

Statement on behalf of the
Board of Governors of the Federal Reserve System,
presented by
Wm. McC. Martin, Jr., Chairman,
at a Roundtable Discussion
before the
Subcommittee on Housing,
Senate Banking and Currency Committee.

November 28-29, 1955.

MONETARY POLICY AND THE REAL ESTATE MARKETS

Congress has placed on the Federal Reserve System responsibility for formulating and carrying out national credit and monetary policies. The System's objective is to contribute to sustainable economic growth and to maintenance of a stable value for the dollar. This responsibility for credit and monetary conditions relates to the over-all credit situation, not to markets for particular goods and services or to the activities of particular producer or consumer groups.* The System's actions influence most directly the lending and investing activities of commercial banks, which supply the credit used by individuals or businesses. These operations of the commercial banks, in turn, influence other financial institutions and markets.

The general economic developments with which the System is primarily concerned are the result of combined activities of the many markets that make up the economy. The System must keep itself informed constantly about these particular markets in order to make judgments and to determine appropriate credit and monetary policies.

* The System's only direct influence on a particular market is exercised through margin requirements (Regulations T and U) in the market for registered stocks.

Response to the Subcommittee's inquiry about the influence of credit and monetary policy on mortgage and housing markets must be considered against this background. As these are specific markets, the influence of credit and monetary policies upon them is indirect.

Monetary Policy and Real Estate Markets
Over the Past Few Years

The amount of housing that may be built, sold, and financed within any period depends upon a number of considerations. Demand for housing depends on growth and shifts in families and other occupants, upon price factors, and upon ability of individual buyers to finance their purchases. It also depends upon the physical availability of resources for construction of new homes--land, building materials, and labor. This places definite limits on the amount of housing that can be added to the supply within any short period of time.

The capacity of the economy to finance home purchases must also be considered. The availability of funds for investment in mortgages depends on the flow of savings, on alternative opportunities for investing funds, and on credit and capital market conditions generally.

Residential building and home purchases are strongly influenced by the availability and terms of credit. The nature of this influence is not easy to trace, for many other factors are always at work. It is clear, however, that because of the complexity of these markets, the impact of credit and monetary policy on their different sectors and on participants therein varies considerably.

Mortgage Markets and Lenders

Because mortgage markets are local in important respects, variations usually develop among geographic areas, reflecting different market structures as well as differences in regional economic development. To a considerable extent the development of Federally underwritten mortgages has served to reduce regional differences in the supply of savings relative to local investment demands. The relative attractiveness of Federally underwritten mortgages and conventional mortgages may change from time to time, partly because interest rates on the latter are free to vary more widely than are rates on the former.

The effects of changes in credit and monetary policy normally take some time to permeate a market as complex and variable as the mortgage market. They may be particularly slow to influence construction, for instance, if the amount of financing commitments by lending institutions is large. The precise timing of events cannot be foreseen in view of the many variables involved and the changing circumstances of each period.

For example, from mid-1952 to mid-1953 large over-all demands for credit pressed upon limited, though growing, credit availability and resulted in some strains on financial markets. Expansion of real estate mortgage debt was restrained at the start of this period by the selective regulation of real estate construction credit.

Regulation X, governing the extension of conventional credit on new

houses and other new structures, was suspended in September 1952, but some restrictive conditions on Federally underwritten mortgages continued until April 1953.

Federally underwritten mortgages having relatively low maximum interest rates became less attractive to investors in a market of generally rising yields, and were salable only at discounts from par. GI loans on new houses, in particular, declined markedly during the year ending June 1953 and were a much smaller proportion of total mortgage lending than in comparable earlier periods. Conventional mortgage lending meanwhile increased substantially, although such loans were generally available to borrowers only at higher interest rates and on more restrictive terms than had been the case prior to selective credit regulation and general credit restraint.

Interest rates on Federally underwritten mortgages were raised in May 1953. Shortly afterwards, the slackening of other credit demands, the easing in credit and monetary policy, and the resulting decline in yields on nonmortgage investments improved the competitive position of mortgages generally in financial markets. Moreover, the flow of savings to financial institutions was increasing rapidly while issues of corporate securities available to investors were reduced.

The changed demand and supply situation in financial markets began to be reflected significantly in mortgage markets late in 1953. By that time, with slackening in other demands for credit and a

continuing decline in yields on competitive investments, funds for mortgages with Federal underwriting became much more readily available, with both FHA and VA loans selling in secondary markets at prices close to par, and interest rates on conventional loans reduced by 1/4 to 1/2 per cent. Investors began actively to seek mortgages on terms which they would not have granted six months earlier. Commitments by lenders to take mortgages, especially those guaranteed by VA, were made in increasing volume toward the end of 1953 and rose sharply in 1954, and many lenders who earlier did not engage in such activity began to do so.

The rise in mortgage credit on newly completed and existing properties did not occur until the second half of 1954. In that period total mortgage lending was one-fourth larger than in the preceding six months, reflecting gains in most types of loans for purchase of both new and existing houses. GI loans were increasingly available to borrowers with no down payment and maturities of 30 years, and other types of mortgage loans were also readily available on favorable terms.

Mortgage lending on residential properties expanded sharply in the first half of 1955 to an all-time high of almost 14 billion dollars. The volume of GI loans made on new houses rose markedly to over 2 billion dollars, the largest total by far for any half year. In the same period there was a sharp rise in FHA-insured loans on existing houses to over 900 million dollars, reflecting chiefly a liberalization of terms made possible by the Housing Act of 1954.

For the full year ending June 30, 1955, new records for nearly all types of mortgage lending were established. The ready acceptance by investors of VA-guaranteed loans on terms favorable to borrowers and the accumulation of a large backlog of commitments by lending institutions, to take mortgages in the future, stand out as major influences on the mortgage market during this period. Increase in the volume of VA loans amounted to over two-thirds of the increase in lending on new houses and over two-fifths of the increase in lending on existing houses. Meanwhile, FHA-insured loans made on new houses during these 12 months showed little change from the two preceding 12-month periods.

Housing Markets

The influence of credit conditions on home building and purchase is even more difficult to trace than that on mortgage markets, particularly as far as the timing of changes is concerned. For example, there was little decline in residential construction activity as a result of the credit stringency in the spring of 1953. Subsequently, there was considerable lag in the adjustment of residential market activity to the change toward easier credit availability which began around mid-1953. The number of housing units started through the first half of 1954 was little different from comparable periods in preceding years. Statistical measures of pre-building activity did not begin to move upward until early 1954, but thereafter rose rapidly.

By August, requests by builders to the Veterans Administration for appraisal of proposed houses were more than double the largest monthly total in the three preceding years. Applications to FHA for mortgage insurance on new houses also reached considerably higher levels in the summer and autumn of 1954 than in previous comparable periods.

Reflecting the upsurge in pre-building activity, new private housing starts beginning in June 1954 increased contra-seasonally through the end of the year, with monthly totals in the last quarter the largest for any comparable month on record. The substantially larger volume of units started in the second half of 1954 compared with the like period of 1953 reflected chiefly a more than doubling in units started under VA guarantee. Units started under FHA financing arrangements also increased slightly, while conventionally financed starts declined.

Sales of old as well as new houses accelerated in the second half of 1954 and continued strong through the middle of 1955. In the 12 months ending June 1955, substantially more houses were sold than during preceding comparable periods. Reflecting the impact of easing terms in the GI loan market during 1954, the increase in units sold with VA-guaranteed mortgages in the year ending June 1955 amounted to almost two-thirds of the increase in new house sales and nearly two-fifths of the increase in existing house sales.

The Current Situation

This summer and autumn economic activity in most lines has been at new high levels. The gross national product in the third quarter was a record 392 billion dollars (seasonally adjusted annual rate) and a further large increase is indicated for the current quarter. In October, industrial production continued at the new high established in September and nonagricultural employment was a record for any October.

The most striking economic developments over the past year have been the marked expansion in consumer buying, especially of durable goods, renewed rise in business outlays for fixed capital, and the relatively moderate nature of inventory accumulation. Since output in many areas is now close to capacity, further increases in production will necessarily be at a slower pace and growth in consumption and investment demands will need to be correspondingly moderated.

Reflecting the pressures of expanding demands upon limited supplies, wholesale prices of industrial commodities have been rising considerably since mid-year, with the increases more recently extending to intermediate products and finished goods. Consumer prices, which have been relatively stable for two years, have recently shown signs of edging up.

The situation is not greatly different in construction and real estate markets, except that these markets have been extraordinarily strong for a longer period. Since the recovery in the general economy began more than a year ago, activities revolving about construction

and real estate, which continued high throughout the 1953-54 recession, have expanded sharply further and are now at record levels. The evidence in recent months suggests increasingly that construction and real estate activities--even more markedly than most manufacturing activities--are close to capacity. In these areas, as in the economy as a whole, a major current problem is to prevent development of inflationary forces, which could lead to serious maladjustments and declines from the gratifying levels of activity experienced in recent years.

The recent volume of construction and high levels of economic activity generally have resulted in large and widespread price increases for building materials. After about two years of comparatively easy material supplies and efficient operations, materials shortages and delays in the progress of work have reappeared. Likewise, financing--in competition with many other expanded demands in a capital market characterized by large, though limited, supply--has become more difficult and more expensive for many types of undertakings.

Some observers in recent weeks have attributed these developments and the moderately reduced level of starts solely to a more restrictive monetary policy. This is by no means an adequate explanation. For example, although housing starts for some months have been below the very high levels reached last spring, the number of houses under construction this summer was probably larger than ever before.

If construction delays have been as serious as some trade reports

suggest, this number may still be rising. The number of new houses completed and occupied in the first six months of 1955 was considerably larger than in any other first half year. Completions in the second half will undoubtedly rise further to exceed the all-time record second half of 1950.

These completions have required an exceptionally heavy volume of financing. In addition, sales of an unprecedented number of old houses have also been financed. Accordingly mortgage lending so far this year is at record levels, more than one-fourth higher than in the comparable period last year. Demands for financing are still rising. Whatever effects the present credit situation may be having on housing markets, it has not prevented an extraordinarily large volume of mortgage underwriting. It is the large demands for credit throughout the economy, rather than a curtailment of funds for investment in housing, that has caused a tightening in the money market.

Mortgage repayments have also been rising, but at a slower rate. As a result, the amount of mortgage debt outstanding has been growing rapidly. Mortgage debt outstanding on small properties this year can be expected to increase by about 13 billion dollars, compared with 9.6 billion dollars in 1954.

This year's increase in all nonfarm mortgage debt will be close to 16 billion dollars, and of this over 11 billion will be acquired by three major groups of lenders--savings and loan associations, mutual savings banks, and life insurance companies. This is a very large proportion of the total increase this year in the capital and liabilities

due from these institutions to the public. In other recent years the increase in their capital and liabilities to the public exceeded the increase in their mortgage holdings by a wider margin.

To obtain the funds needed to keep up the recent high and rising level of mortgage lending and to meet other financing demands which have also been large, these institutions have been borrowing heavily this year from commercial banks. Mortgage lenders have also been obtaining forward commitments from the banking system in order to be in a position to make good their own forward commitments to lend. A special survey of large city banks indicated that in the year ended August 10 loans of such banks to mortgage lenders had risen by over half a billion dollars and that additional commitments for 1-1/4 billion dollars of loans to such lenders were outstanding. In addition, direct real estate loans by commercial banks are likely to rise this year by over 3 billion dollars. It should be borne in mind that expansion in commercial banking operations creates new supplies of money in contrast to other financial institutions which lend existing funds.

It is evident that consumers have been buying houses--both old and new--at a higher rate than ever before. Builders' operations--which means houses under construction, builders' financial obligations, consumption of materials and need for credit--have been higher than ever before. Commitments of financial organizations to take mortgage loans have been very close to if not the largest on record. Moreover, a larger proportion of financial institutions appears to be obligated on

commitments. This means that individual institutions have not had the freedom to respond to the current demands that they might otherwise have had. It no doubt accounts in part for reports that builders are unable to obtain additional forward commitments.

With the housing industry operating close to capacity and bidding actively against other industries for resources, prices of construction materials have increased. Properties under construction have been very high and so also has been construction financing to carry these inventories. The demand for funds has been beyond the supply of savings, and additional funds have been supplied from an unusually large expansion of bank credit.

Except, perhaps, for the extent to which commitments to finance future transactions are outstanding, the situation in residential construction and real estate is very much like the credit situation generally. Heavy demands for credit have been in evidence almost everywhere--to finance the high level of consumer buying of automobiles and other durable goods; to finance business expansion of fixed plant and equipment; to finance public improvements by State and local governments. The Federal Government has also been a substantial borrower in recent months, but most, if not all, of this borrowing will be offset by debt retirement during the remainder of the fiscal year. The volume of investable funds becoming available from consumer and business savings has not been adequate to take care of all these demands. Mortgages are competing with all these other uses

While some expansion of commercial bank credit has been desirable in order to supply additional cash balances, consistent with the growth needs of the economy, the commercial banking system could not have met all of these demands for credit not supplied from savings without running the risk of inflationary consequences.

In a prosperous, expanding economy, funds for financing home ownership, as well as financing ownership of other long-lasting capital goods, should come as far as possible from savings in the hands of the owners or made available on loan from institutional or other holders of accumulated savings funds. Free competitive credit markets are the most effective means for allocating these funds to applicants.

Under prevailing conditions, demands for funds are running far ahead of the supply of savings. To meet these demands by creating new supplies of money through the commercial banking system with Federal Reserve assistance, would invite dangerous inflationary repercussions throughout the entire country.