BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date December 5, 1947

To Chairman Eccles

From Ramsay Wood

Subject: Measures to reduce the inflationary effects of residential mortgage credit

In accordance with your request, I am attaching a memorandum on steps which could be taken by the Federal Government to reduce the inflationary effects of residential mortgage credit.

The greatest single obstacle to agreement among Federal agencies on anti-inflationary policies for residential mortgage credit has been the widespread belief that the only sound way to alleviate the current housing shortage is to encourage production of housing. The Administration generally, and agencies administering Federal residential credit programs in particular, still need to be convinced that by trying to produce enough houses to eliminate the shortage in a brief period we are defeating our own purposes, and that it is essential, if housing needs are to be met at reasonable prices, to reduce demand in the period ahead. Once this basic point is accepted, agreement can probably be reached on specific measures to reduce demand.

The following paragraphs develop an argument along these lines.

If current demand is not reduced by controls to the amount which the building industry can satisfy at stable or declining prices and costs, the shortage will be "eliminated" by prices too high for a large number of families to pay. Moreover, if the shortage is "eliminated" in this way, a large number of families will have overextended themselves, with a consequent high rate of foreclosures. Then demand, even at substantially lower costs and prices, will be below the capacity of the industry, and unemployment, bankruptcies, and foreclosures in real estate and the building and allied industries will be widespread.

In this case, we shall be in a worse position than in the early and middle 1930's because we shall not have the anti-deflationary tools which we had in the 1930's, such as liberalizing mortgage credit terms, and the Government will have to consider much more costly and inefficient direct subsidies for building.

In other words, if the present real estate boom is allowed to run its course, we shall not only have done a disservice to those who suffer in the subsequent deflation. We shall also have made ineffective the most readily available anti-deflationary tools in the Government's possession.

RW

Attachment

MEASURES TO REDUCE THE INFLATIONARY EFFECTS OF RESIDENTIAL MORTGAGE CREDIT

Measures to reduce the inflationary effects of residential mortgage lending which might be taken by the Federal agencies concerned are:

1) Suspend Federal residential credit programs

The most drastic step which could be taken to reduce the inflationary effects of residential mortgage credit would be to suspend for a period all Federal residential mortgage credit programs which can legally be stopped immediately.

Such a step would probably require legislation and would affect the one-third of current mortgage lending which is insured or guaranteed by the Federal Housing Administration and the Veterans Administration. Loans made by institutions insured by the Federal Savings and Loan Insurance Corporation, amounting to about one-sixth of current lending, could probably not be affected immediately because of the contractual nature of the insurance of accounts.

The total effect of such a step might be even greater than would be indicated by the amount of lending involved, if lenders and borrowers interpreted the step as a warning that the Federal Government will not aid those who get into trouble later from uninsured lending or borrowing. It is, however, a step worth considering.

2) Limit certain features of Federal programs by statute

Certain parts of present Federal programs might be eliminated or restricted by statute so as to reduce the total number of house buyers, or to place their borrowing on a sounder basis.

a) Congress might be asked to refuse further authorization for insurance of mortgages under Title VI of the National Housing Act. This would help to remove the inflationary pressure on costs which comes from trying to build more houses than there are materials and labor to finish.

b) Congress might be asked to refuse further authorization for insurance of mortgages under Title VI except for rental housing. Title VI has encouraged rental housing, and, if adequate safeguards are maintained by FHA, this building should be less inflationary than the small-house building under Title VI.

c) Congress might be asked to pass the bill drafted by the Housing and Home Finance Agency to limit borrowing by an individual to $9,000 if any part of the loan is to be insured or guaranteed by the Government. This would withdraw Government aid from those who buy expensive houses, unless they have large amounts of cash, but would permit the purchase of low-priced houses on small equities, with Government encouragement.

d) Congress might be asked to suspend or curtail the insurance of loans on old houses under both FHA Title II and the GI Bill. This, unfortunately, might have the effect, especially in the case of veterans, of shifting some old-house buyers into the new-house market, unless credit for the purchase of new houses were also made more difficult to obtain.

e) Congress might be asked to remove from the GI Bill the implication that 100 per cent financing is to be encouraged, and to direct the Veterans Administration to require down-payments and to shorten maturities to the extent necessary for sound borrowing.

f) Congress might be asked to place appraisals for GI loans in the FHA, and to require that the standards of Title II be used in appraisals of old houses. In effect this would make guaranty of GI loans an FHA operation, with the insurance fund supplied from appropriations for the Veterans Administration. Over a period of time, the entire operation might be brought under FHA.

3) <u>Restrict Federal programs by administrative regulation</u>

a) The Veterans Administration might encourage, rather than discourage, down-payments by veterans, and might encourage or require shorter maturities on GI loans. Such requirements could be imposed selectively so that, for example, the larger the down-payment (without other borrowing) the longer the maturity could be.

b) The Federal Housing Administration might define "necessary current cost" for Title VI insurance as the cost of the most efficient half, for example, of builders in a community. This would give individual builders an incentive to reduce costs. The extent to which such a regulation would reduce building would depend on the proportion chosen. A

provision directing FHA to adopt a regulation of this sort has now been added to the Title VI authorization bill recently reported by the Senate Committee on Banking and Currency.

c) The Federal Housing Administration might require larger equities in all mortgages insured, whether under Title II or Title VI. The amount by which this would reduce demand would depend partly on how large an equity was required, and partly on how plentiful funds are for uninsured mortgage lending. To the extent that builders were required to have capital invested in building, this measure might reduce building, but some reduction of building would help relieve pressure on costs.

d) The Housing Expediter, in cooperation with FHA and VA, should make the regulations governing preference for veterans and for hardship cases in the sale of new housing more strict. The present regulation requires that a new house be held for 30 days, after which time, if no veteran has bought, it may be sold to anyone. The regulation also provides, however, that, in a development, if the first house was not sold to a veteran in 30 days, the rest may be sold to anyone on or before completion. A more strict regulation might reduce building somewhat, but it would increase builders' incentives to reduce costs, and make FHA and VA appraisals more effective in determining prices.

e) The so-called "warehousing plan" for GI loans made by members of the Federal Home Loan Bank System should not be adopted. This plan would permit Federal Home Loan Banks to purchase, with recourse for five years, GI loans made by member associations. The effect of this plan would be to draw more funds into the mortgage market.