MONETARY POLICY AND MORTGAGE MONEY

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I want to talk to you tonight about monetary policy and the mortgage money market. In thinking about ways in which to present this subject, it seemed to me that it could be done best by discussing first the general economic situation and the place of monetary policy in a broad anti-inflationary campaign. This should put into proper perspective the monetary policy actions taken in recent months. Following this I will attempt to discuss some of the implications of recent monetary policy actions for the mortgage money market.

Let us look first at the general economic situation. All of you know that we have been going through a fairly serious inflation. I believe that we face a problem of more inflationary pressures in the future. I do not intend to recite a lot of figures to prove the point that we have been experiencing inflation; I am sure you all know that prices have risen rapidly, that the dollar buys less now than it did at this time last year. Nor am I going to discuss the evils of inflation; I am equally sure that you are all conversant with them. I will have something to say about prospects for the future, however.

Actually we have had inflation for most of the time over the past ten years, - ever since 1940 when the defense program preceding World War II got under way. The basic underlying forces in the economy have been on the inflationary side during that whole period. There have been temporary lulls, even a modest dip in activity, but fundamentally we have had the problem of inflation before us since 1940.

Note this fact; it has implications for the future. The American economy was moving in a strongly upward trend prior to June, 1950 when the war in Korea began. Following the modest dip in late 1948 and the first half of 1949, economic expansion got under way and was proceeding at a fairly rapid rate before the outbreak in Korea. By June, 1950 most of the signs were pointing to a resurgence of strong inflationary forces.

With war in Korea came a great projected increase in our defense program. We all heard that inflationary forces would be intensified because a greatly accelerated defense effort would be superimposed upon an economy which was already straining at the seams. Actually the intensity of economic activity throughout the last half of 1950 - and most of the increase right up to now - has been due mainly to increased civilian demand since the expanded defense program was still largely on paper at the close of 1950. Even today defense expenditures are far from the peak level previously expected, although they are much higher than at this time last year. In the second quarter of this year, outlays for defense and foreign aid combined are running at an annual rate of $36 billion as compared with an annual rate of $17 billion in the comparable period of 1950. To reach the goal set for the program in 1951, these outlays will have to be stepped up to an annual rate of $50 billion by the last quarter of this year. A year from now they may be running at a rate of $60-$65 billion.

The point I am making, of course, is that so far we have had mainly a civilian boom. The military and foreign aid programs have had some effect on the economy but their real impact is still to come.

Let me say a word about the state of the economy at this moment. We seem to be in another of the lulls in activity I mentioned earlier. Nevertheless, we are on a very high level in terms of employment, income, production and prices. There has been no real decline in activity. The movement merely seems to be somewhat sideways, and has been for most of 1951 to date.

This kind of situation was not uncommon during World War II and the postwar era. The fact that we are again moving sideways is not to be taken as indicating that inflationary forces have disappeared. On the contrary, it seems apparent that while these inflationary forces are somewhat dormant as compared with the last half of 1950, nevertheless their potential remains strong and may grow stronger. Informed opinion is that we still face and will continue to face inflationary problems.

There have been and are rumors that the Korean war may be settled quickly. I certainly hope such rumors prove to be true, but I do not have any more definite information about that prospect than you do. However, the end of war in Korea would not by itself bring about much moderation in the inflationary potential. Only if peace in Korea should lead to our cutting back the projected defense program would it reduce basic inflationary forces. My guess is that we will continue our defense build-up pretty much regardless of developments in Korea; that we will continue our efforts to become and remain stronger in a military sense. Our problem is not confined to Korea; it is global in its aspects. The point to watch for, then, is not developments in Korea as such, but their effect on our defense program.

Assuming that the defense program goes ahead as presently conceived, with sharply increasing demands, it appears highly probable that any lull will prove temporary, and that the major domestic economic problem for the next year and longer will continue to be how to restrain inflation. One important point to recognize in this connection is that recent evidence of weakness in some consumer goods markets, accompanied by inventory increases, reflects in part the influence of restrictive measures now in effect.

Consider a few figures to emphasize the nature and extent of the inflationary potential. If we work hard in this country, if we increase our materials supply, our manufacturing and transportation capacity, our employment and hours worked and our general productivity, we may be able to raise our total output by about 6 per cent between now and this time next year. It will not be easy to do this in an economy already operating at such a high level, but this gain is perhaps possible to attain. Convert that increase into dollars and it comes out about $19 billion at present prices (the dollar value of our present output of all goods and services is running currently at an annual rate of $300 billion plus). We have seen that present defense and foreign aid outlays are now running at a $36 billion annual rate, and by this time next year the rate is expected to be $25 to $30 billion higher. Just for the sake of simplicity, forget about bottlenecks, materials difficulties and so on, which might keep us from attaining a full $19 billion increase in total output.

The figures I have cited show that the take of the defense program will increase faster than total output will increase. The result will inevitably be less for the civilian economy. I might note here that the civilian economy will not be badly hurt in such a situation - over-all supplies will be at near record levels - but there will be less for civilians, and for reasons I shall next discuss, that is, or will be, inflationary.

So far I have been talking mainly about production and supply of goods and services. Now let us look at the whole picture - the entire equation of inflation. All production of goods and services in this country generates income. Current income is the major source of current purchasing power. When an economy is in balance, income flows out in such an amount and in such a way that the people receiving it can buy up the production of goods and services as it flows into the market. When the available supply of goods and services is in balance with the supply of purchasing power, a fairly stable economy results. If the rate of flow of purchasing power is increased relative to the available supply of goods and services, the economy gets out of balance. That is just what has been happening. The amount of purchasing power has been increased, and the amount of goods available to the civilian economy has also been increased, but in smaller amount. And we must not forget that as the defense program proceeds there will doubtless be an actual reduction in the amount of goods available for the civilian economy.

I have already said that we are producing goods and services in this country at an annual rate of about $300 billion; and I want now to emphasize that the production of these goods and services generates equivalent purchasing power in the form of income. If we take away, let us say, $50 billion of the production and reserve it for military use, but do not take away an equivalent amount of income generated by its production, it is perfectly clear that we have created an imbalance between the supply of purchasing power and the supply of goods available for the civilian economy.

That is not the whole story, however. Purchasing power coming from current income can be increased from two other sources. It can be increased by the use of past savings, and it can be increased by the use of more credit. Both of these factors have been operating and have been widening the disparity between available purchasing power and available goods and services. The net result, as you see, has been a strong rise in prices.

Now that, as simply as I can put it, is the inflationary situation in which we find ourselves. Current income is rising faster than the supply of goods and services, and in addition is being reinforced by liquidation of savings and use of credit. What can we do about this? That is the question.

In theory, correction can come on either side of the money-goods equation. In other words, the amount of the available purchasing power can be decreased or the available supply of goods can be increased, or both. That is the theoretical answer, or perhaps I had better say, that is the long-run answer to inflation. From a practical point of view, most current action directed at correcting the inflationary situation must of necessity be on the money side of the equation. I have already pointed out the short-run prospect that the supply of goods available for civilians is likely to shrink rather than expand.

So we must try to work on the monetary side to reduce the available amount of purchasing power; in other words, to reduce the supply of money, or to reduce its rate of turnover, or both.

That is the general economic situation as it is now, and that is the background against which to view monetary policy actions taken in recent months. But before turning to the specific actions taken in the monetary field, a most important point must be made.

Sound monetary policy in an inflationary period aims at restricting the amount of credit flowing into the economy. Remember that credit adds to the supply of purchasing power. A restrictive monetary policy operates asaan anti-inflationary device by reducing credit (and hence purchasing power), and thus causing the spending plans of consumers and businesses to be revised downward. It is effective as an anti-inflationary device because it reduces available purchasing power in so far as it reduces available credit. I might point out that a restrictive monetary policy may merely keep credit from expanding further, rather than actually reducing it, or it may merely hold down the rate of credit expansion. The problem, of course, is to make the policy just restrictive enough and not so restrictive as to cripple essential activity.

It is, of course, entirely clear to you that monetary policy is but one phase of an anti-inflationary campaign. It cannot do the job alone; it cannot alone reduce purchasing power enough to warrant being considered a panacea for inflation. To be effective it must be accompanied by consistent and coherent anti-inflationary policies in other fields. It must be accompanied by appropriate fiscal policy and by stimulation of savings. It should be accompanied by well conceived Governmental policy with respect to materials, wages and prices, profits, agriculture, and so on. It should be accompanied by efforts to reduce less essential Government spending, both in and out of the defense program. Nevertheless, monetary policy has its essential part to play and can be a powerful force as part of a general anti-inflationary campaign.

The monetary authorities have made important moves to curtail inflationary effects since the Korean war began. As a matter of fact, the Federal Reserve System was pursuing a moderately restrictive policy even before June, 1950, since there were, as I mentioned earlier, already strong inflationary forces in the economy. Since Korea the following actions (in chronological oeder) have been taken:

(1) The discount rates of the Federal Reserve Banks

were raised somewhat, and short-term money rates were allowed to rise.

(2) Consumer credit regulation was re-established.

(3) A new regulation dealing with real estate credit was made effective.

(4) Reserve requirements of member banks were raised to substantially their upper legal limits.

(5) The Federal Reserve System discontinued its policy of price support for Government securities, thus creating a flexible market in such securities.

The last action was the most important step and the one exerting the most profound effect on the mortgage money market. We should discuss that step in some detail.

The Federal Reserve System has its major influence on the rate of credit expansion through its actions on bank reserves. In this country it is important to distinguish between two types of lenders - nonbank lenders and commercial banks. Nonbank lenders, of which most of you people are representative, cannot increase the supply of money by their lending actions. They can increase to some degree the activity of the money supply but they cannot increase the total supply. Their lending operations result merely in transfers of assets to their borrowers and leave the total supply of money unchanged.

The commercial banking system, however, can and does create new money by its lending activities because bank loans create deposits and banks are required to hold only a fraction of their deposits in the form of reserves. The commercial banking system therefore creates checkbook money on the basis of its available reserves.

The primary responsibility of the Federal Reserve System is to regulate the supply, availability and cost of money; and the System operates to accomplish this function by varying the supply, availability and cost of bank reserves. Without free reserves the banking system is unable to expand credit.

The Federal Reserve System becomes most restrictive, or perhaps I should say, it is in position to become most restrictive, when it is able to withhold reserves from the banking system - when it is able to restrict the supply and availability of bank reserves. When the Federal Reserve buys Government securities it adds to bank reserves. When it sells Government securities it contracts bank reserves. If the System wishes to withhold reserves from the banks it has to be in position to refuse to buy securities offered in the market and perhaps even to sell securities. It cannot do this so long as it is pursuing a policy of supporting Government security prices in order to maintain a predetermined pattern of rates. Support means that the System must purchase securities when they are offered at the support price and there are no other buyers.

Throughout the postwar period, until March 5, 1951, the Federal Reserve had stood ready to support prices of Government securities whenever necessary. And support meant support at fairly rigid levels. We were not always buying securities, of course; some of the time no support was needed, but we were always ready to buy if we had to. On March 5 there came a major change in the financial picture. After the much publicized accord was reached between the Treasury and the Federal Reserve, the System discontinued its major support operations in the Government security market. Since that time the market has been much more free - and much more flexible. The result, as you all know, has been that Government security prices have fallen, in some cases substantially below par. Since we have not bought such securities, except when we wished to, and then mainly on the basis of the credit situation, reserves have not been as freely available to the banking system as before. No longer can Government securities be regarded as interest bearing cash.

I want to make a most important point right here. When the System cut down its support operations and Government security prices fell, the yields on Government securities rose; in other words, the interest rate increased. The actions taken by the System were not taken for the mere purpose of increasing the interest rate. They were taken to reduce the availability of reserves and of credit. Such restrictive action usually results in higher interest rates, but such an increase in rates should be viewed as a by-product of restrictive monetary policy rather than as an end result.

Let me explain here that we do not believe the demand for credit is reduced in any great degree by relatively small rises in interest rates. Some marginal borrowers may be knocked out of the market by slightly higher rates, but there is no great reduction in the amount of credit demanded. Certainly, higher interest rates do not deter lenders from making more loans. The real effectiveness of restrictive monetary policy lies in curtailing the supply of funds available for lending.

I want to stress the following key points: Federal Reserve freedom in the Government security market means that we do not have to buy securities at any given price. Of course, securities can be sold in the market at some price. But if that price is lower than the cost of acquisition, the owner is usually not very enthusiastic about selling. If the owner is a bank, quotations for Government securities below par mean that the banker has to pay a higher price for his reserves if he gets them through sale of Governments. If he cannot sell securities at a price satisfactory to him, he is simply deprived of that means of acquiring additional reserves.

Federal Reserve action to reduce availability of reserves also affects nonbank lenders. If the security owner is a nonbank holder, essentially the same line of reasoning applies. The major difference is that nonbankers cannot multiply credit expansion on the basis of free reserves; they can lend only the proceeds of their security sales.

For the past several weeks the Government security market has been on its own for all practical purposes. System buying and selling has been done primarily in the light of prevailing credit conditions. We have bought relatively small quantities of bonds at times to keep the market orderly, but there have been no large-scale support operations.

The result has been that the supply of funds available for lending has tightened up considerably. And as a result of tighter money we have seen increasing signs of more expensive money. The key factor, however, is not cost but availability. Most of you are fully aware of this fact, I am sure. I understand that mortgage funds are hard to come by nowadays. Most insurance companies, for example, do not seem to find it expedient to sell Governments below par in order to make mortgage loans.

This discussion of the general economic situation and the steps taken to make monetary policy more restrictive may serve, I hope, to bring into focus the factors influencing the supply and demand for mortgage money. On the supply side these points should be noted:

1. As a result, for one thing, of attempting to get as much money committed before Regulation X and its companion regulations by the Housing and Home Finance Agency and the Veterans Administration became effective, the principal nonbank suppliers of mortgage funds took on unusually heavy commitment loads. Thus they began the year 1951 with much of their anticipated

available funds for that year already earmarked. Sources of available funds for such lenders were then considered as being (a) increases in cash assets coming from general cash asset growth and repayments of previous loans and (b) Government securities which could be sold in a supported market. The latter source no longer can be counted on for two reasons: (1) As a result of the decline in Government security prices, holders are reluctant to realize losses by security sales, and (2) as a result of the rise in yields on such securities, they are more attractive as investments and thus more competitive with mortgage loans. Thus, because of previous commitments and because of the fact that Government securities are no longer the equivalent of interest bearing cash, the supply of new mortgage funds has diminished.

2. Commercial banks find themselves in much the same position as nonbank lenders. When banks must sell securities in order to make more mortgage loans, the results of such action have not recently seemed so attractive as they used to be.

3. Both bank and nonbank lenders are following policies of attempting to restrict credit in keeping with the principles of the

Voluntary Credit Restraint Program.

The ultimate result of these three factors is that mortgage money is not so available as it was.

On the demand side these points should be noted:

1. Higher prices for housing have doubtless knocked some prospective buyers out of the market.

2. Regulation X and accompanying regulatory actions, increasing down payments and shortening maturities of housing credit, have brought about some decline in demand for housing and hence for mortgage funds.

3. Restrictions on use of materials and direct restrictions on some types of construction (or permit requirements) are in effect. As the defense program grows, it seems likely that uses of certain materials will be further restricted.

These three factors tend to reduce demand for housing and demand for mortgage funds.

There is perhaps good reason to feel that the restrictive factors operating on the supply side are more powerful than those operating on the demand side. While higher prices, Regulation X, materials shortages and so on are limiting demand to some degree, demand for housing is still strong. There is no appreciable offering of either new or old houses overhanging the market.

The demand for rental housing certainly has not been satisfied. On the other hand, the supply and availability of mortgage funds have been reduced considerably. We are told that a number of insurance companies either are refusing to take on additional commitments at this time or are substantially restricting their volume of new commitments. It is generally true that banks are not eager for more real estate loans.

At this point I suspect you would like me to say whether I believe the conditions just described will continue to obtain and, if so, how long. As much as I would like to know what the future holds, I must confess a complete lack of clairvoyance. Moreover, it is not within my prerogatives to preempt your right to make your own appraisals of the forces affecting future developments, and base your own decisions thereon. If I can make any contribution to your deliberations and your decisions, I believe it will be by casting some light on present conditions and their background, and that I have tried to do.

In the struggle between democratic and totalitarian ways of life, it is important to keep our own economy strong and healthy. By holding down inflation we can aid in building up our economic strength. Monetary policy is one important means to accomplish that end. In order to be effective the makers of monetary policy must be alert to constantly changing and shifting conditions. This is particularly true when international factors beyond our control exert such powerful influences on the conditions with which monetary policy must deal.

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