The saver then can get the market rate by putting his savings in the savings institutions. He loses a quarter of a percent if, for other reasons, he wants to go to commercial banks. And you get a distribution of the moneys, let's assume, according to the first part of this table. Now, how is the saver hurt by that? You have given him the market. Why is that not your preferred position?

Mr. JAFFEE. No, you are still saying there will be a saver who might for various reasons find it more convenient to maintain his deposits at a commercial bank.

Senator SARBANES. So you say accommodating him is more of a plus than what is lost by the shift of resources out of the savings institutions into the commercial banks?

Mr. JAFFEE. That would be my view. But I don't feel firmly on that, and I'm afraid the record will be distorted. I would be delighted if we could move to a situation in which regulation Q ceilings were raised to market levels and in which you did maintain some slight differential.

Senator SARBANES. When you say "delighted," is that your preferred position?

Mr. JAFFEE. No; no. [Laughter.]

I guess we have to get into it. There are a lot of other factors. If we were to remove the differential, I would be strongly in favor—and Mr. Klaman knows I am in favor of this—of giving additional powers to thrift institutions, consumer loan powers, which would make them more of a single-stop institution like the commercial banks. And I think the conglomeration of these additional powers would actually make them as well off as if they did have the differential and would be a net benefit to consumers in general.

Mr. KLAMAN. Senator, may I make one comment?

Senator SARBANES. Yes.

Mr. KLAMAN. I'm glad you elicited from Professor Jaffee that important point because it does not appear anywhere in his testimony. And we have said—and he has supported this view—that you cannot have deposit deregulation without a significant measure of despecialization. That is a critical question for the Congress to decide. While the differential is an instrument of housing policy, and so is regulation in general, it also reflects the fact that commercial banks have a far greater ability to attract savings, given the present powers and balance sheets of thrift institutions.

Consequently, we have supported, and I think the United States League has supported, that we begin to move to a system of market-determined rate ceilings—not getting rid of Q, but letting rate ceilings move with the market and letting the differential persist. Because without the differential, the housing policy of this country will be aborted. And that is critical to maintain adequate flow of housing credit.

Senator SARBANES Let me ask you this question, Professor Jaffee. You are from New Jersey. My understanding is they are going to build 12 to 15 new casinos in Atlantic City?

Mr. JAFFEE. I hope so.

Senator SARBANES. And there is no difficulty in getting the credit for that, is there?

Mr. JAFFEE. No.

Senator SARBANES. What do you think of a national economic policy which creates no problem at all for getting all the credit you want to build gambling casino after gambling casino and yet makes it virtually impossible for people to be able to finance a home. Does that concern you?

Mr. JAFFEE. Well, remember, there are people out there who rather than buying their home would rather go and gamble, and I think they may be in the predominance. I mean that's what is going on. There is a big demand for gambling casinos in New Jersey. And these companies running these casinos are in a position to bid for funds in the capital market only because they have a tremendous demand for their product.

Senator SARBANES. That's right. Mr. Volcker was here, and he indicated to us and subsequently sent a latter to the banks in which he urged them in carrying forward the credit restraint policy of the Federal Reserve to be sensitive to the needs of small business and small farmers and the home bulding industry, and to take a harder view of speculative ventures. I take it from the answer you have just given me with respect to the gambling casinos that you disagree with that advice that Volcker gave. If the activity can claim the money because of the rate of return, then we should let it go there without any regard to its economic or social utility; is that correct?

Mr. JAFFEE. I agree. What I would say is the way to fight this sort of thing is to make your mortgage instrument competitive in the same markets in which the Resorts International are obtaining capital funds. And that is what I see these secondary markets are leading to. And that's why I praise that. Instead of putting artificial constraints which become very costly to administer and frequently lead to absurd results, the thing to do is to make your mortgage instrument competitive in the very same capital markets that corporations are entering to obtain their own funds. Interestingly——

Senator SARBANES. What is the implication of that? America has done an incredibly good job in comparison with other countries in the encouragement of homeownership; isn't that right?

Mr. JAFFEE. Yes.

Senator SARBANES. This is true in terms of the percentage of people who own homes, in terms of when in their life homeownership is available to them on terms at which they are able to acquire it. In my perception, this has been accomplished at least in part because we have established a system of distinctions among financial institutions, assisted to some extent by public policy, which has enabled the savings institutions to play a critical role in the financing of home building.

You want to eliminate those distinctions and throw them all on exactly the same playing field to have them compete in the same market for these funds, so that prospective homeowners are in exactly the same ballpark as the speculator.

The speculator by definition is in a position to reap very large profits. That is what is reflected in speculating in these various markets. That is what is reflected in gambling. And you are just going to crowd out homeowners if you throw them into that arena.

Mr. JAFFEE. Well, the experience in recent years with the growth of these Ginnie Mae pool securities I think is really quite the opposite. They have shown that well-set-up mortgage instruments and mortgage pools can compete very effectively in the capital markets with corporate ventures.

Senator SARBANES. That is not what Mr. Thygerson's exhibit 2 shows. It shows that in the first quarter, after the loss of the differential designed to maintain this flow of funds to the savings institutions, we had a major shift into the commercial banks. Now, they can't get their money for speculative purposes out of these savings institutions because the thrifts are precluded from engaging in that activity. But they can get it from the banks. The best Mr. Volcker can do with the banks so far is to send them a letter and encourage them as a voluntary matter to distinguish between their clientele. But they still have the power to make the loans. The thrift institutions do not. And their loans have to go into this homebuilding area, by definition.

Mr. JAFFEE. I know.

Senator SARBANES. And the fact that they have had to do so in the past is in my judgment one of the reasons we have done so well in this country in homebuilding compared to a lot of other countries.

Mr. JAFFEE. I see. There has been in the last 5 years a fundamental development in the mortgage and thrift institution industry which I call the unbundling of mortgage functions which is that the traditional S. & L. instead of making mortgages and holding them has discovered it can serve its community by making the mortgage which is what the community needs and selling it, selling it to some other holder, some pension fund, some insurance company, some other individual who is willing to buy that when the mortgage rates reach competitive levels. And that is why the flow of funds into or out of the S. & L.'s today is not quite as important as it used to be, because you have many S. & L.'s in this country who are basically operating now as mortgage companies, and they are serving their community every bit as well by originating mortgages. The borrower doesn't even know the difference because the mortgage continues to be serviced by the same guy down on the corner. He doesn't care whether it's held in the portfolio of the first S. & L. or by the X Life Insurance Co. And that's why the flow of funds is no longer important.

Senator SARBANES. Frankly, I don't think that responds to my question, which really addresses the fact that under certain arrangements we have a flow of funds into certain kinds of financial institutions that are essentially responsible for financing the homebuilding industry. When we eliminate the differential, you get a major shift of funds from those institutions into the commercial banks which have no limitations upon them, by and large, as to what they can fund. And then we run into the problem of making available significant amounts of funds to finance these speculative activities, which so far we have found no way to place a lid upon.

I don't agree with your view that you should just throw it all open, and if that's where the money goes that's where the money goes. That's not the system we have used in the past to encourage homeownership in this country—a rather successful system.

We are moving now toward conditions prevailing in a lot of other countries in the world where people need a huge down payment in order to get a house, and then pay enormous charges in order to carry it, so more and more people are going to be pushed out of the market.

Mr. Smith, one thing I thought was not reflected in your affordability table is related to the last column, "Number of families priced out [in thousands]." What happens to the number of households who are priced out—even below the 13 million figure at 7½ percent. There is a large number that can't even qualify there; isn't that the case?

Mr. SMITH. Senator, if you will look at the second-to-the-right column titled "Percent of households who can afford," you will note that as we go down the list from 10 percent in interest rates to the present 13 percent, we drop from approximately 17 percent of the families down to 10 percent, and if we go to the 14-percent interests rate level we are only talking about 8 percent of the American families.

Senator SARBANES. I guess this says that 77 percent of households can't even afford the first column; isn't that right?

Mr. SMITH. Yes, sir. And then we go on down to the 14-percent interest rate level where only 8 percent of families can afford to buy a house. That is the reason I state in my prepared statement, "We believe the Fed's tight money approach is riddled with weaknesses."

When we can afford to "buy" money to build casinos and speculate on commodities while only 8 percent of the families in this country can afford to buy a home, I think it's ridiculous and in my opinion, absurd.

Mr. KLAMAN. I think it is important to say that those data are based on the assumption that a family can afford only one-fouth of its income. And that's been changing. If you change that to one-third, it will change the numbers very substantially.

Senator SARBANES. Would it change them very substantially?

Mr. KLAMAN. Oh, yes.

Mr. SMITH. Ours is based on 25 percent.

Senator SARBANES. Suppose it went to a third?

Mr. SMITH. We'd have to project that through our econometric model.

Senator SARBANES. What percentage of families could not make the first column? Would it drop to 60 percent—those who couldn't make the first row of your table?

Mr. SMITH. I'd have to say that. Remember, the graduated mortgage plan——

Senator SARBANES. Mr. Klaman, I think your point is not bad, but my guess is you'd have a fourth of all American families who would be unable to make this first column.

Mr. SMITH. At least that.

Senator SARBANES. Which I think really has to make you pause and think.

Mr. KLAMAN. It is important.

Senator SARBANES. These recommendations here I find terrible. You are going to end up shifting funds out of institutions interested primarily in homebuilding into institutions that can make any loan at all which will in effect shift money away from the homebuilding area. I don't see why we should do that as a matter of national policy. It is neat and tidy for your economic model when you put the chart up on the blackboard, but I don't think it will accomplish our national goals.

Mr. JAFFEE. I think we may disagree on where the old policies have gotten us, and I see them as having reached a position today where you have a fair part of the thrift industry which is really on the ropes. And I don't view that as a successful policy we should congratulate ourselves on. You also have a policy, as these numbers indicate, where a large amount of young families cannot afford single-family home purchases. And I don't think we should congratulate ourselves for that.

It worked beautifully in the 1950's and very early 1960's. It has been 15 years that it hasn't worked well.

Mr. KLAMAN. But mainly because of inept national economic policies leading us down the road to inflation and to interest rates which we haven't seen in this country since the Civil War. If you had them at manageable levels, we wouldn't be in the situation we are in now. So you can't put everything in the lap of regulations.

Sure, we live in the most hostile economic environment in our history, except for the Great Depression, and that I think is the basis of our problems. And if we can't cure that——

Senator SARBANES. One other thing. Deregulation sounds fine, but I think you have conceded pretty much there is an important distinction today between the ceilings and the differential.

Mr. JAFFEE. I not only concede it, I agree with it.

Senator SARBANES. The secondary mortgage market was a large part of your previous answer.

Mr. JAFFEE. Right.

Senator SARBANES. How can one of these financial institutions participate in selling off to the secondary mortgage market if it doesn't have the funds in the first place with which to make the mortgage?

Mr. JAFFEE. Oh, that's just carrying money. There are mechanical problems of that sort, but the inventory problem is really pretty small.

Mr. KLAMAN. You can't do it in States with usury ceilings. We have been recommending this for years. But there is no way a New York savings bank would sell 10¼ percent mortgage loans in the secondary market today. So that is obviated. And there are some 18 States with 12 percent usury ceilings, so you can't do that in those States.

Senator SARBANES. That is a complicated problem because we have not only the substance of the issue but also the question of whether the Federal Government can overrule State governments.

Mr. KLAMAN. It is in the Senate bill.

Senator SARBANES. I know, but not without a great deal of controversy and concern, and it's put in there in a very modified way, as you know, to allow States to reassert their position. And if the State chooses to do that, should a State be able to do it? That's the question. That's a complicating question beyond the substance of the issue.

I wanted to ask Mr. Smith and Mr. Thygerson a question.

I take it from a careful reading of your statements that your positions differ on the question of the tax-free revenue bonds for home mortgages issued by State and local governments; is that correct?

Mr. THYGERSON. That's correct. The explanation there is very simple.

We are looking at an inflation rate today of 13 percent or 14 percent. And what we are suggesting is that we need some help for housing that will help relieve inflation. That means having people save more at a time like this, and not hope for a mechanism—in this case a tax-exempt advantage of a State and local government—to compete for funds that are already in short supply at a time of double-digit inflation.

So we are looking for mechanisms that expand the supply of credit, that lower inflation, rather than mechanisms that compete for a limited supply of credit and lead to a bidding up of home prices at a time when we all agree that home prices are much too high.

Mr. SMITH. Of course, Senator, our position differs in the fact that we believe in order to help the moderate and lower income own housing that we are not competing with the conventional thrift market. We also have testified to Senator Williams' committee that we consider there would be over $90 million of income to the Government based on the activity generated by each $1 billion in new housing built as a result of financing provided by tax-exempt revenue bonds. At a time when we are looking at a likely decrease in single-family housing starts, the availability of another 250,000 or 200,000 starts through tax-exempt revenue bonds is significant. Keeping the money at home rather than routing it through Washington, D.C., seems to be the best way.

Senator SARBANES. And even there your position is not to maintain it wide open, without any limitation, as has occurred in the past. As I understand it, you would support an approach that contains some limitations in order to assure that.

Mr. SMITH. Right. I state in my prepared statement that we will be supportive of Senator Harrison Williams' bill to be introduced this week. We believe the Ullman bill introduced in the House is not workable.

Senator SARBANES. Gentlemen, you have been a very good panel. Your statements have been helpful, and I think your responses have been very helpful. Is there anything any member of the panel wishes to add? [No response.]

Well, thank you very much.

The committee is adjourned.

[Whereupon, at 12:20 p.m., the committee adjourned, subject to the call of the Chair.]

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