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BUSINESS CONDITIONS

A REVIEW BY THE FEDERAL RESERVE BANK OF CHICAGO

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Credit, Defense, and Inflation

Rising Expenditures Bring New Controls

Communist aggression has forced the nation to embark upon a large-scale defense program at a time when employment and production are at record levels. Rising public and private spending, in part credit-financed, is exerting heavy upward pressure on the general price level, accelerating a trend which had been evident since early this year. Price increases typically were moderate in the first half of the year, but since the outbreak of hostilities in Korea, the flood of new spending, mainly private, has pushed most groups of prices to levels which challenge or exceed the previous peaks reached in the fall of 1948. The extent of the price rise since June—more than eight per cent in the case of wholesale prices—demonstrates that inflation has returned as the nation's primary domestic problem.

INFLATION THUS FAR DUE TO PRIVATE SPENDING

Even before the start of the Korean war many observers were concerned about inflationary pressures. In June important industries such as steel, automobiles, and construction were operating at record rates, and the wholesale price index had risen about four per cent since the start of the year. The post-Korean upsurge in private spending thus was superimposed upon an economy that was already subject to the bottlenecks and strains of a boom. Businessmen scrambled for most types of commodities in an attempt to increase inventories or at least to keep them at levels which would assure continued production. Consumers, fearing that goods would soon cost more or in some cases become unobtainable, rushed to buy the items which were in short supply during World War II.

The initial wave of "scare buying" has spent itself. In fact, during October some forecasters were concerned about the possibility of a letdown in business. Strong deflationary pressures were expected as a result of the extremely high levels of buying during July and August, the apparent quick victory in Korea, and the stern controls which had been placed upon the purchases of homes and consumer's durable goods.

Any belief that "the pressure is off," however, is not based upon a realistic appraisal of the factors influencing the economic outlook. Most important of these is the fast-rising level of Federal expenditures. By June of next year spending for defense is scheduled to reach an annual rate of 30 billion dollars, double the pre-Korea level. Other types of spending are also on the rise. Business leaders have announced vast new programs of capital expansion for both civilian and defense production. In addition, business firms are continuing their attempts to build inventories, which generally are at low levels relative to production and sales.

Wage earners will gain purchasing power through larger incomes, as a result of longer work weeks and a tighter labor market. Although a small reduction in liquid assets owned by individuals occurred during the summer months, the current volume of such holdings still represents a huge reservoir of readily available spending power. Another wave of anticipatory buying is possible in view of the allocations of scarce commodities which already have been announced and the recent indications that total victory in the Korean war may be months away. All of these factors suggest that inflationary pressures will increase in the months ahead.

CREDIT EXPANSION BOOSTS SPENDING

An accelerated growth in most types of private credit has financed an important part of the increased expenditures of recent months. Since June business loans at weekly reporting banks have increased by one-fifth, consumer instalment credit has increased by about twelve per cent, and mortgage credit has risen at a record rate. The growth in these three types of credit in the past four months has added about seven billion dollars to the spending stream. Any further credit expansion will add to the inflationary spiral of expenditures.

Last September, Congress formally recognized the inflationary potential of continued growth of outstanding credit by including in the Defense Production Act provisions for regulating the volume of housing and consumer loans. The Act also gives to the President the authority to control prices and wages directly if the need arises. Up to this time, however, the Government has restricted its primary anti-inflation efforts to indirect controls over the availability of credit.

This issue of *Business Conditions* is devoted to a discussion of those measures which are now in force or which could be employed to restrict credit availability and direct money and materials into channels which will aid the defense program. Steps have already been taken to raise short-term interest rates, to require higher down payments and shorter maturities on mortgage and consumer loans, and to provide a program to guarantee loans made for defense purposes. The reasons for these moves and an evaluation of their effects are presented on the following pages.

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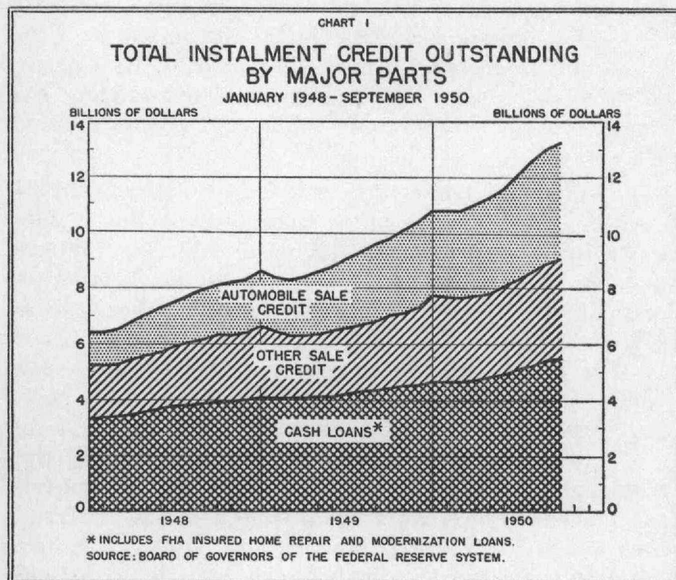
Regulation W Returns

Consumer Credit Curbs Quickly Made More Restrictive

In an attempt to slow the rapid growth in instalment credit witnessed during recent months, the Board of Governors of the Federal Reserve System reinstituted controls over consumer credit on September 18. The new Regulation W, as in previous periods, prescribes minimum down payment percentages and maximum contract maturities for various classes of instalment credits and loans, with the idea that more stringent terms will reduce the use of such credit. The terms initially prescribed by the Regulation apparently failed to exert sufficient downward pressure on credit activity and have already been superseded, as of October 16, by significantly more restrictive requirements.

Instalment credit was increasing sharply even before the outbreak of war in Korea, and this event merely served to add impetus to the expansion. Credit outstanding increased 345 million dollars in May and 441 million dollars in June; reflecting the strong but brief surge in anticipatory buying of consumers' durable goods during July and early August, outstandings jumped 500 and 407 million dollars further, respectively. The increase in instalment credit during the first nine months of this year amounted to 2,440 million dollars, 88 per cent more than in the comparable period of 1949 and 39 per cent more than in the previous record period in 1948. As a result, instalment credit outstanding now totals more than 13.3 billion dollars, after a growth exceeding 11 billion dollars in the five postwar years.

During 1949 and the early part of 1950, the strong upward movement in consumer credit was an important factor supporting business activity and retail sales. Now, however, a continuation of the rapid credit expansion bears important inflationary connotations. First, the demand for many types of durable goods since the end of June has outrun production. Since sharply increased defense requirements are expected to result in some curtailment of output of at least consumer hard goods in the near future, it is necessary to limit the demand for these goods. Second, the additional purchasing power created by increases in debt will merely serve to bid up prices generally, so long as production remains at the present near-capacity levels. For these reasons, it is desirable that the growth in consumer credit, and particularly instalment credit, be restrained as much as possible over the period immediately ahead.



* INCLUDES FHA INSURED HOME REPAIR AND MODERNIZATION LOANS.
SOURCE: BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM.

COVERAGE AND TERMS

The provisions of Regulation W regarding down payments and contract maturities apply to loans and credits extended for purchase of a wide list of consumers' durable goods. These instalment credits are classified according to purpose into several major categories. Group A credits are those extended for purchase of either new or used automobiles. The principal amount of such credit extensions may not exceed 66⅔ per cent of the retail price charged or the appraisal guide value, whichever is lower, and may not have a contract maturity longer than 15 months. Thus, the required down payment will not be less than one-third of the retail price and may be somewhat more during periods when the average retail values indicated by the appraisal guide lag behind sharp price increases in the field.

For Group B credits, which cover most major household appliances including radio and television sets, the required minimum down payment is 25 per cent of the sale price of the article, and the maximum maturity is 15 months. Credits for purchase of furniture and soft-surface floor coverings (Group C) are also limited to a maturity of 15 months or less, but the required down payment is only 15 per cent. Group D home modernization and improvement credits cover the cost of material and labor as well as finished articles used, such as furnaces, water heaters, and electrical and plumbing fixtures. Such loans may have a final contract maturity no longer than 30 months, and the required down payment is 10 per cent of the cost of the improvement. Unclassified instalment loans are restricted to maturities of 15 months or less, and refinancing loans in hardship cases may have a contract term as long as 18 months, but no down payment is required in either case. All instalment loans and credits of $5,000 or less for purchase of automobiles and of $2,500 or less for other purposes not specifically exempted are subject to the Regulation, except that no down payment is required on credit purchases of articles costing less than $50.

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The new credit requirements differ from those initially specified by Regulation W principally in that contract maturities for all but Group D credits are limited more sharply and required down payment percentages are higher, except for Group A and D loans and credits. Contract maturities have been reduced from 21 to 15 months for automobile credits and from 18 to 15 months for both unclassified instalment loans and credits extended for purchase of other durable goods. Minimum down payment percentages have been increased from 15 to 25 per cent for Group B credit purchases and from 10 to 15 per cent for loans on furniture and soft-surface floor coverings.

Required terms at present are considerably more stringent than those initially prescribed by the first Regulation W, during late 1941 and early 1942, and are somewhat more restrictive than those specified at first by the second Regulation W, during the winter months of 1948-49. Down payment requirements are generally higher, except in the case of automobiles, and limitations on contract maturities are stricter for all articles than in 1941-42 and for most new and the more expensive used automobiles than in 1948-49. Furthermore, the effective change in terms is significantly greater than was the case with the 1948 Regulation, since at least marginal terms offered during the past year have been more lenient than those extended prior to imposition of the earlier Regulation.

It seems clear, however, that the situation at present calls for more drastic curbs on credit buying than was the case in 1948. In the earlier period, the level of outstanding credit was increasing much less rapidly than at present, and although production was at high levels, output of durable goods could have been expected to expand gradually. Currently, demand is tending to outrun a much higher level of production, and expectations are for a cut in output of civilian goods as military requirements increase. In addition, wage and salary payments are higher than in 1948 and are rising rapidly. Credit purchasers in general are consequently able to meet larger monthly repayment requirements than in the earlier periods.

RECENT TRENDS IN CREDIT ACTIVITY

Following a small and less than seasonal decline last January and February from the 1949 year-end record level, total instalment credit has risen rapidly and at an accelerating rate (see Chart 1). Outstanding credit rose 193 million dollars in March, 345 million dollars in May, and 500 million dollars in July. The increases in August and September were smaller than those of the previous two months, but nevertheless were substantially higher than in the same months of previous years. Each class of instalment credit contributed importantly to the rise, with automobile sale credit expanding 1,066 million dollars, other sale credit increasing 542 million dollars, and cash loans rising 831 million dollars since the beginning of the year.

The 2,440 million dollar expansion in total instalment credit since January resulted from an excess of new credits granted over repayments of debt previously incurred. The impact on consumer spending of these two components of credit activity is quite different, however, in that new credits add directly to the demand for specific durable goods, while repayments reduce the purchasing power available for all types of consumer spending. In addition, since the aggregate amount of credit outstanding is the principal determinant of the level of repayments, the volume of new credits granted fluctuates considerably more than does the volume of repayments. For these two reasons, it is necessary to look beyond changes in outstanding indebtedness to the components of instalment credit activity in order to reveal fully the growing importance of credit sales in durable goods demand and to appraise the magnitude of the problem of consumer credit control.

The most dynamic segment of instalment credit during the past two years has been sale credit extended by dealers for purchase of automobiles. The volume of automobile sale credit extended has expanded steadily from a monthly average of about 260 to more than 550 million dollars between the summers of 1948 and 1950 (see Chart 2). Repayments have moved upward less rapidly than credit granted, with the result that the level of automobile sale credit outstanding has been rising at an accelerating rate. The 963 million dollar increase in outstanding automobile sale credit between January and August of this year resulted from a volume of new credits granted totaling 3,885 million dollars and a volume of repayments amounting to 2,932 million dollars.

A significant part of the financing of purchases of automobiles is done through direct cash lending to the purchaser. Commercial banks are by far the most important group of financial institutions in this field. The volume of automobile cash loans made by commercial banks has increased less than that of automobile sale credit, but was nearly 80 per cent larger during June-August of this year than in the summer of 1948 (see Chart 2). Reflecting the failure of repayments to keep pace with new loans granted, the former totaled only 960 million dollars while the latter amounted to 1,260 million dollars during the past eight months. As a result, the increase in total automobile loans outstanding has been twice that of 1949 and 70 per cent greater than in 1948.

The volume of sale credit extended by dealers for purchase of durable goods other than automobiles is subject to substantial seasonal fluctuation. During the seasonal low of January and February this year, however, the amount of credit extended was much higher than in 1949, and subsequently has advanced rapidly (see Chart 2). The 3,535 million dollars of other sale credit granted from January through August compares with a 2,955 million dollar volume during the first eight months in the previous peak sales year of 1948. During this period, the level of repayments has increased only moderately, reflecting in part a considerable easing in credit terms which has occurred in the past year and a half. As a result, this year's advance in other sale credit out-

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standing has totaled 410 million dollars through August, as compared with a 300 million dollar increase in 1948 and a 105 million dollar decline in 1949.

An important segment of consumer instalment lending is in the form of direct cash loans made by financial institutions. Although many of these loans are made for purchase of specific durable goods as well as emergency needs, limitations of data prevent a classification of loans by purpose, except for commercial bank loans on automobiles. The monthly volume of unclassified loans is relatively large, and the margin between new loans and repayments has been widening this year, probably indicating an increased use of this type of credit for longer-term purposes. During the first eight months, new loan volume totaled 3,320 million dollars, while repayments amounted to 2,990 million dollars.

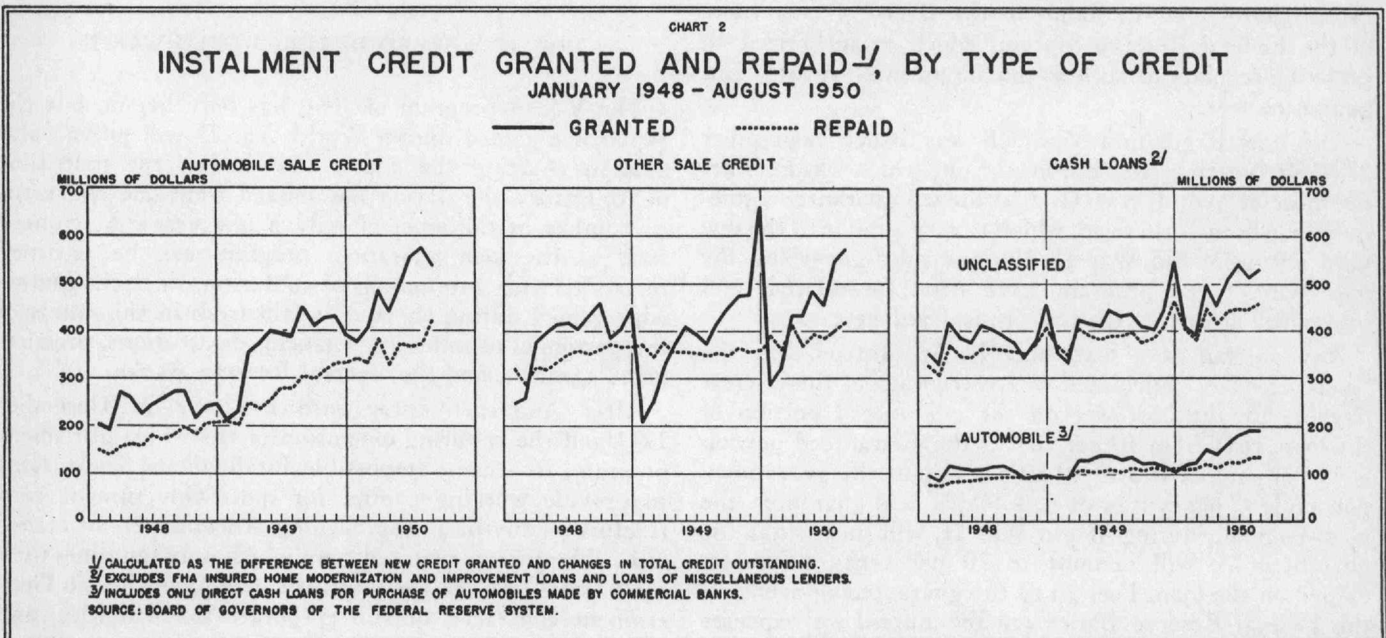
In recent months the margins between new credit volume and repayments have been large as a percentage of credit granted as well as in dollar amounts. Although repayments may increase moderately further, this margin serves as a rough indicator of the reduction in the volume of credit granted which would have to take place if outstanding credit is to be stabilized at about current levels. From April through August, the margin of increase amounted to 28 per cent of automobile sale credit granted, 29 per cent of commercial bank direct automobile loans, 21 per cent of other sale credit extended, and 13 per cent of unclassified instalment loans. For the combined classes of credit, the excess of new credits over repayments amounted to 22 per cent of the total volume of new credit granted.

WHAT WILL CREDIT CURBS ACCOMPLISH?

The primary objective of Regulation W is to effect a contraction in the credit sector of durable goods demand and thus to moderate the inflationary pressures arising from a forced cut in production. The new terms specified are considerably more restrictive than those which were generally available prior to imposition of the Regulation. Hence, those credit purchasers who were financially able to meet only the easier down payment and monthly repayment requirements available earlier this year will be unable to undertake new credit commitments at the stricter terms. Consequently, the volume of new credit extended will be depressed, perhaps substantially, and the growth in total consumer instalment credit outstanding will be slowed.

In addition, it should be noted that Regulation W will automatically exert pressure on the upward trend in credit outstandings, through the methods of credit restriction—requiring higher down payments and shorter maturities. To the extent that down payments are increased, the financed portion of individual articles purchased will be smaller, and the total volume of new credits will tend to decline. Likewise, shorter maturities will result in higher monthly repayments on individual credits, and so the total level of repayments will tend to rise gradually until all outstanding contracts are on the new terms.

The number of credit purchasers who will be forced out of the market by the stiffer terms required by Regulation W should not be overestimated. A large proportion of the purchasers who make use of credit do not need or want the easiest terms available; in addition, many of the consumers who do request the more lenient terms would be able to pay off their indebtedness more rapidly if required to do so. Furthermore, individuals have accumulated a large stock of liquid assets—totaling 172 billion dollars at the end of 1949—and wage and salary payments have risen sharply in recent months. The effects of the new restrictions on credit activity are thus likely to be reduced significantly by the large and expanding capacity of consumers to meet higher down payment and monthly repayment requirements than have prevailed during the past year.



1/ CALCULATED AS THE DIFFERENCE BETWEEN NEW CREDIT GRANTED AND CHANGES IN TOTAL CREDIT OUTSTANDING.
2/ EXCLUDES FHA INSURED HOME MODERNIZATION AND IMPROVEMENT LOANS AND LOANS OF MISCELLANEOUS LENDERS.
3/ INCLUDES ONLY DIRECT CASH LOANS FOR PURCHASE OF AUTOMOBILES MADE BY COMMERCIAL BANKS.
SOURCE: BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM.

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Credit Mobilized for Defense

V-Loan Guarantees Available Again

Most developments in the credit picture in recent weeks have been the result of attempts to restrict inflationary loan expansion in various fields, but when supplies and equipment for the armed forces are concerned liberal credit to finance operations is essential. To assure that the armament program will not be hampered by the inability of producers to meet operating expenses, Government procurement agencies once again have been empowered to guarantee working capital loans through the agency of the Federal Reserve Banks, a procedure which worked successfully in World War II. Up to this time applications for V-loan guarantees have not been numerous, but as the defense program gains momentum many firms will require funds in excess of their normal credit responsibility because of greatly expanded operations, and it is expected that increasing numbers of financing institutions will seek the protection of loan guarantees.

On September 9, 1950, the President issued Executive Order No. 10161 which implemented some of the powers vested in him by the Defense Production Act of 1950. The Order lists the Departments of the Army, the Navy, the Air Force, the Interior, Commerce, and Agriculture and the General Services Administration as "guaranteeing agencies," which may guarantee any loan made by a financing institution which is "deemed by the guaranteeing agency to be necessary to expedite production and deliveries or services under Government contracts for the procurement of materials or the performance of services for the national defense." The Federal Reserve Banks are designated as fiscal agents of the United States and may arrange guarantee agreements for any of the guaranteeing agencies. General authority over the program is in the hands of the Board of Governors of the Federal Reserve System, which is authorized to prescribe regulations such as maximum interest rates and guarantee fees.

The new Regulation V which was issued September 27, 1950, is little changed from the one which was in effect for most of World War II. A standard guarantee agreement has been authorized, which is very similar to the one used during World War II. Various rules governing the operation of the program have been formulated, and others will follow as they are considered necessary.

Any portion of a loan may be guaranteed, but the "guarantee fee," calculated as a percentage of the interest payable by the borrower on the guaranteed portion of the loan, rises from 10 per cent if the guaranteed portion is 70 per cent or less to 40-50 per cent if the guaranteed portion is 95 per cent or over. A 90 per cent guarantee, the most common during World War II, will mean that the guarantee fee will amount to 30 per cent of interest earned on the loan. Fees go to the guaranteeing agencies; the Federal Reserve Banks are reimbursed for expenses incurred in carrying out their functions.

HOW V-LOAN GUARANTEES ARE ARRANGED

Business firms engaged in defense production should apply to a commercial bank or other financial institution if funds for working capital purposes are needed. If the prospective lender decides that the extraordinary circumstances of the loan require a guarantee, an application is filed with the Federal Reserve Bank or Branch of its District asking that the loan be guaranteed by the appropriate procurement agency.

Any bank, whether a member of the Federal Reserve System or not, finance company, or other private lending institution may apply for guarantees of eligible loans. Only contracts which will expedite defense production qualify, and a certification to this effect by one of the guaranteeing agencies is required.

Loans eligible for guarantees are those intended to finance "defense production contracts," which are defined in the guarantee agreement as "any contract made or order accepted by the Borrower for the sale or furnishing by the Borrower of materials, equipment, supplies, facilities, or services" to the armed forces. Losses on such loans "shall be shared ratably by the guarantor and the financing institution in accordance with the guaranteed percentage . . . " Either the financing institution or the guaranteeing institution may decide that the guaranteed proportion of the loan should be purchased by the guarantor before maturity. Loans are administered by the financing institution involved which holds the obligation and the collateral.

HOW IT WORKED DURING WORLD WAR II

The V-loan program of 1950 has only begun, but the experience gained during World War II will prove valuable in charting the course ahead. For the first time in its history the nation has moved from one war crisis to another in the span of only a few years. Machinery such as the loan guarantee program can be returned to service with a minimum of confusion, since the knowledge gained during the war is still fresh in the minds of the personnel of industry, financing institutions, procurement agencies, and the Federal Reserve Banks.

After America's entry into the war in December 1941 and the resulting expansion of the whole armament program, it became impossible for financing institutions to provide working capital for most Government contractors on any basis approaching peacetime credit standards. Many firms required loans which were ten times their total assets prior to the war. Advance payments on Government contracts, unpaid corporate tax liabilities, and

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accelerated depreciation provided important amounts of working capital, but the need for residual funds to tighten any slack which might develop in the productive process remained, as always, a function of the commercial banking system. Bankers were anxious to put to work the huge excess reserves possessed by the banking system at the start of the war. If the natural fear of the unorthodox risks presented by greatly expanded war plants could be overcome, at least partially, the banks' trained credit personnel would be an asset in policing business financial practice during a critical period.

Regulation V of the Federal Reserve Board was first issued April 6, 1942, shortly after President Roosevelt had empowered the Army, the Navy, and the Maritime Commission to guarantee working capital loans to aid war production. During the entire V-loan program of World War II including the so-called "T" loans to facilitate termination of Government contracts, about 5,000 business firms were granted almost 9,000 guaranteed loans (see accompanying table). A total of 10.3 billion dollars of loans were authorized and 12.3 billion dollars disbursed (much of the money was made available on a revolving credit basis).

Only 1,422 or about ten per cent of all commercial banks in the country participated in the program. In general small banks did not participate since war contracts were concentrated among large firms who were customers of big city banks. Twenty-one institutions other than commercial banks obtained guarantees, including most of the Federal Reserve Banks, the RFC, the Smaller War Plants Corporation, one life insurance company, and a number of finance companies.

V-loan borrowers included firms whose operations covered every phase of war procurement, but the industries which expanded most drastically or which turned to products quite unlike their peacetime output required the major share of the loans granted. Machinery and electrical equipment, metal products, aircraft equipment, and transportation and combat vehicles accounted for about 80 per cent of the authorized loan volume, whereas industries such as food, textiles, petroleum, chemicals, and rubber needed little V-loan assistance.

The guaranteed loans ranged in size from a few hundred dollars to the one billion dollar credit granted to General Motors, in which 400 banks participated. Although the original backers of the V-loan idea thought the program would be of special importance to small business, most of the total volume of guaranteed loan money went to large firms. Nine authorizations of 100 million dollars or more equaled 25 per cent of the total, and firms with assets of over five million dollars accounted for a considerably larger proportion of V-loans, both number and volume, than was the case in peacetime. Small concerns, defined as those with assets of less than 500 thousand dollars, accounted for 60 per cent of the V-loan borrowers, but it is unlikely that more than 100 million dollars was loaned to these firms at any one time. Many V-loans, however, were arranged with the understanding that the holder of the prime contract would aid subcontractors financially.

Before a V-loan guarantee was authorized, a meeting of the parties to the agreement usually was held. At that time the purpose of the loan was made clear, and the maturity, proportion of guarantee, and other conditions such as the restriction of executive salaries and dividend payments were agreed upon. Only general rules for the V-loan procedure were laid out by the Board of Governors. Considerable leeway was left in the hands of the individual Federal Reserve Banks.

Interest Rates—The maximum interest which could be charged on World War II V-loans was five per cent, the same restriction which applies under the present program. The maximum was charged on 40 per cent of all loans authorized, but these mainly involved small firms and accounted for only seven per cent of the total volume. Interest rates below the maximum were a matter for negotiation between the borrower and the financial institution. Large loans often paid less than three per

SUMMARY OF LOAN AUTHORIZATIONS, DISBURSEMENTS AND REPAYMENTS AND CREDIT OUTSTANDING OR AVAILABLE, BY PERIODS REGULATION V PROGRAM

(Amounts in millions of dollars)

Period	Guaranteed Loans Authorized		Disbursements	Repayments	Status, End of Period	
	Number	Amount			Credit Outstanding	Additional Credit Available Under Agreements Outstanding
1942—April-December	2,665	2,688	1,134	330	804	1,430
1943—January-June	1,552	2,030	2,402	1,778	1,428	2,216
July-December	1,130	1,844	2,538	2,053	1,915	3,146
1944—January-June	1,086	1,484	2,218	2,068	2,064	3,811
July-December	1,001	1,264	1,826	2,154	1,736	4,454
1945—January-June	988	839	1,431	1,780	1,387	3,695
July-December	335	190	672	1,549	510	967
1946—January-June	14	5	87	527	70	143
Total, April 1942-June 1946	8,771	10,344	12,309	12,238	70	143

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cent. In addition to the interest paid on the amount borrowed, a stand-by authorization sometimes involved a small commitment fee which could be no more than one-fourth of one per cent for most of the war. The commitment fee under the present program has been set at one-half of one per cent.

Security—Most V-loans were secured by the assignment of claims against the Government resulting from war contracts. This practice, forbidden for most of our history, was permitted under the Assignment of Claims Act of 1940. When the circumstances of a loan indicated the need for additional security, real estate and chattel mortgages, personal endorsements, and assignments of life insurance were employed.

Maturities—Loans were restricted to five years maturity during World War II, but most ran only a year and one-half. Large loans usually had longer maturities than did small loans. Repayments were usually geared to payments on contracts but were often based upon the amortization principle. Under the present program no maximum maturities have been established.

The Proportion of Guarantee—The guaranteeing agencies and the Federal Reserve Banks desired that financing institutions should shoulder as much of the risk in each loan as possible so that the affairs of the borrower would be watched carefully. Nevertheless, the majority of the World War II V-loans involved a 90 per cent guarantee even when the loan might have been considered a good risk under normal standards. Only on rare occasions was the guaranteed proportion of a loan allowed to rise above 90 per cent.

The restriction placed upon national banks which requires them to lend no more than 10 per cent of capital and surplus to one borrower was relaxed during the program so that it did not apply to the guaranteed proportion of a loan. Even so, most V-loans over one million dollars were spread over two or more financing institutions.

WHAT V-LOANS ACCOMPLISHED IN WORLD WAR II

How vital to the war effort was the V-loan program? About 12.3 billion dollars was disbursed through V-loans, but not more than 2.1 billion dollars was in use at any one time. This amount accounted for about two-thirds of all war loans held by commercial banks in mid-1944. A large portion of the financing done under V-loans was evidently transferred from the nonguaranteed portfolio of commercial banks, for nonguaranteed loans dropped substantially as the V-loan program got under way.

As business firms accumulated large amounts of liquid assets later in the war, bank lending became less important relatively. All types of bank loans for war purposes are estimated to have amounted to 3.5 billion dollars, at most, in mid-1944. At that time the Federal income tax liability on the books of U. S. Corporations had reached 16.6 billion dollars, an increase of 15 billion dollars over prewar. Thus, the lag in collection of corporate income taxes supplied far more working capital than did bank loans. Advance payments and accelerated wartime depreciation also supplied an important amount of funds, with the result that many firms used only a small portion of their V-loan authorization.

Loss experience on war loans was extremely low, far less than had been the case during peacetime. The agreement on the part of the guaranteeing agencies to purchase guaranteed loans before maturity was seldom invoked. These observations, however, are hindsight. The assurance to business firms that no legitimate need for funds would be refused and to financing institutions that most of the risk involved could be shifted to a guarantor fulfilled the purpose of the V-loan program—that no war production should be held back for lack of adequate financing.

POST-KOREA V-LOANS

How important will the new V-loan program be in light of the expanded armament expenditures now planned? Next year defense outlays will reach and probably exceed a 30 billion dollar annual rate, or approximately 10 per cent of the nation's total output of goods and services. During World War II the portion of our total output going to the military approached one-half. On a unit basis the relative effort is even less since prices of goods for the armed services have risen more than other prices, partly as a result of the more complicated weapons and equipment which are now on order.

Business is in a better financial position than was the case ten years ago. Net working capital of American corporations is almost 74 billion dollars today in contrast to about one-third that amount in 1940. In addition, the banks have shown a willingness to expand loans vigorously when demand for them appears. From the end of June to the end of October, business loans of weekly reporting banks rose 2.9 billion dollars to a total of 16.5 billion. The increase was far more rapid than in any similar previous period. If civilian production is cut back, banks will be anxious to try to replace loans which might be liquidated with defense loans even if no guarantees were available.

Some banks will hesitate to request guarantees on defense loans as they begin to appear in volume. The experience of World War II shows that the war loans could have been carried without guarantees. Claims on Government contracts offer excellent security, and procurement agencies sometimes adjust prices on contracts if it appears that the supplier is experiencing difficulties. For these reasons some financing institutions will prefer to carry the entire risk of defense loans rather than sacrifice part of the interest and bring other parties into negotiations with their customers, if the amount of the loan does not exceed the lender's legal limit.

Although V-loans are unlikely to become a major factor in business finance in the months ahead, the amount of such credit will undoubtedly increase substantially in volume as the nation rearms. The function of the guarantee program, once more, is to assure that no impediment to war production exists because suppliers lack the funds needed to meet operating expenses.

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Money Market in a Warmer War

Inflation and Federal Reserve Credit Restraint Dominate Developments

Amid growing inflationary dangers, the Federal Reserve System on October 18 began increasing market rates on short-term Government securities for the second time in nine weeks. The tightening of one-year rates toward a level of one and one-half per cent was the latest in a four-month series of dynamic developments in the financial markets, induced by the war and growing inflation. On last August 18 the System raised interest rates and lessened the availability of bank reserves, despite the difficulties imposed by a concurrent Treasury refunding of historic magnitude. With the refunding complications past, the System was able to take its October 18 action in a further step to tighten credit and slow the inflation.

Competition among governmental and private purchasers for the nation's output of goods and services had sharpened dramatically after the outbreak of war in Korea and was distorting production and distribution flows, cutting efficiency, and developing inequities in the division of real income. Very large injections of credit-based purchasing power only aggravated these distortions. With the nation involved in its crucial defense program, the usual adverse effects of such an inflation assumed doubly serious proportions. In this environment, Federal Reserve powers of credit restraint were used to apply increasing pressure to mitigate the growing spiral of expenditures.

KOREA AND MONEY MARKET STABILIZATION

The roots of the present inflation reach back before Korea. For several months before the outbreak of hostilities, the economy had been experiencing rising levels of sales and incomes, partly financed through credit expansion. But June 24 dramatically altered the pattern of the developing boomlet. The Korean conflict was quickly interpreted by the public as a signal that the home front chronology of World War II might be repeated. An almost frenzied expansion of spending ensued as business and consumers alike attempted to buy goods as a hedge against shortages and price rises of the type common in the early stages of the past war. To finance a large portion of this anticipatory buying, purchasers turned to lending institutions. In the seven weeks from June 28 to August 16 commercial loans of reporting banks[1] jumped 760 million dollars, real estate loans nearly 200 million, and consumer loans well over 200 million.

At the same time, the warming up of the cold war brought the Federal Government face to face with the certainty of very large increases in defense spending and the prospect of substantial increases in borrowing needs. The unsettling effects of the outbreak of war on market attitudes and Treasury financing prospects prompted the Federal Reserve System to begin providing general support of the short-term Government market in order to protect the prevailing level of rates. In the two weeks from June 21 to July 5 the System, largely through purchases of certificates and notes, added one billion dollars to its holdings of Government securities. Half of these purchases approximately offset temporary income tax drains on banks, but the remainder were made primarily to maintain short-term rates and added directly to available member bank reserves.

In the succeeding two weeks the System was able to dispose of a considerable amount of short-term Governments, largely due to seasonal and technical factors which provided banks with a half-billion dollars of free funds. By the third week in July, however, private selling pressures reappeared in the market, and the System had to purchase large blocks of short-term securities throughout the remainder of July and midway into August.

By far the heaviest sellers of short-term Governments to the System were commercial banks, which were seeking funds to lend to ever-growing numbers of borrowers. Reporting banks alone reduced holdings of short-term Governments by 1.7 billion and increased holdings of private debt by 1.7 billion in the first seven weeks after Korea. Even with considerable net acquisition of short-terms by various other classes of investors, the Federal Reserve as residual buyer purchased a net of over one billion of bills, certificates, and notes between June 28 and August 16.

In contrast to the short-term market, investor demand for outstanding long-term Governments was whetted by expectations of few or no new Treasury issues of marketable bonds in the near future and by the possibility of reinstitution of the World War II policy of "freezing" the pattern of interest rates, thus in effect making Government bonds fully as liquid as much lower yielding short-term issues. Strong nonbank investor demand particularly enabled the Reserve System to sell bonds to offset the reserve-creating effects of its concurrent support of the short-term rate pattern. Consistent selling by the System of bonds maturing in over five years reduced its holdings of such issues by 970 million dollars between June 28 and August 16. Almost all types of investors, as well as dealers, were net purchasers of bonds—some with the proceeds of net new savings or deposits and others with funds obtained from switches out of shorter-term Government securities.

Over the period long-term sales by the Federal Open Market Committee absorbed all but 100 million dollars of the reserve funds created by System acquisition of bills, certificates, and notes. Other factors of a seasonal

[1]Member banks reporting assets and liabilities to the Federal Reserve System weekly. These banks hold somewhat more than half of all commercial bank assets.

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and technical nature, however, released an additional 400 million dollars of cash reserves. Even with a coincident 275 million dollar outflow of gold in payment of debts to foreigners, member bank reserve balances were increased by 310 million in the seven weeks after Korea. Such a rise in reserve balances, due for the most part to changes in passive influences on reserve funds, would even in times of business stability normally be offset by a Federal Reserve policy of selling Government securities. However, the Federal Reserve could have sold no more Governments in the weeks after June 24 without pushing the price of issues which it held below June 24 levels. Given the policy of maintaining the June 24 rate pattern, the System was unable to offset the 310 million increase in reserves. In the face of mushrooming business and consumer demand for funds, these newly created reserves facilitated further inflationary credit expansion.

TREASURY REFUNDING AND CREDIT RESTRAINT

It was against this background that the Board of Governors and the Federal Open Market Committee announced the major change in System policy on August 18:

> The Board of Governors of the Federal Reserve System today approved an increase in the discount rate of the Federal Reserve Bank of New York from 1½ per cent to 1¾ per cent, effective at the opening of business Monday, August 21.
>
> Within the past six weeks loans and holdings of corporate and municipal securities have expanded by $1½ billion at banks in leading cities alone. Such an expansion under present conditions is clearly excessive. In view of this development and to support the Government's decision to rely in major degree for the immediate future upon fiscal and credit measures to curb inflation, the Board of Governors of the Federal Reserve System and the Federal Open Market Committee are prepared to use all the means at their command to restrain further expansion of bank credit consistent with the policy of maintaining orderly conditions in the Government securities market.
>
> The Board is also prepared to request the Congress for additional authority should that prove necessary.
>
> Effective restraint of inflation must depend ultimately on the willingness of the American people to tax themselves adequately to meet the Government's needs on a pay-as-you-go basis. Taxation alone, however, will not do the job. Parallel and prompt restraint in the area of monetary and credit policy is essential.

Simultaneously with the Federal Reserve announcement, the Treasury made public the terms for refunding of the 13.5 billion dollars of Government bonds and certificates maturing September 15 and October 1. The refunding issue selected was again a 13-month 1¼ per cent note. Measured against the market, these two announcements were directly contradictory, inasmuch as the System's anti-inflationary action implied significantly higher short-term rates while the terms of the Treasury's refunding issue were slightly less attractive than current market yields on outstanding issues of comparable maturities.

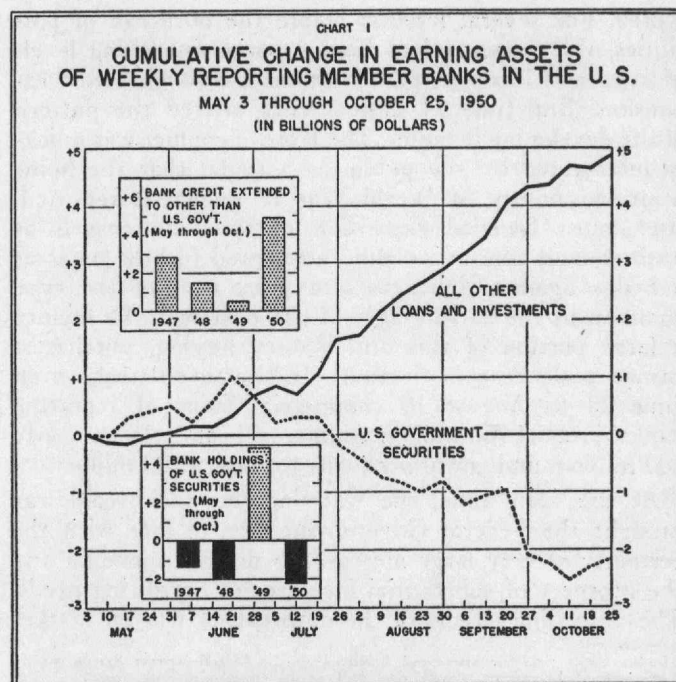
Faced with this dilemma, the Federal Reserve provided a stable market for the refunding issue by willingly purchasing the maturing bonds and certificates at a price slightly above par. At the same time, the System effectuated its own new policy by heavy counterbalancing sales of most other issues, lowering prices and raising yields in all other sectors of the Government market.

The initial market reaction to these twin announcements was twofold. In the long-term market, yields declined several points with the revelation that the September refunding would not add a new bond to the continually shrinking supply of long Governments. In the short-term market, on the other hand, rates rose immediately in adjustment to the higher rediscount rate.

Magnitudes in Federal Reserve open market operations in the following weeks reached unprecedented levels, with a peak of well over four billion dollars of transactions in the week ended August 30. By the week ended September 13, the System had acquired a net 5.7 billion dollars of bonds and certificates and had sold nearly 5 billion dollars net of bills and notes.

After the September 15 refunding, the System's support purchases were of a much more modest order. In the week ended September 20 (subscription books for the October 1 refunding closed September 21) the Federal Reserve was able to sell a net of 540 million dollars of Governments. Consequently, for the entire period, August 16 to September 20, the System's two-handed policy resulted in a net addition to its Government portfolio of only 190 million dollars.

In supporting the September-October refundings, the Federal Reserve became virtually the only subscriber to the new 1¼ per cent note. Despite the fact that the System acquired or exchanged upwards of four-fifths of the maturing bonds and certificates, the relative share of the maturing issues cashed (18 per cent) was by far the highest in recent Treasury history. Even though almost all the maturing Governments retained by private holders were turned in for cash, however, the reduction of such private holdings to 2.4 billion dollars enabled the Treasury easily to meet the demand for cash redemption on maturity dates by concurrent calls on newly acquired tax deposits in commercial banks.



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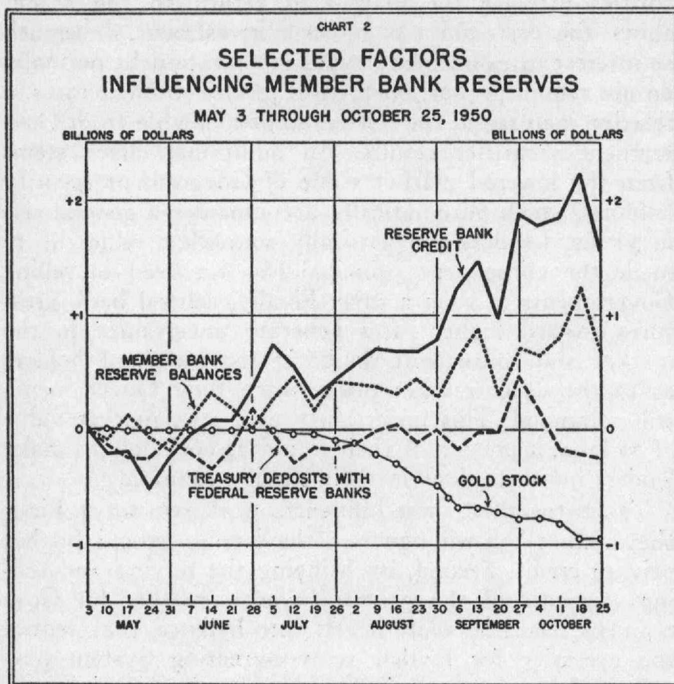


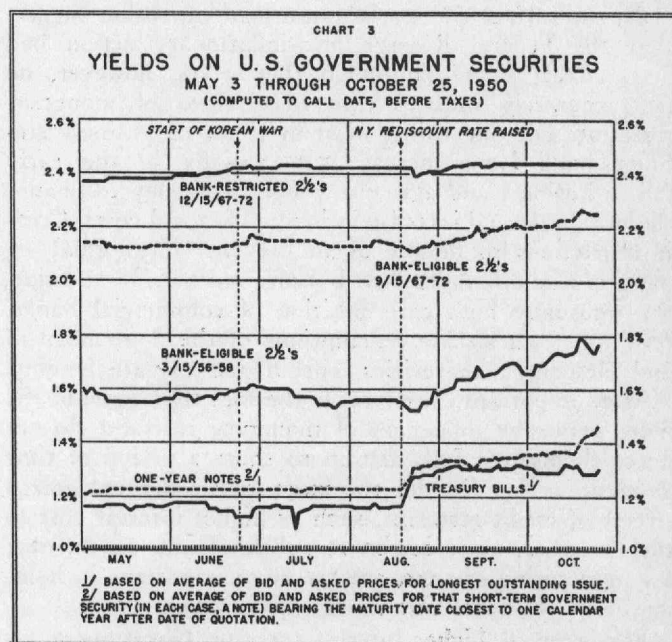
At the same time, the anti-inflationary side of Federal Reserve policy operations between August 16 and September 20 was complicated both by refunding support and by technical and seasonal fluctuations in reserve balances. Alternating drains on reserves due to a seasonal rise in money in circulation and September 15 tax payments, and additions to reserves through net System credit on uncollected checks and the heavy cash pay-off of maturing Governments, added on balance 45 million dollars to bank reserve totals. A 430 million dollar outflow of gold, however, appeared as the strongest contractive factor during the period, even though half of that outflow was paid for by withdrawals from foreign deposits at Federal Reserve Banks and hence had no direct effect on member bank reserve balances. In net terms all of these other factors exerted a contractive influence which almost exactly offset the reserves created by the small net System purchase of Governments. Consequently, member bank reserve balances were held to an increase of only one million dollars between August 16 and September 20, in contrast to the 310 million dollar expansion in reserves during the seven weeks of complete market support immediately after Korea. Member banks accordingly were subjected to increasing pressures on reserve positions, as the additional requirements for reserves growing out of substantial loan and deposit expansion cut member bank excess reserves to a low of 390 million dollars by September 20.

The aftermath of this extremely tight reserve position, together with continued seasonal and technical changes in bank reserves, set the tone of the market in the weeks after September 20. In the week ended September 27, a temporary half-billion dollar increase in Treasury deposits at Federal Reserve Banks, sizable sales of the maturing October 1 certificates by private holders on the last subscription day (September 21), and bank selling of Governments to ease deficient reserve positions necessitated Federal Reserve net purchases of Governments of nearly 830 million dollars. As a result, member bank reserve balances rose 400 million dollars, in contrast to the typical postwar rise in this week of from 200 to 300 million. In the ensuing two weeks, net reserve drains of a temporary and technical nature partly offset 150 million dollars of System support purchases of long-term bonds from sellers desiring funds for acquisition of private securities. Member banks reserve balances, therefore, rose but 90 million dollars in the two weeks ended October 11.

CREDIT CONTROL: RESULTS AND RATIONALE

By October 11 the money market in all its segments was significantly different from 3½ months earlier. The multiple impact of war, domestic inflation, a record Treasury refunding, and a beginning drive against inflation on the part of the central bank changed money market rates, values, holdings, and expectations in marked degree.

As of October 11, yields on taxable Government securities were typically from 10 to 20 points higher than at the start of the Korean war. As indicated in Chart 3, almost all of this rising trend occurred after the switch from Federal Reserve support to Federal Reserve pressure in the market on August 18. In the short-term market, which characteristically leads in general rate changes, the average yield on subscriptions to new Treasury bill issues rose from 1.174 per cent for the issue dated June 22 to 1.337 per cent for the issue of October 13. Changes in the intermediate term bank-eligible market were still larger although more gradual. Yields in this sector generally eased about 8 points in the period of market stability immediately following Korea, but climbed some 20 points in erratic movements after August 18. The yield movements of these issues were aggravated to some extent by selling on the part of nonbank



1/ BASED ON AVERAGE OF BID AND ASKED PRICES FOR LONGEST OUTSTANDING ISSUE.
2/ BASED ON AVERAGE OF BID AND ASKED PRICES FOR THAT SHORT-TERM GOVERNMENT SECURITY (IN EACH CASE, A NOTE) BEARING THE MATURITY DATE CLOSEST TO ONE CALENDAR YEAR AFTER DATE OF QUOTATION.

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financial institutions and by the general unwillingness of banks to invest funds in these issues because of the possibility of higher reserve requirements. In the long-term Government bond market, yield changes were relatively small and confined primarily to the period after August 18. In the 3½ months the longest Victory bonds, in part because of Federal Reserve support in latter weeks, rose by only 2 points. The one exception to the general rise in yields was the tax-exempt sector of the market. The outlook for sharply higher Federal taxes pushed the longest tax-exempt issues down some 6 points during the period.

These sharp readjustments in the yield pattern had their counterpart in important shifts in ownership of the Government debt. Both maturity distribution and total net investment in the Government securities portion of most investors' portfolios were significantly altered in the period between June 28 and October 11. The impact of the July 1 and September 15-October 1 note refundings is evidenced, in the accompanying table, by the decline in certificate and bond holdings and the rise in note holdings for the three classes of investors. Reporting banks, however, were by far the largest net sellers of Governments over the period, reducing their investment by almost 3.3 billion dollars. In absorbing a large part of these sales, the Federal Reserve added 1.3 billion to its portfolio. But very large System sales, particularly of bills, to other investors, together with a decline in the gold stock, held the increase in member bank reserve balances to 800 million.

Despite the Reserve System's initiation of its anti-inflationary program, credit expansion in the economy continued at a scarcely slackened pace from mid-August through mid-October. A continuing upsurge in business loans raised reporting bank loan totals by nearly two billion dollars. By October 11 total loans (gross) of reporting banks stood at an all-time peak of 29.3 billion dollars.

On the surface the statistics on loan expansion suggest that the Federal Reserve anti-inflationary action had little effect. These figures in themselves, however, do not accurately measure the effectivness of monetary restraint. For one thing, even in times of business stability bank loans increase substantially in the early fall as business and agriculture borrow money to finance the usual seasonal increase in inventories and costs. Credit restrictions so drastic as to prevent this normal expansion would hamper distribution processes. In addition, the unusually high cash position of commercial banks, resulting from sizable redemptions of the September 15 and October 1 maturities, encouraged private lending.

More important, however, is the fact that some of the more pervasive influences of monetary restraint do not make themselves fully felt in so short a period of time as eight weeks. Besides the more commonly recognized effects of credit restraint, such as higher interest cost to the borrower, there are more subtle effects which, over a longer period of time, are far more important in holding down the total volume of expenditures.

For instance, higher interest rates on Government securities increase the margin of return to the holder above the cost and risk of such investment. Inasmuch as interest rates on many types of private debt normally do not rise in proportion to rises in Government rates, a relative increase in the net earnings available from Government securities results. An additional effect stems from the lowered market value of Government security holdings which automatically accompanies a general rise in yields. Lenders are naturally somewhat reluctant to incur the consequent principal loss involved in selling Governments at such a time. Finally, central bank pressures toward higher rates generate uncertainty in the market and consequent doubt in the minds of holders as to the exact market price which their Governments will command. This uncertainty as to the market value of so large a portion of their liquid assets tends to make lenders more cautious in their credit extension.

Taken together, these influences work two ways. First, they reduce the willingness of lenders to extend further private credit. Second, by bringing the buying and selling segments of the private investor market for Government securities more nearly into balance, they reduce the necessity for further reserve-creating System purchases of Governments in the interest of maintaining an orderly market.

In the weeks and months ahead, with the abatement of seasonal pressures and the cumulating influence of the above longer-term factors, the braking effect of recent Federal Reserve anti-inflationary action will become more apparent. If, however, the inflation-generating forces of a budget deficit, stepped-up private spending, and an accelerating wage-price spiral overcome the damping effects of recent System action, the Federal Reserve has additional anti-inflationary powers which it can utilize, including tightening of the selective controls discussed elsewhere in this issue as well as applying further pressure on the sources of money and credit creation.

CHANGES IN HOLDINGS OF MARKETABLE GOVERNMENT SECURITIES JUNE 28 TO OCTOBER 11, 1950

(Millions of dollars)

Holders	Bills	Certificates	Notes	Bonds	Total
Reporting banks:					
June 28	2,641	2,916	6,648	24,433	36,638
October 11	2,159	1,023	7,782	22,394	33,358
Net change	*−482*	*−1,893*	*+1,134*	*−2,039*	*−3,280*
Federal Reserve System:					
June 28	3,837	5,357	3,379	5,644	18,217
October 11	1,347	73	14,164	3,922	19,507
Net change	*−2,490*	*−5,284*	*+10,785*	*−1,722*	*+1,290*
All other investors:					
June 28	7,055	10,145	10,377	72,719	100,455
October 11	10,131	4,277	14,996	70,354	99,915
Net change	*+3,076*	*−5,868*	*+4,619*	*−2,365*	*−540*
Total amount outstanding:					
June 28	13,533	18,418	20,404	102,796	155,310
October 11	13,637	5,373	36,942	96,670	152,780
Net change	*+104*	*−13,045*	*+16,538*	*−6,126*	*−2,530*

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Residential Construction Credit Curbed

Housing Boom Conflicts With Defense Requirements

A decline of approximately 25 to 30 per cent in new house starts appears to be a likely prospect for 1951, as compared with the record 1950 levels. Several influences seem likely to bring about this decline. These include probable shortages of certain basic materials, some pressures upon the supply of skilled labor, and a minor reduction in housing demand resulting from the increase in the Armed Forces, in addition to the recently announced credit restrictions. Although the normal seasonal drop and uncertainties surrounding the new restrictions should result in a tapering off of new starts during the final quarter of the current year, a total of more than 1,300,000 units will stamp 1950 as an all-time record home-building year. The pre-World War II high was 937,000 in 1925, and the 1946-1949 average was about 870,000 units per year.

The drop in housing starts this fall—it is already under way—will not be noticed immediately insofar as construction activity is concerned. The exceedingly high level of starts in July and August will not reach completion until early next year. Moreover, September authorizations, although down considerably from the earlier peaks, totaled 115,000, which is well above any month in 1949. In the meantime the easing of the upward pressure on materials prices and upon wage rates will be a welcome development to many builders.

There is no evidence that the underlying need for housing has been met, but there is ample reason to believe that the rate of home building which prevailed during the first nine months of 1950—and particularly from May to August—could not be maintained in the face of the defense requirements of the nation. Nevertheless, high and rising personal incomes combined with the large volume of liquid assets outstanding seem likely to support a level of 900,000 to one million new homes next year, even at the new credit terms. Moreover, a substantial volume of FHA and VA commitments made prior to the effective date of Regulation X seem likely to hold over to next year before they become actual starts.

MINIMUM DOWN PAYMENTS AND MAXIMUM MATURITIES REQUIRED UNDER REGULATION X EFFECTIVE OCTOBER 12, 1950

Value of House[1]	Maturity[2] (Years)	Conventional and FHA Loans		Veterans' Administration Loans	
		Down Payment		Down Payment	
		Amount	Per Cent	Amount	Per Cent
5,000	25	500	10	250	5
6,000	25	850	14	250	3
7,000	25	1,200	17	500	7
8,000	20	1,550	19	750	9
9,000	20	1,900	21	1,000	11
10,000	20	2,300	23	1,300	13
11,000	20	2,700	25	1,600	15
12,000	20	3,100	26	1,900	16
13,000	20	3,500	27	2,450	19
14,000	20	3,900	28	3,000	21
15,000	20	4,300	29	3,550	24
16,000	20	5,100	32	4,300	27
17,000	20	5,900	35	5,050	30
18,000	20	6,700	37	5,800	32
19,000	20	7,500	39	6,550	34
20,000	20	8,300	42	7,300	36

[1] Determined as provided in section 2(i) of Regulation X. In general this means the bona fide sale price of new houses, and for major improvement the cost, or estimated cost, of such improvement.
[2] For loans guaranteed by VA, maturities may extend up to 30 years in veteran hardship cases.

CREDIT RESTRICTIONS NEEDED

The curb upon housing credit was necessitated by the inflationary pressures prior to and incident to the Korean War and by the shortages of basic materials to carry on the expanded defense effort. By late summer it had become clear that the very liberal credit arrangements existing during the spring and summer of 1950 were responsible for much of the strong housing demand, and it was therefore logical that steps be taken to tighten such credit so as to reduce some of this demand.

The credit-supported housing boom of 1950 has been inflationary in two general ways. On the one hand it has resulted in the spending of a large volume of income far in advance of its receipt by the spender. In other words there has been a substantial net addition to total credit outstanding from this source, and this has been one of the factors accounting for the expansion of both money supply and rate of turnover which has occurred this year. On the other hand the boom has caused builders to bid against each other for the available supply of materials and labor. This, as always, has resulted in a rising level of material prices and wage rates. In many cases these price rises and wage rate increases have been greater than the official figures on them would indicate, because the purchases were made on a "gray market" basis and bonuses and other premiums have been paid to workers.

A reduction in residential construction to a level 30 per cent below the 1950 total would relieve many of these inflationary pressures. It is not likely that it would stop the expansion of real estate credit entirely, since it affects only new construction and major alterations and repairs. Nevertheless, such a decline—still leaving a very high level of activity in terms of pre-1950 standards—would reduce the price pressure on the principal building materials and should end the practices of paying more than union scales for construction workers. These reduced pressures would likewise make many basic materials more readily available to the defense effort and lessen the likelihood that military procurement will have to take place in markets characterized by sharply rising prices.

By midsummer it was clear that even with no Korean War there would have been materials scarcities

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and labor shortages in the most active building areas of the Seventh Federal Reserve District. The Government had taken several steps during 1949 and early 1950 to assure more liberal credit on new residential construction (see *Business Conditions,* May 1950). These liberalizations took place during a period of rising business and price levels and increasing general business confidence. The result was that an unprecedented volume of residential starts was added to the other rising inflationary influences. The advent of the Korean War brought forth additional economic pressures, and it became clear that reduction of the developing civilian strains was necessary.

Faced with this general situation, which was partly of its own making, the Federal Government has taken specific steps to bring about a correction. The earliest of these, issued July 19, 1950, consisted of a series of amendments to the administrative rules of FHA and VA, the net effects of which were to reduce the loan-to-value ratio which FHA would insure and VA would guarantee by approximately five per cent, thereby increasing the size of the down payment. These amendments to the administrative rules also required that all appraisals should be based upon July 1 costs so as not to reflect the cost increases which might occur from that period on.

The second action—and the more basic one—was the passage of the Defense Production Act of 1950 and the executive orders which have been issued subsequent to it. Section 602 of this Act provides for the establishment of construction credit controls. The power to promulgate such controls is given by the Act to the President, and he by executive order has delegated that part which affects conventional mortgage loans to the Board of Governors of the Federal Reserve System and that affecting FHA insurance and VA guarantees to the Housing and Home Administrator, with the proviso that the three agencies act concurrently. Thus, the FHA, the VA, and the Federal Reserve System worked jointly in preparing the restrictions. The Act provides, however, that the "relative credit preferences accorded to veterans under existing law" shall be preserved in the new regulations.

PROVISIONS OF REGULATION X

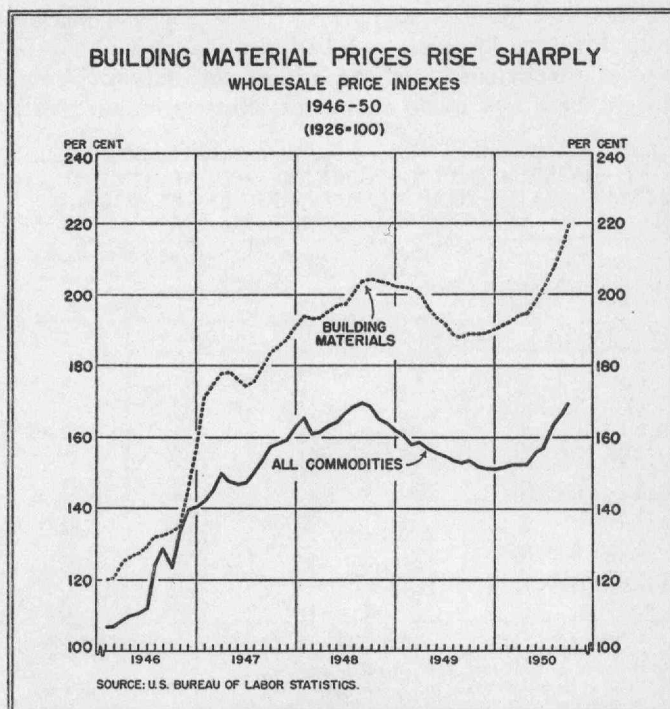
Regulation X applies only to extensions of real estate construction credit. Real estate construction credit is defined as that which (1) is wholly or partly secured by, or (2) is for the purpose of purchasing or carrying, or (3) is for the purpose of financing, or (4) involves a right to acquire or use real property on which there is new construction. Strictly speaking, Regulation X does not apply to FHA or VA loans. The Federal Housing Administration and the Veterans' Administration, however, have adopted restrictive rulings which are comparable with the terms of the Regulation.[1]

The basis for ascertaining property values under the Regulation is the bona fide sale price. This concept of value for loan purposes represents an important change, since appraised value always has been the basis upon which loans have been made. Unquestionably, a certain period of time will be required for lenders to adjust their thinking to loan-to-value ratios that are based on sale price rather than appraised value. The fact that the Regulation applies only to new construction, however, means that this spread will not be as great as would be the case if it applied to older houses.

Regulation X covers only construction which has taken place since August 3, 1950. Thus, a "new" house that had been completed prior to that date could still be financed without regard to the new restrictions. However, a house which was in construction at that time but completed later would be subject to the terms of the Regulation.

In view of the fact that the extension of real estate credit frequently involves a somewhat lengthy period of negotiation, Regulation X provides that firm commitments made prior to the effective date of the Regulation—that is, October 12, 1950—are exempt from the provisions. However, the new terms do not change the limitations on conventional loans which already are required for banks, insurance companies, and savings and loan associations. These limitations in many cases are more restrictive than the Regulation itself, provided conservative appraisals are used. For example, most life insurance companies can loan only up to two-thirds of the appraised value of residential properties. National banks are limited to 60 per cent of the appraised value, while Federally incorporated savings and loan associations can loan up to 75 per cent of the appraised value.

Among the other important provisions of the Regulation are those respecting the maturity of the mortgage contract. The Housing Act of 1950 had lengthened such maturities as respected FHA and VA guarantees to 25 years commonly and in some cases to 30 years. Under



[1]In subsequent discussion Regulation X will be construed to include the total of these regulatory measures.

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Regulation X loans secured by houses having a value of more than $7,000 are limited to a 20-year maturity on the mortgage. Houses valued at $7,000 or less may have a maturity of not more than 25 years, but in such cases the loan must be fully repaid by the use of substantially equal periodic payments. Since relatively few new houses are completed today at the sale price of $7,000 or less, the standard maturity period may now be described as 20 years. VA-guaranteed loans may extend over a maturity period up to 30 years in cases where the veteran can demonstrate inability to handle the shorter maturity period, but otherwise are subject to the same limitations.

In general, the approach to credit control in Regulation X is similar to that followed in Regulation W.

Based upon the analysis that the unduly large housing demand is in major part a result of small down payments and small monthly payments, Regulation X prescribes minimum down payments according to the price of the house and a schedule of monthly payments based in general upon a maximum amortization period of 20 years. As shown in the accompanying table, the schedule of down payments increases sharply as the price of the house increases.

REAL ESTATE MARKET TO CONTINUE STRONG

Because of the long-term nature of financial arrangements affecting housebuilding, most of the over-all effects of Regulation X upon inflationary pressures may be delayed. One effect which appears likely to be more immediate, however, is the changed expectation regarding building material supplies. Builders will be less inclined to pay gray market prices for unduly large inventories. Lumber prices had begun to soften slightly before the Regulation went into effect. They should decline somewhat more now that a marked reduction in new starts is in prospect, but the advent of military requirements will offset this somewhat.

Home building is not the major use of cement, but unquestionably has an important effect in this market. A significant month-to-month decline in new starts would have a fairly immediate effect here, however, since cement uses occur largely in the first stages of home construction. Combined with the seasonal drop in highway construction, it may act to alleviate the upward price pressure on this product.

The frenzied demands for gypsum products, nails, plumbing supplies, and millwork items should ease somewhat in the period immediately ahead. Gray markets in most of them are disappearing, but general price declines do not appear to be a near-term prospect. Likewise, general increases in wages and other costs seem to preclude the probability of price drops in these items over the longer run period. It would seem to require something stronger than credit regulation to reverse the upward trend in materials prices, considering the fact that these increases have been greater than those in all commodities as a whole (see accompanying chart) and the general rise in manufacturing costs.

The new credit requirements are somewhat more strict in most price brackets than before. This is particularly the case with the higher priced homes—that is, those costing $15,000 or more. Perhaps the most seriously affected group will be homes costing from $15,000 to $20,000. Prospective buyers in this price range frequently consist of persons in the upper-middle salary range who are able to carry a substantial monthly payment but do not possess sufficient cash to meet large down payments.

Also affected will be many of the new homes which previously had been guaranteed by the Veterans' Administration. Before October 12, GI loans were obtainable at five per cent down and 30-years' maturity. Under the new regulations, both the down payment and the monthly payment will be substantially higher, and this increase seems sure to remove some veterans from the new house market. As previously mentioned, however, a large holdover of commitments exists.

Only future reaction can clarify the effects of the Regulation upon the market for existing homes. These do not come under the provisions of Regulation X, and many observers feel that the prices of these older structures will move upward. Such movement, if it comes about at all, would seem likely to be somewhat delayed. This is because it will take time for the Regulation to be understood by lenders, builders, and particularly by the buying public and because the large volume of starts prior to August 3 and financial commitments prior to October 12 will reach market during the coming winter and spring. These will not have been subject to the Regulation and hence will not be indicative of the market possibilities under the Regulation. Thus, several months will be required to test the relationship between a decreased volume of new building and the price structure of existing units. Unless effective ways (in addition to Regulation X) are found to curb all inflationary forces, house prices seem likely to continue upward along with the prices of other goods, however.

A further aspect of the market effects of the new Regulation will be evidenced in the demand-supply relationships of the mortgage market. If new house starts should be reduced to a figure somewhat under a million, one obvious result would be to decrease the demand for mortgage funds in comparison with the current year. At the same time rising incomes probably would provide increased inflow of savings thereby making more funds available for this type of investment. It is entirely possible that an augmented supply of funds available for mortgage lending and somewhat lessened demand in the new house field might, therefore, cause the terms on existing homes to be relaxed and support a rising price structure.

An opposing price influence is possible, however, in new homes. As previously pointed out, Regulation X prescribes stiffer terms on the higher priced homes. This seems likely to concentrate building emphasis more markedly in the lower priced field.

It has long been claimed—with some justification—that liberal credit has contributed to the increases in home-building costs. Perhaps the stricter terms may operate in the other direction.

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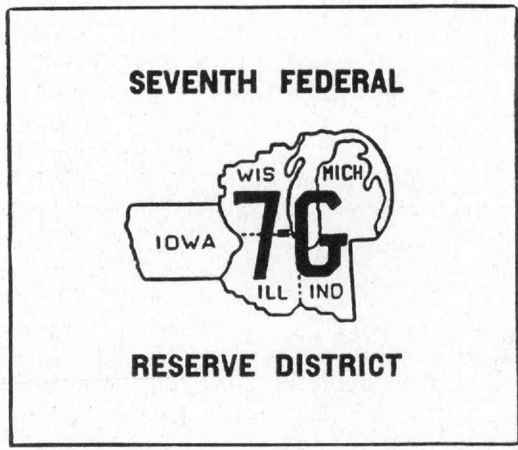

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