STATEMENT OF CHAIRMAN MCCABE

ON BEHALF OF THE

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

ON

S. 2246

BEFORE THE

SENATE COMMITTEE ON BANKING AND CURRENCY

THURSDAY, FEBRUARY 16, 1950

FOR RELEASE

UPON DELIVERY

In response to a formal request made by the Chairman of your Committee, I am presenting this statement on behalf of the Board of Governors of the Federal Reserve System with respect to the effect which various sections of S. 2246 might have on the national economy. This is a complex bill. A thorough appraisal by housing, as well as monetary, specialists would be required to assess all of its provisions from a general economic standpoint. Our comments, accordingly, will be directed to those phases with which the Board is concerned because of its responsibilities in the monetary and credit field.

At the outset, I should like to express the strong sympathy which the Board has for the objective of this Committee in helping to solve the nation's housing problem. We realize that your task is extremely difficult because of the many facets of the problem -- social and political as well as economic and financial. Socially, an adequate supply of housing of reasonable quality and comfort and at bearable cost is essential to a decent standard of living. Economically, housing construction is one of our strategic areas of industrial activity, and stability of housing construction is of vital importance to the maintenance of over-all economic stability. Financially, housing is a principal outlet for the direct placement of individual savings as well as a principal asset in the financial statement of a large proportion of American families, and housing mortgages are a principal medium of investment for our savings institutions and a source of indebtedness for American families.

The Board of Governors is confining its comments on the proposed bill to its economic and financial implications. We recognize, however, that the President and the Congress must take full account of all aspects of this legislation and that such opinions as we may offer on the economic or financial phases will be judiciously balanced against other relevant considerations.

Our first concern with this housing legislation, as with most legislation, is to assess its potential effects on the total volume of debt or credit and therefore on the problem of maintaining high level economic stability, i.e., of avoiding the twin perils of inflation and deflation. The traditional powers entrusted to the Federal Reserve System are concerned primarily with influencing the total volume of debt and credit in the interest of monetary and economic stability. From the end of the war through 1949 the total debt in the economy, i.e., public debt (excluding trust funds) plus private debt, increased about 37 billion dollars. Private debt increased 67 billion dollars, to 208 billion dollars, while public debt declined 30 billion, to 237 billion. The decline in public debt was due mainly to a repayment of outstanding Federal obligations, held by the banking system, through the drawing down of Treasury cash balances accumulated as a result of the Victory Loan and budget surpluses. The greatest relative increase in private debt was in consumer and mortgage borrowing. Consumer credit increased from 7 billion dollars to nearly 19 billion and residential mortgage credit on 1-4 family structures doubled and rose phenomenally from 19.2 billion dollars to 37.5 billion in the four year period.

It should be pointed out that there is such a thing as a credit inflation as well as price inflation. There is some limit to the volume of debt an economy can carry and service. It is desirable to retain as much of our national borrowing power as possible for periods of recession when the availability of funds for cash purchases by consumers and business enterprise is relatively low. We must always bear in mind the possibility of periods of recession. The carrying over of huge debts into such periods will restrict consumer buying power and accentuate the downward cycle.

As you will recall, from the end of the war through 1948 our economy was characterized by heavy and persistent demands for all types of goods and services by consumers, business enterprises, all levels of Government, and for export to the rest of the world. During this period the supply of goods and services available to satisfy the large over-all demand was growing, but still limited. As a result, prices rose sharply and during 1948 we were in a dangerously inflationary situation. During this early postwar period, personal and business incomes were high, accumulated holdings of liquid assets were large, and bank and other credit was readily available at low cost.

It was in this environment that the Federal Reserve System undertook, through its monetary and credit powers, to exercise some anti-inflationary restraint. Voluntary commercial bank efforts to avoid excessive or speculative lending activity were encouraged; stringent curbs on stock market credit were maintained; wartime consumer credit regulation was extended to late 1947 and reimposed in the early fall of 1948; and higher reserve requirements were imposed on member banks. It was mainly in the mortgage lending and agricultural areas that no restraint was directly applied. Yet the impact of the Government's support programs in both these areas, by contributing to the volume of spending power and the demand for materials and labor in short supply, accentuated the inflationary trends that pervaded the economy during those years.

In making this statement, I wish to say that I am aware that the acute shortage in the existing housing supply was an important factor in the inflationary situation. I also appreciate fully the contribution which the Housing authorities made in their strenuous efforts to channel new construction activity into the building of low-cost units, thus adding the largest number of units to the housing supply with available labor and materials. During these years, however, the Federal Reserve System was subjected to sharp criticism because the sacrifices which were imposed on those sectors of the economy subject to its restraints were being offset by inflationary developments in other sectors, such as mortgage finance.

Your Subcommittee has included in the bill Mr. Foley's suggestion which would give the President authority to adapt the terms and scale of operations of any Federal program involving loans for housing to the state of the construction industry and to the state of the economy generally. It is a source of satisfaction to the Board that the importance of gearing the scale and character of Federal housing programs to the general economic situation has been recognized.

Our second main concern with housing legislation in general is the effect it may have on the total volume of public debt with which the Open Market Committee of the Federal Reserve System has to cope. The complex problems presented to the Treasury and the Federal Reserve by the huge volume of publicly held securities now outstanding has been thoroughly explored and reviewed by the Subcommittee of the Joint Committee on the Economic Report of which Senator Douglas is Chairman. Certainly the efforts of the Federal Reserve to restrain the postwar inflation in the years from 1945 to 1948 would have been considerably more successful if the System had not felt obliged by the then existing circumstances to purchase huge quantities of marketable securities. Right here I would like to repeat the statement I made to this Committee in reviewing that situation in May of last year.

". . . From September 1 (1948) to November 1 (1948) bonds in the amount of 3-1/4 billion dollars were purchased to carry out this policy of stability.

"In retrospect, I am certain that our action in support of the Government securities market was the right one. That program was a gigantic operation. In the two years 1947 and 1948, the System's total transactions in Government securities amounted to almost 80 billion dollars. Despite this huge volume of activity, the net change in our total portfolio was relatively small. I am convinced that we could not have abandoned our support position during this period without damaging repercussions on our entire financial mechanism as well as seriously adverse effects on the economy generally."

In the legislation now before you we have noted the section of the bill which would provide for building up separate reserves back of the securities to be issued by the proposed National Mortgage Corporation for Housing Cooperatives. These reserves are designed to insulate the Treasury against any losses that might be incurred from the Corporation's operations. Nevertheless, the guaranteed securities issued by this public corporation would generally be considered United States Government securities. They would be purchased by banks and others on this basis. Indeed, it is this fact of market standing which would permit them to be sold at the low rates contemplated. This very same fact would mean that these guaranteed issues would represent additions to the volume of publicly held debt with which the Federal Reserve is particularly concerned.

In this connection, I would like to call to the attention of the Committee the fact that we have had some experience with publicly floated guaranteed securities of Government corporations. Several issues of this kind were brought out during the early part of the recovery program in the 1930's. This device was used, for example, to finance the operations of the Home Owners Loan Corporation. These experiments were later discontinued as a matter of public policy.

Inflationary problems have not been acute since the end of 1948 but it would be an illusion to premise major public policies on the assumption that all inflationary dangers have passed. During the first half of 1949, inflationary pressures generally abated, prices declined moderately, and the rate of growth of private debt tapered off. The response in the field of housing was particularly noteworthy. Larger supplies were available and there was a relaxation of the high pressure demand that had characterized preceding years reflecting in part the reluctance of lenders to finance low interest mortgages. In response, costs of new housing reversed their previous upward trend and fell moderately. Subsequently, in fact from near the middle of 1949, housing demand expanded and a year that opened with marked consumer resistance to high building costs, closed with a record for the largest number of houses ever started in this country. The expansion in the operations of the Federal National Mortgage Association played its part in financing this renewed activity. During this recent period, construction costs and values of improved real estate were not far below postwar peaks of about double prewar levels.

During the first half of 1949, the Federal Reserve was prompt to recognize the change in current trends, and showed great flexibility in relaxing its special anti-inflationary restraints. It also inaugurated a more flexible money market policy. These actions had some effect in checking recession tendencies of that period and in encouraging revival, but the contribution of credit relaxation to these developments should not be overestimated. To an important extent, the sustained high level of economic activity has reflected continuing large consumer spending out of high current incomes and the continuing use of previously accumulated liquid savings.

Since about the middle of 1949, both public and private debt have shown increases as well as tendencies toward accelerating growth. In recent weeks, prices have strengthened in selected areas, notably those relating to the building trades where as I have said, activity is at record-breaking levels for this time of the year. Personal holdings of liquid assets -- totaling 177 billion dollars -- are still large in relation to current production. In view of the Government deficit and consequent borrowing, which is increasing outstanding liquid assets, it is important to scrutinize closely all legislation such as this that will further add to their volume.

This brings us to our third point of concern with housing legislation -- namely, the extent to which it will contribute to the deficit. All of us, I am sure, look with anxiety on the present fiscal situation where we are running a deficit at a high level of activity. Both the Administration and Congress are exploring every channel of taxation and expenditure to see how the deficit can be minimized and how the economy can be protected from the inflationary implications of an unbalanced budget. I mention this third area of concern to remind us that close to one billion dollars, or one-fifth of the current cash deficit is attributable to the special support given housing by the operation of the Federal National Mortgage Association. The proposed bill would broaden the operations of the Federal National

Mortgage Association. If some way could be found to make the mortgages now purchased by the Federal National Mortgage Association more attractive to private lenders, it would contribute to monetary and fiscal stability. It would also seem well worthwhile to consider restoring the authorization that was previously in the law for organizing private National Mortgage Associations.

We have a fourth area of concern of a somewhat different order with respect to housing legislation, namely, that programs to stimulate housing should not be pushed at any one time to the point where problems of instability are created for the future. Today, we are all aware of the inflationary impetus that can be given to the spiral of wages, prices, and costs throughout the economy when the supply of housing is acutely short relative to effective demand. Conversely, as we all know, the opposite situation can prevail and when it does the effects are deflationary on widely ranging aspects of the economy. This result comes about, for one reason, because the housing industry, directly or indirectly, is perhaps our largest area of employment, and for another, because it is a major form of investment and saving for the mass of the people. I mention this point, not because we think it is raised acutely by the proposed bill but because it is implicit in all legislation that promotes housing construction.

The areas I have outlined summarize the concern which we in the Federal Reserve have for the varying aspects of all housing legislation. Concentrated as we are on watching the economy to detect trends that may foster instability, inflation or deflation, we must ask ourselves of each piece of proposed housing legislation: (1) Will it overly-stimulate the total volume of credit? (2) Will it still further expand the now huge volume of marketable public debt which greatly complicates the conduct of Federal Reserve open market operations? (3) Will it add to a cash deficit when the economic situation calls for a Government surplus? And (4) is there serious risk that it will over-stimulate construction activity and eventually contribute to deflation in the housing industry?

During recent years many pieces of housing legislation have given us concern on one or more of these grounds. At the same time, we have recognized that the housing situation was abnormal and that emergency measures were required. We are aware that, although the housing situation is steadily improving, and shortages and exorbitant rentals are abating, there may still be areas where special action may be justified.

We believe that the time is close at hand when it will be desirable to begin adjusting housing legislation toward a pattern better adapted to normal peacetime conditions. These adaptations should be based on the principle that credit for residential building should be private credit, subject to the market tests governing other private credit, to be influenced in its volume by Federal Reserve monetary and credit policies. Such adaptations should not proceed on the assumption that residential mortgage credit should be public credit, relatively immune to market restraints and to restraints arising from Federal Reserve operations but at the same time requiring Federal Reserve support. If it were to be the latter, the sheer volume of credit that would be transferred from the private to the public field would greatly complicate the monetary problems with which we in the Federal Reserve have to deal.

We are fully aware that the adjustment to normal peacetime conditions cannot be made all at once or by any one session of the Congress.

As I mentioned earlier, recognition of the fact that Federally sponsored housing activities should be varied in accordance with changing economic conditions is an important forward step. It is another step in the right direction that Section 608 of the National Housing Act would finally be terminated.

We suggest that your Committee will make a fundamental contribution to greater economic stability if in considering legislative adaptations in this field it keeps in mind four major principles:

(1) Interest rates in the mortgage market should be flexible. If Congress promotes programs premised on an interest ceiling, the Federal Reserve will not be able to operate as recommended in the Douglas Subcommittee report.

(2) As long as the Federal debt is so huge, the contribution of mortgage financing to the outstanding volume of marketable public debt in terms of which the Federal Reserve is obliged to operate should be held to a minimum.

(3) The impact of housing assistance on a Federal budget already running a deficit at a time of high level employment should also be held to a minimum.

(4) Housing programs should be judged not only by the contribution they make to the current availability of housing and current levels of employment, but also by their effects on the long-term stability of the market for residential construction and on the mortgage market.

I would like to say a few words directed specifically to the program for middle-income housing provided for in Title III, possibly the most controversial portion of the bill. The primary objective of this Title, as we understand it, is to provide lower rentals for the middle-income families in certain areas where current rents on uncontrolled dwellings are abnormally high in relation to the current incomes of these groups. We have studied this Title carefully in the Board and I think I summarize our observations correctly when I state:

1. We recognize that the cooperative principle has shown great merit in other areas and that its encouragement in the field of housing may prove helpful in improving middle-income housing.

2. We believe that important benefits can flow from those sections setting up technical services and making them available to potential cooperatives.

3. We believe that use of the cooperative principle is justified to the extent that it achieves its economies on a competitive financial basis. Our fundamental concern is with the financial terms. We know of no mortgage credit currently available in this country on amortization terms of 50 to 60 years or at interest rates such as are contemplated here. It seems to us also that securities floated publicly in the market on the credit and guarantee of the Government, though not through the budget, might create difficulties, especially if the operation should ever attain sizable volume.

4. We believe that it would be appropriate for the ideas embodied in this bill to be given a full and fair trial on an experimental basis, with the financing on the FHA principle, rather than through the establishment of a new Government lending institution on a permanent basis. We understand that cooperative projects have encountered some difficulty in obtaining construction loans because of the lack of familiarity of lenders with this type of operation. Perhaps some special provision should be devised to remedy this particular difficulty.

American industry has grown great through research and experimentation. This is an occasion which the Congress might well utilize, to adopt the experimental method and develop a record of experience that could be extremely valuable in another period of recession. Then there would be real economic need for accelerated effort in the construction industry. Today on the other hand, the industry is already operating at a very high level.

This brings me to a point on which I would like to place great stress. So far as the mass of our people is concerned, the monthly cost of housing depends on two major elements, (1) the monthly cost of financing, including both interest costs and amortization, and (2) the capital cost of land acquisition and construction. The monthly cost of housing can be lowered either by providing for more lenient financial terms or by promoting greater efficiency in the construction industry. Conversely, the advantages of more lenient financial terms can be nullified by rising construction costs. Something of this sort seems to have been happening in recent years of inflationary conditions and abnormal demand.

Although the Congress has recently made desirable provision for technical and economic research in the field of housing most of the efforts of Congress to improve the housing conditions of our people have been directed toward the lowering of interest rates on home mortgages and toward the relaxation of repayment terms. The reforms inaugurated under Title II of the National Housing Act in 1934, for example, had far reaching effects in this direction. Looking backward over the period since 1934 as a whole, I think we can fairly say that those reforms actually contributed materially to lowering the monthly costs of housing for people who bought their homes up to, say, the outbreak of the war. Since that time, it is much more difficult to assess their effects or the effects of other comparable measures which Congress has taken in the same direction.

The great contributions of American industry to our standard of living have come about as the result of lowered real costs, of continued increases in the efficiency of production. It is to this factor that we must chiefly look for the emergence of higher standards of housing. Any contribution that can be made to increase the efficiency of construction, and thus to lower building costs, will produce manifold returns to the welfare of the American people.

In conclusion may I again say that our presentation here today has been confined to the economic and financial aspects of this legislation. I want to emphasize, for myself personally and on behalf of the Board of Governors, that we will willingly accept and wholeheartedly help to carry out any program which the Congress evolves. As I said in the forepart of this statement, we fully appreciate that there are many other aspects to this proposed legislation which, in the judgment of the Congress, may override the financial and economic considerations that I have presented, important as these are, from our point of view.