

mortgage credit, with savings banks dominating FHA and VA mortgage markets and savings and loan associations dominating the market for conventional loans. As 1966 so graphically demonstrated, when they are unable to compete for lendable funds, the flow of mortgage credit and the level of homebuilding are severely restricted.

SHORT-RUN POLICY IMPLICATIONS

The immediate short-run cause of savings institutions' and housing's troubles in 1966 was the failure to adopt adequate fiscal restraints to dampen inflationary pressures in a full-employment economy. This forced the Federal Reserve to shoulder most of the responsibility for containing inflation, with the result that open market interest rates were pushed to levels not seen in more than a generation. The rise in open market rates in turn triggered a massive round of "financial disintermediation," as individuals shifted a record volume of funds from savings accounts into direct open market instruments.

This process was temporarily reversed in 1967 as short-term open market rates fell sharply earlier in the year, but by yearend individuals were again responding to rising interest rates by shifting funds into open market investments. Preliminary data for the Federal Reserve's flow of funds accounts, for example, indicate that households channeled almost \$15 billion into such direct investments (at seasonally adjusted annual rates) in the fourth quarter of last year, only slightly less than the peak volume reached in the second quarter of 1966. Flows into savings accounts at thrift institutions and commercial banks, by contrast, fell by more than half to an annual rate of less than \$18 billion in the fourth quarter of 1967, slightly less than the low reached in the fourth quarter of 1966. Savings flow data for January, moreover, indicate that savings and loan associations experienced a net savings outflow of more than \$200 million—the largest net outflow for the month on record—and that the net savings gain at mutual savings banks was almost two-fifths less than the January 1967 record.

A repetition of the 1966 mortgage credit squeeze in 1968 hopefully can be avoided, however. Thrift institutions have strengthened their liquidity and are not so heavily committed as they were in 1966, while the Federal Home Loan Bank System is also in a substantially stronger position to extend needed assistance. Nevertheless, the current high level of short-term open market interest rates, and the possibility of further increases under the pressures of a stronger shift to monetary restraint and continued heavy Treasury deficit financing in the short-term area, indicate that financial disintermediation and renewed declines in housing may well be a serious matter of concern in 1968. Together with the prospects for strong inflationary pressures outlined so clearly in the President's and Council's reports, and the need to maintain international confidence in the strength and stability of the dollar, these considerations strongly reinforce the need for a tax increase in 1968 combined with strict Federal expenditure control.

In this regard, our soundings of the 1968 economy are generally in accord with the picture outlined by the President and the Council. Gross national product should rise by about 8 percent this year, in contrast with last year's increase of about 5½ percent, with more than 3 percent of the increase representing inflation. While business activity