March 14, 1950.

Dear Bill:

I am enclosing herewith two sets of the following papers:

1. General statement covering the housing legislation entitled "S 2246";

2. An appraisal of the principal provisions of Title III of S 2246 as referred to on page 6 of the general statement;

3. A statement by me covering "The Effects of Housing Finance on Federal Reserve Policies". This statement you can use as your own or put it in the record, if you choose to, as a statement by me given to you at your request.

The general statement is not as effective as I would like it to be, but it is the best that could be done in the time limitation. I hope it will be of assistance to you.

Sincerely yours,

M. S. Eccles.

Honorable William J. Fulbright,
United States Senate,
Washington, D. C.

March 14, 1950

S. 2246

S. 2246 is the latest, and probably not the last, of a series of legislative actions and proposals designed to provide special Government aid to enable the American people to obtain housing of higher quality and at lower prices than might be available without such aid.

The major question is whether this chain of development, in which S 2246 is the latest link, has gone further than is necessary and is leading to establishment of special privilege groups and to the accumulation of financing procedures which will operate as inflationary stimulants with the danger of overbuilding and subsequent collapse of values.

The early actions of the Federal Government to intervene in housing problems were reasonably successful before the war in achieving their purposes, which were mainly to encourage the formation of stronger mortgage financing institutions, to secure greater mobility of funds available for mortgage lending, to relieve distress--on the part of both mortgage lenders and debtors--and to provide a method of distributing the risk of home ownership and financing in such a way that people would be willing to take their proper share of the risks.

Before the war, the Federal Housing Administration was successful in achieving a distribution of risks which made for wide acceptability of insured mortgages. This led to the use of the insured mortgage as a device by which the Federal Government assumed the risk of emergency building during the defense and war periods, and since the war, the Government has continued to assume a larger part of the risks of lenders and builders than was necessary or desirable.

The prewar progress toward raising standards of construction has been halted, and the Government has become a party to lowering standards, and shares the risk of this deterioration with the borrowing home owners. In the case of rental housing, the owners do not even share the risk, the Government carries practically all of it.

The borrowing home-owner has been encouraged to overlook his risk by being able to obtain insured loans almost large enough to cover, in many cases, the entire cost of the property, and by having his monthly payment cut--both through low interest rates and through long amortization periods--to a level that is in many cases less than the cost of renting.

All of this has been done with the object of broadening the market for housing. Toward the end of the war it was decided that the market had been made so broad that veterans returning from the services would not be able to compete successfully for housing. So an entirely separate program, providing still easier financing terms, was provided for veterans--but without curtailing any of the easy terms on new housing available to non-veterans.

Maximum interest rates have been legislated at a level which is so low as to stimulate demand beyond the supply of savings available. So the Government is forced to advance the funds through Fanny May, thus adding to the Government deficit and inflating the cost of housing. It is now proposed in S 2246 that the Veterans Administration have power to make direct loans, using additional Government money. Maturities have been lengthened so that twenty-five years has become common, and, under some programs, thirty years is possible.

This easing of terms has been introduced at a time when demand would have been strong enough in any case to absorb the supply of housing that could be made available. People wanted houses. Enough of them had funds for larger down-payments, and had sufficient incomes to support larger monthly payments.

It has been argued that not every family could have met the more traditional terms. This is true, but it is also true that even under the best of circumstances, not every family can have a new house. The supply of housing can be increased only slowly, even when building goes forward at capacity. The million houses built in 1949, for example, added only about 2 1/2 per cent to the total supply. The bulk of the families must depend upon existing houses for their homes.

When demand for housing rises rapidly, as it did after the war, building is stimulated. But building cannot be increased indefinitely. When demand increases faster than building can increase, consumers are bidding against each other for land, labor, and materials to build new houses, and for possession of old houses.

So the fact that not every family could have met more traditional mortgage terms does not mean that the easier terms got many more families into houses. Under more traditional terms, many families would not have been in the market. With the easier terms, many families have been priced out of the market. More houses may have been built since the war in the very strong market which Federal programs have helped to produce than would otherwise have been built. But it may be doubted that this additional building will compensate for the inflation of building costs and property values which has also resulted.

Problems have been raised for the future. We have used extremely easy terms during a period of high economic activity and demand for housing, when people had large amounts of accumulated savings. What terms shall we offer in a period of lower economic activity or slack demand for housing, or when people's savings are smaller or needed for other purposes? We may very well find that the cheap credit we have offered in recent years will turn out to be very expensive.

These programs have not only created inflation in the housing market, but have also added to general monetary inflation. Widespread extension of credit on mortgages, stimulated by the Federal programs, has resulted in over-all monetary expansion. At a time when Federal Reserve authorities were attempting to restrain inflationary pressures by appropriate actions to make credit more difficult to obtain, insurance companies and other investors in Government securities have been encouraged to sell such securities and obtain insured mortgages. The Federal Reserve has had to support the market for Government securities and indirectly that for insured mortgages. In this process additional inflationary bank reserves have been created.

S.2246 continues these developments

S.2246, in all of its major provisions, would accentuate the main developments of recent years. It would permit Section 608 of the National Housing Act to expire, but would transfer to various portions of Title II many of the provisions for easy terms which were first written into Title VI as emergency provisions--such as making 90 and 95 per cent mortgages widely available. It would increase the number of persons eligible to borrow under the terms of the Servicemen's Readjustment Act, and would authorize the Administrator of Veterans' Affairs to make direct loans to those eligible to borrow under that Act. It would broaden the authority of the Federal National Mortgage Association to purchase mortgages, and increase the amount of loans the Association might hold.

Altogether, the bill would increase the authority for Government underwriting, buying, or making of mortgage loans by somewhat more than 3.6 billion dollars. But it does not say that this is the end.

Hasn't the time come to stop broadening Government participation in real estate financing and to revert to the encouraging of private parties to assume the risks that are rightly theirs as under the prewar F.H.A. plan?

If this is the appropriate course, is it proper to make easier the present financing arrangements? Is it proper to provide for further expansion of operations under existing arrangements? Might it not be desirable to curtail some existing programs and substitute in part new programs under which more risk would be borne by private persons, and less support would be lent to private obligations? Should not programs be sought which will not reinforce booms and add further to the already difficult job of credit and monetary management?

Title III of S.2246. In part, the provisions of Title III reflect the competitive deterioration of standards which has developed in mortgage financing programs during the past decade. Just as it was felt necessary to make terms under the Servicemen's Readjustment Act somewhat easier than those available under the F. H. A. programs of the time, and then to successively relax terms under both programs, it is now felt necessary to ease terms for middle income families who want to try obtaining housing through cooperative efforts. It is difficult to see what other effect progressive relaxation of terms by Government action can have, or whether the process can logically stop. Someone is always likely to be priced out of the market by relaxed terms which sustain inflation. And there will always be someone who cannot meet even the easiest terms.

Attached is an appraisal of the principal provisions of Title III, indicating the differences between its probable operation and existing F.H.A. procedures. (The statement by Governor Eccles discusses more fully the differences between the two programs with respect to their financing and the effects on the money market.)

The conclusions that may be drawn from an appraisal of the bill and comparisons with existing legislation may be summarized as follows:

(1) The middle income cooperative housing provisions would within the limits established by the Act stimulate the building of cooperative projects, because of the more favorable terms, than would otherwise be available.

(2) These projects would have definite advantages in competition with existing and other newly constructed projects and would tend to depress the markets for other housing.

(3) Purchasers of the Corporation's debentures would be much more adequately protected against risk and the inconvenience of foreclosure and default than is generally the case for other Government corporations such as Federal Land Banks and Home Loan Banks.

(4) The debentures would be practically the same as Government guaranteed obligations, thus in effect restoring a practice which was abandoned years ago as undesirable.

(5) Under the guarantees and safeguards now in the bill, the Corporation should be able to borrow in the money market in competition with Government securities at only slightly higher rates.

(6) The effect on the monetary situation of the issuance of such securities would be practically the same as a Government deficit. Purchasers would either sell or refrain from buying Government securities in the form of direct obligations. Banks, and to some extent the Federal Reserve, would then have to buy more Government securities. The result would be an expansion in bank credit and the supply of money, that is, a credit inflation.

We should be moving away from, instead of further into, the kind of program that has developed toward socialization of housing credit. Title III suitably modified could provide a means for bringing about some of the necessary changes.

Amendments which would improve Title III of the amendment in the nature of a substitute for S.2246 are attached.

March 14, 1950

PRINCIPAL PROVISIONS OF TITLE III, S.2246, AND COMPARISON WITH FHA-INSURED LOANS

The National Mortgage Corporation for Housing Cooperatives would have greater control over the kind of housing it would finance and the timing of its operations than existing agencies have for the most part. The Corporation would be in a stronger position to enforce standards in the public interest and to audit costs. It would also be in a position to minimize the inflationary influences of building it financed. All of these advantages could, of course, be nullified if the program were used, as other programs have been used, to satisfy housing demands faster than is economically desirable.

In general effect, the cooperative financing plan is closely similar to much of the financing now being done with FHA-insured mortgages, although the mechanism used would be different. Under the FHA plan, private lenders advance their own money on mortgages covering either existing properties or properties to be built. The loan may represent not more than 80 per cent of the value of an existing house, as determined by FHA, and if S.2246 is enacted may be as high as 90 or 95 per cent of FHA's estimate of value in the case of new construction which, according to many, may be equal to or greater than actual construction cost. The loan may bear interest at not more than 4, 4-1/2, or 5 per cent, depending on the transaction involved, and may run for as long as 20, 25, or 32 years.

In addition to interest, the borrower under an FHA mortgage pays an annual insurance premium of 1/2 of 1 per cent, in most cases, of the average outstanding principal. Out of this premium FHA pays its operating expenses and sets up a reserve fund to pay losses. Credits to this reserve have apparently amounted to about 1/4 of 1 per cent of outstanding balances. If a mortgagor defaults, the mortgagee has the task of foreclosing. After foreclosure, he may turn the title over to FHA and in exchange obtain debentures payable by FHA and fully guaranteed by the United States, which are negotiable, bear interest at not more than 3 per cent, and mature 3 years after the maturity of the defaulted mortgage. In practice, FHA has called such debentures very soon after issue.

Under the cooperative financing plan, the proposed National Mortgage Corporation for Housing Cooperatives would obtain its initial capital of 100 million dollars from the Treasury, as other housing agencies such as FHA, HOLC, and the Federal Home Loan Banks obtained their capital, and would be authorized to have outstanding eventually not more than 1 billion dollars of debentures. These debentures would not be guaranteed, but would provide that, if the Corporation defaulted on its debentures, it would exchange them for debentures fully guaranteed by the United States which would be negotiable, bear interest at not more than 3 per cent, and mature three years after the maturity of the original debenture.

Cooperative associations or non-profit housing corporations would be able to borrow from the Corporation only for the construction of housing for "middle income families". Before borrowing from the Corporation they would be able to obtain a certain amount of technical assistance from the Housing and Home Finance Agency, and, if the project looked sound, a loan for planning and development from the HHFA, which would be paid off from the proceeds of loans from the Corporation.

Property loans from the Corporation would run for as long as 50 years, and would provide for possible extensions to a maximum of 63 years. The loans would bear interest at the rate determined by the Corporation so as to cover the cost of money to the Corporation, operating expenses, any reserves the Corporation might decide on, and a sum equivalent to 1/4 of 1 per cent of the outstanding loan balance to be credited to an "Insurance Fund" against which losses on mortgages would be charged.

The maximum amount of loan would be the cost of the borrower's project, but the borrower would buy stock in the Corporation equivalent to 2-1/2 per cent at the time of application, another 2-1/2 per cent on completion of construction, and 5 per cent during the succeeding 20 years. When the loan had been paid down so that the remaining balance was equal to the amount of the borrower's stock, the stock could be applied as payment in full. The report of the Senate Committee on Banking and Currency calculates that a 50 year loan would be paid off in this way in 36 years. When the private capital in the Corporation amounts to one-half of the Government capital, the Corporation would begin retiring the Government capital.

The attached statement of Governor Eccles includes further discussion of methods of financing the Corporation and its possible effects on the money market and on Federal Reserve policies. It also contains a further comparison with FHA procedures and their effects on the money market.

March 14, 1950

EFFECT OF HOUSING FINANCE ON FEDERAL RESERVE POLICIES

Statement Prepared by Marriner S. Eccles,
Member of Board of Governors of the Federal Reserve System

Under Title III of Senate Bill 2246—the Housing Act of 1950—the obligations which would be issued by the proposed National Mortgage Corporation for Housing Cooperatives would compete directly with Government securities in the money market. They would be purchased largely by banks and other investors, which otherwise would probably hold Government securities. As a result, either the Federal Reserve would have to purchase additional Government securities, thus creating new bank reserves, or prices of Government securities would decline, i.e., interest rates would rise.

Although the protective aspects of the Corporation's obligations authorized by the bill are designed to be similar to those of FHA mortgage insurance, there are important differences between the two. Apart from the original capital of the Corporation, the funds extended by the Corporation would be private funds, but the ultimate lender, i.e., the purchaser of the debenture, is more adequately protected against difficulties and risk of loss than is the mortgagee or holder of an FHA-insured mortgage. If the Corporation defaults on a debenture, it itself makes the exchange for a guaranteed debenture, whereas if an FHA mortgagor defaults on his mortgage, FHA makes the exchange of the mortgage for a guaranteed debenture after the mortgagee has foreclosed and obtained title to the property. It would be reasonable to expect, moreover, that the Corporation would have less occasion to issue guaranteed debentures because, while FHA issues guaranteed debentures for every individual mortgage which is foreclosed, the Corporation would not have to issue guaranteed debentures in exchange for its other debentures until a very large proportion of its mortgages had gone bad and its capital, surplus, and reserves had been impaired to a point where the Corporation could not meet its obligations.

For these reasons and because of the other safeguards, the Corporation's debentures issued to obtain new funds should have an even more favorable market than the obligations of other Government corporations, such as Federal Land Banks, which are not protected in the same manner, and would be in effect the same as guaranteed Government securities. The competition which would arise in the market between Government securities and obligations of the Corporation would, therefore, be very direct. Most of the buyers of the debentures would be banks, institutions, and other investors that would probably otherwise hold Government securities.

As the bill stands, the Corporation would have a great deal of discretion about the gross interest rate to charge borrowers and the mortgage maturities to permit. The Corporation would probably be able to borrow at slightly above the long-term Government rate, and the lowest gross rate to borrowers might be little over 3 per cent, although it would have the authority to charge higher rates and build up reserves. On the other hand, by issuing short-term debentures, the Corporation might get its money as low as 1-1/4 or 1-1/2 per cent, which might permit a gross rate much lower than 3 per cent.

If the Corporation were to obtain funds for long-term mortgage lending by borrowing substantial amounts on short-term obligations, it would not only run the risk of adverse market fluctuations, but it would in all likelihood obtain these short-term funds largely from expansion of bank credit. This could be undesirable in a period when general credit policy was directed toward limiting expansion of bank credit.

In view of the safeguards with respect to capital of the Corporation and insurance reserves against the debentures included in the law, it is unnecessary to add the undesirable feature of what is in effect a direct Government guarantee of the debentures. The Corporation should be able to borrow on terms just as favorable as the Federal Land Banks and the Home Loan Banks, which now have no such guarantee. The debentures then would be more truly of the nature of private obligations and compete less directly with Government securities.

The practice of issuing securities guaranteed by the Federal Government was abandoned many years ago because such issues came to be viewed as practically the same as direct Government obligations and were an indirect means of keeping the expenditures out of the budget. Issuance of guaranteed obligations has the same effect as an increase in the public debt. Investors buying the new securities might sell direct obligations of the Government. Either the prices of Government securities would fall and interest rates rise or the Federal Reserve would have to support the market by buying securities, thus creating bank reserves.

Action by the Federal Reserve of this nature might at times be inconsistent with major aims and statutory obligations of the Federal Reserve. An excellent description of the appropriate aims and procedures of Federal Reserve policies is given in a recent report of the Subcommittee on Monetary, Credit, and Fiscal Policies of the Joint Committee on the Economic Report, after conducting a comprehensive inquiry under the Chairmanship of Senator Douglas. This description may be summarized and paraphrased approximately as follows:

The role of the Federal Reserve in our economy is to supply the banking system with adequate lending power to support a growing and relatively stable economy and to exercise restraint upon excessive credit expansion that will lead to instability. This task has been made exceptionally difficult by the tremendous wartime growth of the public debt, the pervasive distribution of Government securities among many holders, and the tendency of these holders to view their securities as liquid assets readily convertible into money to be spent or otherwise invested. Attempts to sell these securities, unless buyers are readily available, tend to lower their prices, which means a rise in interest rates. In the absence of a demand by other investors, declining prices can be prevented only by Federal Reserve purchases.

But any expansion of Federal Reserve credit has the effect of supplying banks with additional reserve funds, on the basis of which the banking system by lending or investing and relending can expand bank credit, and the volume of money, by many times the amount of the reserves supplied.

This process of monetary inflation can be somewhat restrained by limiting Federal Reserve purchases of Government securities. As the Douglas Subcommittee report pointed out,[1/] "the essential characteristic of a monetary policy that will promote general economic stability is its timely flexibility." But Federal Reserve policies cannot be varied in response to changing needs without affecting interest rates. For the Federal Reserve to endeavor to maintain a rigid level of interest rates would mean supplying all credit demands in time of expansion and absorbing all of the unused supply of credit in times of contracting demands. Such policies would tend to create instability, because they would tend to reinforce both the expansion and the contraction phases of economic fluctuation.

Another general point which should be kept in mind is that there are many interest rates which reflect, on the one hand, varying degrees of risk and liquidity involved in different obligations and, on the other hand, the supplies of funds that may be seeking relative safety and liquidity at the sacrifice of higher return or vice versa. For example, the Treasury can borrow at between 1 and 1-1/4 per cent on short-term obligations and at less than 2-1/2 per cent on long-term bonds, while business borrowers at banks pay from 1-1/2 to more than 6 per cent, depending on the size and risk of the loan, and consumer loans carry higher interest charges. These differences in the structure of interest rates must be taken into consideration in the determination of Federal Reserve policies.

What bearing do these observations have on housing finance and housing legislation? An important aspect of most of the housing legislation of the past two decades has been to make it possible for lenders to tap money markets at lower rates of interest and on more favorable terms than were previously available. These were and are, on the whole, desirable aims, as institutional arrangements in the mortgage market have had much need for improvement. Particularly during periods of depression and substantial unemployment it was most helpful to facilitate the flow of available investable funds into the mortgage market at reduced rates of interest. It is quite another matter, however, to adopt measures which will lead to the creation of new money to finance construction at a time when activity is already fully utilizing available supplies of material and labor and prices are higher than a large portion of potential buyers can afford.

The aim of many of the measures adopted and proposed has been to lower the cost of housing by obtaining low interest rates on mortgages—an important cost of home ownership. This is generally done by attaching some

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1/ "Monetary, Credit, and Fiscal Policies", Report of the Subcommittee on Monetary, Credit, and Fiscal Policies of the Joint Committee on the Economic Report, January 23, 1950, p. 19.

sort of Government insurance or guarantee to the mortgages or to the obligations of mortgage lending agencies or by providing facilities for increasing their liquidity. One result is that these obligations can tap sources of lendable funds that would otherwise not have been available to them. The lower rates and increased availability of funds tends to stimulate borrowing.

Obligations guaranteed or insured by the Federal Government are to a considerable degree competitive with Government securities; therefore an increase in such obligations is likely to result in a decline in prices of Government bonds, i.e., a rise in interest rates. In the absence of a large unused supply of loanable funds in that sector of the market, the only way a general rise in interest rates could be avoided would be by Federal Reserve purchases of Government securities, which would mean the creation of new money.

Thus the issuance of additional amounts of obligations directly or indirectly guaranteed by the Federal Government would have the effect either of depressing the prices of Government securities or of requiring creation of supplies of new money by the Federal Reserve. In the case of the first alternative, the benefits of lower interest rates expected by the sponsors of the measures to provide cheaper housing would not be fully realized and, in addition, all other Government securities would decline in price. In the latter case the inflationary policies might result in higher prices. Whether such a result ensues depends upon the general economic situation at the time.

It is because of these possible consequences that the Federal Reserve has a particular interest in housing finance and in the various legislative proposals that have been made. Their effects on the economy, and perhaps their success in accomplishing their objectives, will in the final analysis influence, or be influenced by, Federal Reserve policies.

While the monetary consequences of financing the amount of debentures proposed under the present bill might be slight, the principle, however, is one which, if adopted in a moderate amount for one purpose, might well be extended in magnitude and scope. It is difficult to provide special privileges to one group and deny them to others. This principle, if widely adopted, could unduly stimulate housing construction at lowered interest costs and eventually undermine the values of existing houses and of mortgages outstanding against them. It would be at first an inflationary factor and ultimately lead to a deflation of values.