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4

The Policy Reversal of 1956-1957

Only a few months after the selective restraints on housing credit had become operative, governmental policies shifted toward efforts to cushion the impact of tightening credit on the housing sector. Successive steps were taken to help check the decline in the supply of funds available for home building and purchase. First, the restrictions on borrowings from the Federal Home Loan Banks were relaxed. Later, mortgage originators were given easier access to the Federal National Mortgage Association, and mortgage purchases under the secondary market program of the Association were stepped up sharply. Finally, toward the end of 1956 and again in 1957, maximum interest rates were raised on FHA loans. Other measures acted on the demand for housing credit rather than the supply. Among these were the restoration of the maximum maturity of 30 years for FHA and V.A. loans and the withdrawal of the additional 2 per cent down payment required under regulation for FHA home loans (while the 2 per cent minimum down payment for veterans' home loans was retained until April 1958). In addition, administration-sponsored legislation adopted in August 1957 further reduced the minimum down-payment requirements for FHA home loans.

These and other actions reversing the 1955 policies of restraint were taken over a two-year period beginning in late 1955, during most of which there were strong demands for funds in the capital markets generally and continued restrictive measures of the monetary authorities. They merged finally into actions to stimulate residential construction in order to combat the recession that began in the latter part of 1957. At about the same time, the policy of general credit restraint was modified.

The rate of housing starts had dropped from 1.4 million dwelling units in early 1955 to less than 1.2 million by the end of the year; it continued to fall in 1956 and by early 1957 had declined to a little over 930,000 units. After a minor recovery in the spring and summer of 1957, it resumed its

downward movement until a trough of 915,000 units was reached in February 1958 (Table 6). Construction expenditures on new dwelling units declined more moderately, from an annual rate of $15.2 billion in the summer of 1955 to a little over $12 billion in the spring of 1957, since higher building costs and the tendency to provide somewhat larger and better equipped homes cushioned the effects of the sharp fall in the number of new units started. Gross and net mortgage credit extensions for housing also receded from the high levels of 1955 (Tables 9 and 3). Because of time lags, however, their decline did not reflect the full impact of tightening credit on the housing sector and particularly on builders. Forward commitments for residential lending dropped much more sharply than final mortgage loans. New commitments by life insurance companies, for example, fell by 46 per cent between the last quarter of 1954 and the last quarter of 1956, and reached still lower levels in 1957. Their outstanding commitments in the spring of 1957 were only half the amount of outstandings in late 1954 (Chart 1 and Table 24). The volume of outstanding commitments on government-underwritten mortgage loans by New York savings banks between September 1955 and September 1957 declined by nearly 60 per cent (Table 8). Reflecting the general rise in interest rates, average yields on FHA home loans purchased in the secondary market, which had already increased moderately in 1955 and the first half of 1956, moved up at an accelerated rate thereafter and in late 1957 were almost 1.5 per cent higher than in late 1954 (Chart 2 and Table 25). The reduced availability of funds manifested itself chiefly in the government-underwritten segment of the housing market, and the drop in housing starts occurred solely in that segment.

Thus, residential building and mortgage lending were shrinking in the midst of the continued, though at times slowed, general economic expansion through mid-1957. It was under these conditions that the specific housing credit policies of the federal government shifted in the direction of relaxation and relief.

The Record of Actions

The first relaxation of the 1955 restraints occurred in December of that year. The Federal Home Loan Bank Board allowed members of the bank system to obtain new nonemergency borrowings up to 5 per cent of their savings capital as long as the outstanding borrowings of the member institution did not exceed 10 per cent of its capital.[1] This relaxation went only a small part of the way toward restoring the borrowing privileges existing before the fall of 1955.

In January 1956, the FHA and V.A. restored the 30-year maximum maturity of home loans, which had been reduced to 25 years six months

[1] Press release of the Federal Home Loan Bank Board, December 13, 1955.

earlier.[2] At the same time, the Federal National Mortgage Association adopted a "mortgage purchase option plan" designed to help lenders obtain temporary funds for new lending activity without permanent sale of mortgages in an unfavorable market. Under the plan, sellers of mortgage loans to FNMA could repurchase them, for a fee, within nine months at the same price at which they had been sold. This program was akin to the "mortgage warehousing" arrangements which had become increasingly difficult to obtain, but its volume remained quite small.[3]

In April 1956 the Federal Home Loan Bank Board again relaxed its earlier restrictions on nonemergency advances by allowing all members to borrow up to 10 per cent of their savings capital. This figure was raised to 12.5 per cent in September, and another 2.5 per cent was added in 1957 for cases of "undue hardship." [4]

In August, the Federal National Mortgage Association put into immediate effect two liberalizing provisions of the Housing Act of 1956 which had been enacted by Congress early that month.[5] One was its new authority to reduce the amount of the Association's stock that sellers of mortgages to FNMA under its secondary market program were required to buy. The stock purchase requirement, introduced in 1954 both to make sales to FNMA less attractive and to effect a gradual transfer of stock ownership to private hands, had been set by law at 3 per cent of the amount of loans sold. Together with FNMA's fees, it acted as an effective penalty for selling mortgages to the Association, particularly since FNMA common stock, a new security acquired involuntarily by mortgage originators who generally were not interested in holding it as an investment, was traded at large discounts from par. There was powerful agitation for reducing the required percentage permanently, and the administration was eager to improve access to the Association temporarily. The result was an amendment which gave FNMA administrative discretion in establishing the required stock subscription, provided it was not less than 1 per cent of the amount of mortgages sold. This gave the government another flexible tool for influencing the supply of mortgage funds; and it is perhaps significant that the administration's request for the amendment appeared in a section of the President's Economic Report of January 1956 entitled "Increasing the Stability of our Expanding

[2] Press release of the Veterans Administration, January 17, 1956, making a joint announcement for both FHA and V.A.

[3] *10th Annual Report, Housing and Home Finance Agency, 1956*, p. 217.

[4] Letter from the Office of Director, Division of FHLB Operations, to the Federal Home Loan Bank Presidents, dated April 4, 1956. Statement on Housing Credit, a press release of the White House dated September 20, 1956. *Report of the Federal Home Loan Bank Board for the year ending December 31, 1957*, p. 20.

[5] *Public Law 1020*, 84th Congress, 2nd Session, approved August 7, 1956.

Economy," which also included a proposal to study the desirability of stand-by power to control consumer instalment credit. Immediately upon enactment of the amendment, the minimum stock subscription was reduced from 3 to 2 per cent.[6] The effect was to raise the seller's cash proceeds from the transaction, i.e. to make sale of mortgages to FNMA less costly.

The other provision of the Housing Act of 1956, which was not sought by the administration, allowed the Federal National Mortgage Association to issue forward commitments for secondary market purchases. Similar authority had existed during earlier periods and had at times converted FNMA from a secondary market facility to a primary lender, since mortgage originators made loans not only with the intention of offering them to the Association but also with the assurance that FNMA would buy them. The reorganization of the agency in 1954 was intended to abolish this practice, except for the limited "special assistance" programs. In 1956, however, the Congress was so impressed by the current difficulties of builders in obtaining advance commitments from private lenders that it re-established FNMA's commitment authority for secondary market purchases "at prices which are sufficient to facilitate advance planning of home construction, but which are sufficiently below the price then offered by the Association for immediate purchase to prevent excessive sales to the Association. . . ."[7]

The Housing Act of 1956 included other liberalizing measures. The minimum down-payment requirements on existing homes bought with FHA loans were reduced to match those for new homes. By facilitating the sale of old houses by owners seeking new ones, this amendment could be expected to provide a mild tonic for residential building. In addition, the act raised the maximum mortgage amounts and mortgage loan ratios for multi-family projects financed with FHA loans. This measure, together with other amendments and a more liberal administration of the FHA rental housing program as the agency recovered from the shock of the "scandals" uncovered in 1954 in connection with the earlier Section 608 rental program, contributed to a marked recovery of rental housing in 1957.[8]

Further credit relaxations were announced in September 1956. The Federal National Mortgage Association reduced the stock purchase subscription again from 2 to 1 per cent of the amount of mortgages sold to it. Simultaneously, the purchase price for advance commitments on 4.5 per cent

[6] *10th Annual Report, Housing and Home Finance Agency, 1956*, p. 213.

[7] *Public Law 1020*, Sec. 204(a).

[8] The number of dwelling units started in privately financed multi-family structures in 1957 was 119,300 as against 82,300 in 1956, while privately financed starts of units in 1- and 2-family structures declined from 1,011,600 in 1956 to 871,800 in 1957 (*Housing Statistics*, April 1958, p. 6). The number of units in multi-family projects started under the FHA program rose from 5,991 in 1956 to 18,297 in 1957 (*ibid.*, p. 10).

mortgages was raised from 92 to 94,[9] bringing it closer to the current price in the private market. And the Federal Housing Administration revoked the 2 per cent increase in minimum down payments for houses appraised at $9,000 or less, while maintaining it for houses appraised in excess of this amount, which represented the bulk of the market.[10]

As a result of the measures to ease access to FNMA and because of the increasing difficulties in placing government-underwritten loans in the private market, mortgage sales to the Association rose sharply in the fall of 1956 (Table 11). Continued purchases at the current rate would possibly have exhausted the available funds before the Congress, then in recess, could raise FNMA's authorization for secondary market operations. Consequently, the Association was soon forced to retreat part of the way. In late November, purchases were limited to mortgages which were originated not more than four months before offering them to FNMA. This rule was designed to concentrate FNMA's support for new lending and new construction and to minimize "dumping" of existing mortgage portfolios, and it resumed a practice adopted on earlier occasions to conserve funds. In December, the Association's purchase prices on forward commitments were lowered. In January 1957 the minimum stock purchase requirement was raised from 1 to 2 per cent of the amount of mortgages sold to FNMA, and purchase prices for loans offered for immediate delivery were reduced so as to adjust them more closely to those prevailing in the private secondary mortgage market.[11]

In December 1956, the Federal Housing Administration increased the maximum interest rate on home loans from 4.5 to 5 per cent and the rates on other residential mortgages to the extent that the agency had discretionary power to do so.[12] Since about mid-year, the maximum rate of 4.5 per cent on FHA and V.A. mortgages had begun to act as a special restraint on the flow of funds into the government-assisted housing sector as interest rates generally continued to rise. Discounts in the secondary market on 4.5 per cent loans were increasing at an accelerated rate. Yet, for reasons discussed in Appendix A, even the higher discounts failed to prevent a sharp fall in investment in government-underwritten mortgages and home building under the government programs. In view of the legislative ceiling of 4.5 per cent on the interest rate for veterans' home loans, administrative discretion in raising the rate was limited to the FHA program where current maximum rates prescribed by regulation were below the ceilings set by law. The December 1956 increase in FHA rates was followed in January by an

[9] *10th Annual Report, Housing and Home Finance Agency, 1956*, pp. 213-215.

[10] Statement on Housing Credit, White House press release of September 20, 1956.

[11] *10th Annual Report, Housing and Home Finance Agency, 1956*, pp. 213 and 215.

[12] *Ibid.*, pp. 41-43.

administration request that Congress raise the ceiling on interest rates for veterans' home loans.[13]

Late in March 1957, the FHA revoked the additional 2 per cent down-payment requirement, which had been lifted earlier for low-priced homes, for houses in all price classes.[14] This action followed the administration's even more far-reaching request that Congress liberalize the legal down-payment requirements for homes bought with FHA mortgages so as to "ease the adjustments in home building and financing that are likely to accompany the expiration... [of the V.A. loan program for veterans of World War II, then scheduled for July 1958]... and to unify the mortgage insurance facilities available to veterans and nonveterans."[15] Obviously, any reduction of the legal FHA down-payment minima was predicated upon using first the minima then allowed, which had been raised by administrative action in July 1955.

In August, the lower FHA down-payment requirements authorized in the Housing Act of 1957[16] were made immediately effective. As shown in Table 16, the reductions in minimum down payments were substantial. For a house valued at $15,000, for example, only $1,050, or 7 per cent of the appraised value, was required as against $2,000, or 13 per cent of value, before the revision. Simultaneously with this action which tended to raise the demand for funds, the maximum interest rate on FHA loans was increased again from 5 to 5.25 per cent.[17] The increase adjusted the rate to the further rise in the general level of interest rates since December 1956, when the FHA maximum had been raised from 4.5 to 5 per cent, and it could be expected to help stimulate the flow of funds into FHA-insured mortgages.

The Housing Act of 1957, by authorizing a $65 million increase in the Treasury subscription to FNMA stock, also enlarged the capacity of the Federal National Mortgage Association for purchase of government-underwritten mortgage loans in the secondary market. The Association's borrowing capacity in the private market was augmented by ten times this amount, and the "backstop" credit line of FNMA with the Treasury was increased.

The stimulative effects of the Housing Act of 1957 were dulled, however, by its mandate to both FHA and V.A. to place regulatory limits on mortgage loan discounts (see Appendix A). While the maximum discounts prescribed by the agencies were generally sufficient to maintain competitive yields on

[13] *Economic Report of the President,* January 1957, p. 65.

[14] White House press release, dated March 29, 1957.

[15] *Economic Report of the President,* January 1957, p. 66.

[16] *Public Law 85-104,* 85th Congress, 1st Session, approved July 12, 1957.

[17] Press release of the Federal Housing Administration, dated August 7, 1957.

TABLE 16

Illustrations of Minimum Down-Payment Requirements on New 1- and 2-Family Homes Bought with FHA-Insured Loans, 1955-1958 [a]

FHA-Appraised Value	Under Regulation of July 30, 1955 [b]		After Removal of Regulation, 1956 [c]		Under Housing Act of 1957 [d]		Under Housing Act of April 1958 [e]	
	Dollars	Per Cent [f]	Dollars	Per Cent [f]	Dollars	Per Cent [f]	Dollars	Per Cent [f]
$ 9,000	650	7.2	450	5.0	300	3.3	300	3.3
10,000	900	9.0	700	7.0	300	3.0	300	3.0
12,000	1,500	12.5	1,200	10.0	600	5.0	400	3.3
13,000	1,800	13.8	1,500	11.5	750	5.8	400	3.1
14,000	2,000	14.3	1,700	12.1	900	6.4	500	3.6
15,000	2,300	15.3	2,000	13.3	1,050	7.0	650	4.3
16,000	2,600	16.2	2,200	13.7	1,200	7.5	800	5.0
18,000	3,100	17.2	2,700	15.0	1,800	10.0	1,400	7.8
20,000	3,600	18.0	3,200	16.0	2,400	12.0	2,000	10.0
22,000	4,200	19.1	3,700	16.8	3,000	13.6	2,600	11.8
24,000	4,700	19.6	4,200	17.5	4,000	16.7	4,000	16.7
25,000 [g]	5,000	20.0	5,000	20.0	5,000	20.0	5,000	20.0

[a] Loans insured under Section 203 of the National Housing Act, which comprises the bulk of FHA loans. In administrative practice, the FHA adjusts the mortgage amounts in multiples of $50 or $100 depending on the size of the mortgage, after being computed from legal or regulatory provisions.

[b] The regulation of July 30, 1955 raised the then existing legal requirements by 2 per cent, from 5 per cent on the first $9,000 of house value to 7 per cent, and from 25 per cent of the amount of value exceeding $9,000 to 27 per cent:

[c] The regulation was withdrawn on September 20, 1956, and this action restored the legal minima given in footnote *b*.

[d] 3 per cent on the first $10,000 of house value, plus 15 per cent of the next $6,000, plus 30 per cent of the amount of value exceeding $16,000.

[e] 3 per cent on the first $13,500 of house value, plus 15 per cent of the next $2,500, plus 30 per cent of the amount exceeding $16,000.

[f] Per cent of appraised value.

[g] During the period under consideration, FHA home loans under Section 203 were subject to a maximum mortgage amount of $20,000.

the 5.25 per cent FHA loans, this was not the case for the 4.5 per cent V.A. loans. It was only after the repeal of discount controls in the Housing Act of April 1958,[18] after an increase of the maximum interest rate on V.A. loans to 4.75 per cent in the same act, and after the new policy of credit ease initiated in the fall of 1957 had penetrated into the mortgage market that

[18] *Public Law 85-364,* 85th Congress, approved April 1, 1958.

the V.A. program began once more to be operative. But these efforts to encourage residential building, as well as other 1958 legislative and administrative measures to mobilize the federal housing credit programs as bulwarks against recession, are beyond the scope of this essay. It may merely be noted that actions taken in 1958 removed some of the last remnants of the credit restraints imposed in 1955. In January 1958, the FHA withdrew the requirement that loan closing costs be paid in cash by the borrower,[19] and in April the Veterans Administration eliminated the minimum down payment of 2 per cent, thus restoring the veterans' privilege of obtaining V.A.-guaranteed loans without down payment.[20]

Rationale of the Policy Shift

The reversal of the 1955 policies of credit restraint in the housing sector can be largely attributed to three phenomena. One is partial correction of most of the sector maladjustments that had been an important reason for the selective restraints. The second is the disproportionately severe and undesirable effect of prolonged credit restrictions on residential construction. The third is the special and unintended impediment to home building and home purchase that resulted from maintaining maximum interest rates on government-underwritten loans, particularly veterans' home loans, below competitive levels. Each of these points warrants more detailed examination.

Adjustments in the Housing and Mortgage Markets. Some of the excesses associated with the housing boom of 1954 had been modified, if not corrected, when the first relaxations of selective credit restraints occurred. At the beginning of 1956, local housing market surpluses were reported to be fewer than in the spring of 1955.[21] The average vacancy ratio in FHA-financed rental housing projects in March was 3.2 per cent as against 4.4 per cent a year earlier; vacancy ratios exceeding 5 per cent were reported by only 22 field offices as against 38, and ratios of 10 per cent or more by only 6 offices compared to 12 in March 1955. In the nation as a whole, the vacant units available for rent or sale in early 1956 represented a somewhat larger percentage of the housing inventory than in the year before (Table 17); but restoration of a greater vacancy reserve than in the early postwar years was a desirable and anticipated result of the large amount of construction of the several previous years and did not necessarily indicate general overbuilding.

The extreme pressures on home builders to sell their current output,

[19] Press release of the Federal Housing Administration (FHA 58-2), dated January 9, 1958.

[20] V.A. letter to lenders (Loan Guaranty Issue 58-138), dated April 7.

[21] *Economic Report of the President,* January 1956, p. 44. This statement was based on reports of FHA and V.A. field offices initiated in 1955.

TABLE 17

Vacant Dwelling Units as a Percentage of All Dwelling Units, 1950, 1955-1957 [a]
(units available for rent or sale)

Year and Quarter	Per Cent Vacant [b]			Vacancy Rates [b]	
	Total	For Rent	For Sale	Rental	Home Owner
1950 Apr.	1.6	1.1	0.5	2.6	0.9
1955– II	2.3	1.8	0.5	n.a.	n.a.
III	2.3	1.8	0.5	n.a.	n.a.
IV	2.7	2.2	0.5	n.a.	n.a.
1956– I	2.7	2.2	0.5	5.6	0.9
II	2.6	2.1	0.5	5.4	0.9
III	2.8	2.2	0.6	5.8	1.0
IV	2.5	2.1	0.4	5.3	0.8
1957– I	2.3	1.8	0.5	4.8	0.8
II	2.3	1.8	0.5	4.9	0.9
III	2.4	1.9	0.5	5.2	0.8
IV	2.5	2.0	0.5	5.3	0.9

SOURCE: *Housing Vacancies*, Bureau of the Census, Series H-111.

[a] The census classification "dwelling units available for rent or sale" omits vacant "dilapidated" units, while the occupied housing inventory includes such units. Vacant dilapidated units are offered in the market and therefore represent a portion of the effective market supply. For this reason as well as others, the level of the vacancy ratios shown in the table probably understates the true level of vacancies. However, vacant dilapidated units during the period covered showed no significant change, varying between 1.0 and 1.2 per cent of the housing inventory.

[b] Whereas the "Per Cent Vacant" columns show the number of available vacant dwelling units as a percentage of the number of all dwelling units, the rental vacancy rate gives the vacant housing offered for rent as a percentage of the total rental housing stock, and the home-owner vacancy rate gives the vacant housing offered for sale as a percentage of the total supply of home-owner housing. See source for greater detail.

which were evident in their marketing practices the year before, had been moderated. Shortages of building materials had been somewhat alleviated.[22] While the mortgage market was still congested as a large volume of loans went begging for purchase by permanent investors, the sharp decline in forward commitments of major financial institutions (Tables 8 and 24) indicated a better balance between the demand for mortgage loans and the available supply of funds; "savings and loan associations had already

[22] *Ibid.*

succeeded in bringing their commitments into reasonable adjustment with their inflows of cash."[23] The trend toward easier credit terms, exemplified in the earlier rise of no-down-payment loans to veterans, had been halted.

To be sure, one manifestation of maladjustment—the increase in construction costs—was continuing, but this movement was now associated with the expansion of nonresidential construction and the general upward push on prices at a time when demands on resources in the housing sector were receding.

Progress toward correcting maladjustments in the housing sector, however, would at the most have warranted the removal of the selective restraints that had been imposed earlier, not the positive aid offered to home builders and home purchasers in 1956 and 1957. The rationale for positive steps to bolster the housing sector must be sought elsewhere.

Disproportionate Effects of Tight Credit. The view that the credit conditions of 1956 had a disproportionate impact on the housing market (as well as on small business) is succinctly expressed in the President's Economic Report of January 1957:

> In the course of the year it became increasingly apparent that tighter credit conditions affected unevenly different sectors of the economy and different types of businesses. New and smaller business firms appeared to find it more difficult to satisfy their financing requirements than established and larger concerns. Also, the changes in the cost and availability of credit exerted especially severe effects on home building. Consequently, the Administration took steps to moderate the adverse impact of credit stringency in certain areas but sought to do this without impairing the effectiveness of the general policy of credit restraint.[24]

That general credit restraints are selective in their effects, even though they are not intended to be, is widely understood. But it is much more difficult to demonstrate and assess such differential effects in specific cases. The concept of differential impacts is as yet poorly developed. There are few if any relevant data for measuring the effects of changes in the availability of funds; and it is impossible to disassociate satisfactorily the results of such changes from the many other forces operating simultaneously on various economic activities. In the case of housing, two general criteria may be used to illuminate the response of this sector to changes in the availability of funds. One is the relative dependence of residential construction and real-estate activity on external funds. The other is the sensitivity of the housing sector to changes in the cost of borrowing, defined broadly to include noninterest cost and especially credit terms such as loan maturity

[23] *Ibid.*, p. 46.

[24] *Economic Report of the President,* January 1957, p. 42.

and down-payment requirement as well as the interest rate. Both criteria show at least a strong presumption that tightening credit over time will impinge with greater severity on housing than on business in general.

Other things being equal, an economic sector which is so organized that its activity depends heavily on borrowings will be more adversely affected by decreasing availability of credit than sectors less dependent on external funds. The production and acquisition of residential real estate are unusually dependent upon borrowed funds; and the forces behind this phenomenon are so deeply embedded in our economic and institutional structure that short-term economic stabilization policy must accept it as a fact of contemporary life, although the federal housing credit aids themselves may have had a part in it over the longer run.[25] According to estimates for the postwar years through 1955, about 70 to 75 per cent of the funds used to acquire new residential construction were borrowed. A similar proportion probably holds for the purchase of existing homes.[26] On the other hand, only 35 per cent of the total funds used by corporations from 1948 to 1957 came from external sources.[27] While similar data for unincorporated business firms are not available, national income and expenditure estimates confirm that aggregate business investment has been financed largely through internal funds. Even in the period 1955-1957, for example, when business borrowing was high, gross retained earnings of business accounted for about two-thirds of gross private domestic investment.[28] It is thus clear that home building and home purchase are much more dependent on external funds than is business investment. This is true also for capital expenditures by state and municipal governments, but taxing powers in this case lend at least potentially the kind of support to capital spending programs that privately financed housing cannot command.

Activity in the housing sector is also more sensitive to changes in the cost of borrowing than business investment generally. Business firms usually borrow on the basis of expected profits which must be so high to compensate

[25] For an analysis of the reasons for the great dependence of residential construction and real-estate activity on external funds, cf. Miles L. Colean, *American Housing,* Twentieth Century Fund, 1944, especially Chapters 4 and 9.

[26] For new construction, see Leo Grebler, David Blank, and Louis Winnick, *Capital Formation in Residential Real Estate,* Princeton for National Bureau of Economic Research, 1956, Appendix M and Table 80. As for the purchase of both existing and new homes, a survey made in the fall of 1956 showed that 84 per cent of the home owners who purchased their houses between January 1954 and August 1956 had incurred mortgage debt ("National Survey of Households," in *Consumer Instalment Credit,* Federal Reserve Board, Part I, Vol. 2, Section IV, Table C-2). This percentage is consistent with similar figures reported for several postwar years in the Consumer Finance Surveys.

[27] *Economic Report of the President,* January 1958, Table F-59.

[28] *Ibid.,* Table F-6.

for uncertainty and risk that increases in the cost of borrowing within the range prevailing in 1956-1957 (or, for that matter, equivalent increases in the real cost of using internal funds for expansion) are mild deterrents. Moreover, the cost of money in most instances is a relatively minor item in the total cost of doing business.[29] In contrast, changes in the cost of borrowing have a pronounced effect on the ability of consumers to invest in homes. For one thing, the mortgage debt payment represents the overwhelming proportion of the current housing expense of home owners using mortgage loans. In the case of purchasers under the FHA program, for example, the average share of mortgage payments in the "prospective housing expense" calculated by the Federal Housing Administration has been more than three-fourths.[30] Second, mortgage debt payments represent a larger percentage of family income than debt payments do of the revenue of most business firms—in the case of home purchasers under the FHA program, typically about 15 per cent.[31] While the sensitivity of housing demand to changes in interest rates alone, within reasonable ranges of rates, may not be great, its elasticity is considerable in respect to variations in down payments and mortgage loan maturities combined.

Much more research needs to be done to measure the dependence of various economic sectors on external funds and their sensitivity to changes in the cost of borrowing. Meanwhile, the above observations seem to warrant the conclusion that tightening credit has a sharply disproportionate impact on the housing sector. Because of time lags, this effect was not immediately discernible in the net flow of residential mortgage funds relative to the total flow of capital funds, for the amount of funds going into the housing sector during 1956 still reflected partly the large volume of earlier financing commitments that had "come home to roost." In 1957, however, the mortgage market apparently absorbed a markedly smaller proportion of total funds

[29] High income taxes are also sometimes adduced as a reason for low sensitivity of business investment to rising cost of borrowed funds. See, for example, Arthur F. Burns, *Prosperity without Inflation,* Fordham, 1957, pp. 46-47. However, this reasoning raises the difficult point of tax incidence. Also, in light of the observations in the text, the tax argument seems unnecessary to support the proposition that home building and home purchase are more sensitive to changes in the cost of borrowing than is business investment. Moreover, the tax argument is apt to open a pandora box of fiscal recriminations as among different economic sectors. If a high tax rate is said to favor corporations and other businesses in their ability to pay for external funds, it can also be said that home purchasers (and therefore builders of homes for sale) are favored over renters by income tax deduction for mortgage interest and real-estate tax or by the exclusion, for income tax purposes, of imputed net income derived from the investment in their home.

[30] See, for example, *10th Annual Report, Housing and Home Finance Agency, 1956,* Table III-53, and similar tables in other annual reports.

[31] *Ibid.*

than in 1956 and a somewhat smaller portion even than in 1955.[32] The disproportionate impact of tightening credit on the housing sector was felt more acutely and immediately in the sharp decline in forward commitments for the financing of future building than in the actual flow of funds. The degree of disproportionate results of credit restraints seems to depend as much on the duration of the restraints as on their severity.

The Impediment of Noncompetitive Interest Rates. Even though tightening conditions in financial markets have uneven effects throughout the economic system, these may be considered an unavoidable by-product—a low price to pay for the maintenance of general stability when economic resources are strained. Is the impact on residential construction not only disproportionate but also undesirable? Consideration of this question obviously involves value judgments. An affirmative answer rests generally on the view that economic stabilization policy concerns itself with the composition of output as well as with aggregate output, on the preferred position of better housing as a national objective, and on the possibility that the resource use associated with an unsustainable expansion of business investment would push residential building below sustainable levels.

An affirmative answer in this particular case, however, can also be based on the existence of a special and unintended impediment to the flow of funds into the housing sector. This was the legislative ceiling of 4.5 per cent on the interest rate for veterans' home loans, which became increasingly noncompetitive in 1956 and 1957. The unattractive maximum rate resulted not only in a sharp decline in housing starts and mortgage lending under the V.A. program, but also contributed indirectly to diminishing activity under the FHA program. For although the law provided ample discretionary authority for raising the maximum interest rate on FHA loans, the administration was reluctant to use this authority and, through such action, encourage shifts from V.A. to FHA lending and hasten the demise of the V.A. program.[33] Thus, the increase in the FHA rate was deferred until December 1956, a timing perhaps affected by political considerations as well as others. The nearly simultaneous request of the administration that Congress raise the ceiling on the interest rate for V.A. loans was rejected, and it was only

[32] According to the statement of uses and sources of funds prepared by the Life Insurance Association, residential mortgages accounted for 30 per cent of total funds in 1955, 35 per cent in 1956, and 27 per cent in 1957. A similar movement is evident from the statement prepared by the Bankers Trust Company of New York, although the latter, because it employs different concepts of uses and sources of funds, shows a different level of the ratios.

[33] Different levels of maximum interest rates on FHA and V.A. home loans existed during most of the 1945-1952 period, however, and a uniform rate was only adopted in 1953. Since December 1956, of course, there have again been different levels of maximum rates.

in the Housing Act of April 1958 that a small increase to 4.75 per cent was granted. Meanwhile, new activity under the V.A. program came nearly to a standstill.

As the V.A. home loan program went into a coma, more FNMA aid and greater liberalization of FHA down payments were offered than would have been otherwise required, in order to help offset the rapidly diminishing activity under that program. This condition also explains, at least in part, why executive actions were taken in 1956 and 1957 that tended to increase the demand for mortgage funds when the main difficulty was reduced availability of funds. It is always tempting to attribute such actions to the undeniable fact that "housing is politics," but this interpretation does not do full justice to the particular circumstances of the time. The efforts to cushion the impact of tightening credit on the housing sector represented not so much interference with the market allocation of funds as an attempt to help offset a legislative obstacle to the flow of funds into housing.

To what extent a more competitive interest rate on V.A. loans would have attracted funds to residential construction and reduced the need for support through FNMA and FHA remains a matter of speculation. In view of the pressure on commercial bank reserves and the less favorable liquidity position of financial institutions, a larger volume of residential mortgage investment would have required, for the most part, the bidding of funds away from other investment outlets. Such bidding would have raised the cost of money to all borrowers, with small impact on the business demand for funds which is relatively insensitive to changes in the cost of money. Also, the loss of V.A. activity may have been partly offset by shifts to conventional mortgage lending, including an increasing volume of junior financing.[34] It is perhaps instructive, however, to compare the decline in housing starts under the V.A. program with the decline in starts under the FHA program, in which administrative adjustments of the interest rate were made, although belatedly. Between 1955 and 1956, starts under both FHA and V.A. auspices dropped at about the same rate, nearly one-third. Between 1956 and 1957, however, starts under the V.A. program fell by 53 per cent while those under the FHA program declined by only 11 per cent. If the relative decline in starts under V.A. auspices in 1957 had been 33 per cent, still three times as great as the drop in FHA starts,[35] about 53,000 additional dwelling units

[34] No comprehensive data are available on the use of junior mortgages during the period under consideration. In the opinion of FHA and V.A. field officers, junior financing increased in many areas. Cf. *Second Mortgage Practices,* Staff Report to the Subcommittee on Housing of the House Banking and Currency Committee, 85th Congress, First Session, December 21, 1957.

[35] This conservative illustration is selected to allow for the probably greater volatility of production under the V.A. program irrespective of the maximum interest rate on V.A. loans.

would have been placed under construction, and total private starts would have fallen short of the 1956 volume by only 48,000 units (Table 1). Or, alternatively, a more competitive interest rate on V.A. loans would have obviated about two-thirds of the support given to the market by the Federal National Mortgage Association in 1957 when FNMA bought 87,000 loans.[36]

Conclusion

Among the measures acting on the supply of funds, the mortgage purchases by FNMA unquestionably gave the market a substantial measure of support. In the course of 1956 and 1957, the Association bought about $1.6 billion of FHA and V.A. loans in the secondary market; more than $1.2 billion of these were V.A. loans. Purchases were stepped up from $72 million in the first quarter of 1956 to $388 million in the first quarter of 1957. Although they declined thereafter, they still were more than $200 million in the final quarter. When the relatively small acquisitions under the Association's other programs are included, the total during 1957 exceeded the previous peak of FNMA's gross purchases in 1950. Likewise, when net purchases (purchases minus sales of mortgages) are considered, the dollar volume in 1957 was greater than in any previous year, and the 1956 amount approximated the earlier peak of 1949. Net purchases in FNMA's combined operations exceeded $600 million in 1956 and were nearly $1.1 billion in 1957, compared to the previous peak of $652 million in 1949 (Chart 5).

The impact of FNMA activity on the market can best be gauged by reference to the volume of government-underwritten loans made during 1956 and 1957—the only kinds of loans eligible for purchase by the Association. Its net purchases in all operations combined equaled about 7 per cent of the amount of FHA and V.A. loans made during 1956 and as much as 18 per cent of the total during 1957. And the impact on the V.A. home loan sector, which felt the pinch in the private secondary mortgage market most, was even greater. The net amount of veterans' home loans bought by FNMA in 1956 equaled nearly 8 per cent of the total amount of V.A. loans made during the year, and that percentage rose to more than 20 per cent in 1957 (Tables 2 and 11). The influence of FNMA purchases on the flow of FHA and V.A. loans into new construction was still greater, for over 80 per cent of all mortgages bought by the Association in 1956 and 1957 were secured for homes less than two years old.[37]

Of course, not all of FNMA's purchases were necessarily net additions to the supply of mortgage funds. In the absence of its support program, some

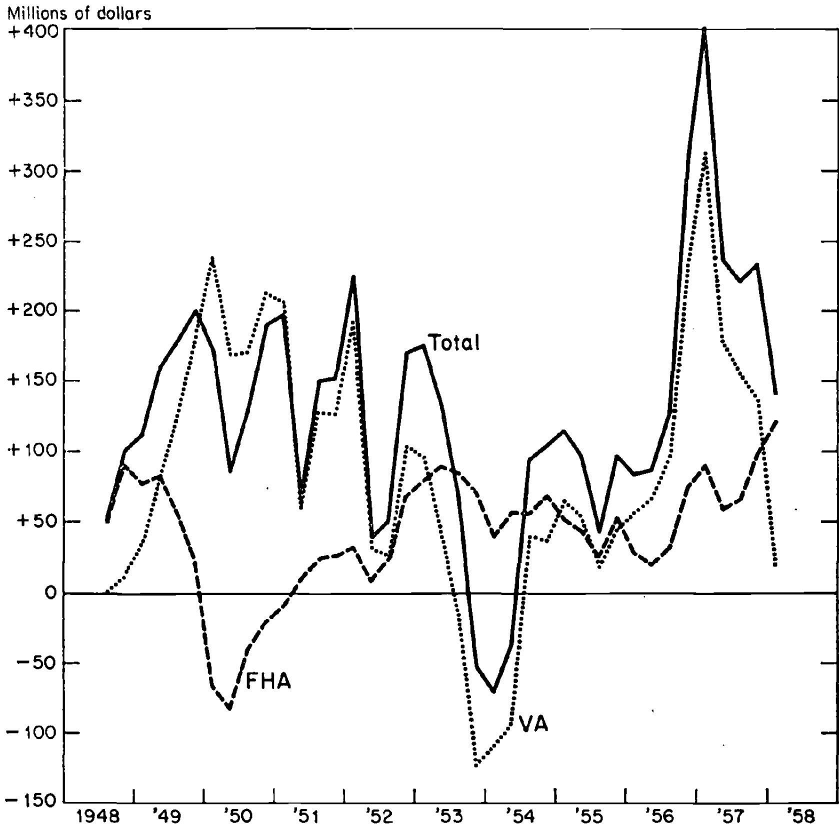
[36] *Report and Financial Statement of Secondary Mortgage Operations,* Federal National Mortgage Association, December 31, 1957.

[37] *Semi-Annual Report,* Federal National Mortgage Association, June 30, 1956; December 31, 1956; June 30, 1957; and December 31, 1957.

of the loans bought by the Association would have found their way into the private secondary market, though probably at lower prices than those paid by FNMA. Also, the FNMA obligations issued to private investors in order to finance its purchase program (Table 18) might have absorbed some of the funds potentially available for mortgage investment, although most of

CHART 5

Net Purchases of Mortgages by the Federal National Mortgage Association, Quarterly, 1948-1958 (combined operations)



Source: Table 11.

these obligations were for short terms and, since the money and capital markets are to some extent compartmentalized, did not compete directly for the same funds. Even when reasonable allowance is made for these side effects, the purchases of the Association, by supplementing the sharply declin-

TABLE 18

Outstanding Borrowings of the Federal National Mortgage Association, Combined Operations, 1948-1957
(dollars)

December 31	From Public	From U.S. Treasury	From RFC
1948	—	—	174,872,627 [a]
1949	—	—	792,375,593 [a]
1950	—	1,310,322,313	—
1951	—	1,813,221,115	—
1952	—	2,199,508,000	—
1953	—	2,375,000,000	—
1954	—	2,448,518,477	—
1955	570,374,000	2,001,781,341	—
1956	770,374,000	2,162,733,729	—
1957	2,687,435,000	958,679,722	—

SOURCE: Federal National Mortgage Association.
[a] Includes accrued interest on notes.

ing volume of private investment in FHA and V.A. loans, acted as a substantial stabilizing force in the housing and mortgage markets.[38]

The administrative adjustments of the maximum interest rate on FHA loans also helped to cushion the decline in the flow of funds into residential building. In response to these actions, FHA housing starts recovered substantially in 1957, in spite of generally adverse financial conditions. During the last quarter of 1957, starts under the FHA program were nearly 30 per

[38] The role of FNMA's price schedule in supporting the mortgage market bears further examination, which would lead too far afield in this essay. When funds become less freely available, the Association can increase its market support by delaying the adjustment of its prices to the decline of prices for FHA and V.A. loans in the private secondary market. Under such conditions, FNMA may even lead rather than follow the prices paid by private investors. The great imperfections of the secondary mortgage market make it extremely difficult to determine current market prices. Prices paid by private investors at any one time vary a great deal, depending, among other things, on geographic area, loan terms, and the quality of the underlying security. Information on prices as well as the volume of transactions is sketchy since most buyers and sellers are interested in clothing their transactions in a veil of secrecy. There are elements of uniqueness in every "deal." Consequently, FNMA's prices cannot be attuned to the market with any precision. This was recognized in 1956 by changing the legal requirement that FNMA buy "at the market price for the particular class of mortgages involved" to the requirement that FNMA establish its price schedule "within the range of market prices." No matter what the legal formula may be, the structure of the market allows varying legitimate interpretations of price changes. The Federal National Mortgage Association sets its purchase prices by states or for groups of states. Within each state or region, prices vary depending on loan terms.

cent larger than in the corresponding period of 1956, while starts under the V.A. program with its frozen interest rates were about two-thirds lower.[89]

Nevertheless, the measures of 1956-1957 did not prevent housing starts under the government programs from declining since the sharp drop in V.A. starts more than offset the recovery in FHA starts. Housing starts financed with government-underwritten loans during 1957 were 35.5 per cent less than in 1956 and accounted for about 30 per cent of the total as against 42 per cent during the preceding year (Table 1). Even so, it does not seem far-fetched to attribute part of the recovery of total housing starts from March to August 1957, when the number of dwelling units placed under construction increased at an annual rate of 123,000, to the combined effects of the earlier stepping up of FNMA purchases of mortgage loans, the upward adjustment in FHA maximum interest rates, and the liberalization of FHA down-payment requirements. To be sure, this expansion in activity, which was also accompanied by a rise in conventionally financed starts, proved to be short-lived, but it did help moderate the decline in starts from the 1956 level.

There remains the question of whether the credit relaxation and relief offered through the governmental housing programs tended to blunt in any appreciable measure the effectiveness of the general monetary and fiscal restraints maintained until the fall of 1957. Such an effect may have been associated directly with the increased borrowings of the Federal National Mortgage Association, which in 1956 and 1957 added nearly $1.1 billion to its indebtedness to the Treasury and private investors, and more indirectly with the other actions to cushion the impact of tightening credit on the housing sector. FNMA's demand for funds may have increased the over-all pressures in financial markets, but its net effect on these pressures was probably small in view of the increasingly limited elasticity in the supply of funds in 1956 and 1957. More likely, the main result of the increased FNMA borrowings was to bid funds away from other users and to raise the level of interest rates. In terms of the use of real resources, the governmental efforts to moderate the impact of tightening credit on the housing sector, because of time lags, became effective largely in 1957. At that time, the overall demand pressures on resources were already beginning to subside and the general business expansion was slowing down, giving way to a decline in the fourth quarter of the year.

In view of both the timing and the limited magnitude of the relief actions for housing, then, it is unlikely that they occasioned an appreciably greater severity of the general credit restraints than would have been the case otherwise, or that they caused the policy of restraint to fall far short of its objective. In fact, the moderate liberalization of governmental housing credit

[89] *Housing Statistics,* April 1958, p. 10.

programs may have aided in maintaining restrictive monetary policy by relieving the pressure for a change in over-all policy and by restraining Congressional attempts to legislate an even greater measure of assistance to the housing sector. Moreover, as was pointed out before, much of the support to housing served only to offset in part the unintended depressing effects of the premature inactivation of the veterans' home loan program by circumstances over which the executive branch of the government had no control. Thus, far from writing "a prescription for benzedrine at a time when what the state of the economy calls for is a tranquilizer," [40] the liberalization of housing credit merely counteracted an overdose of sedatives unintentionally administered to the housing sector.

This conclusion, based as it is on the particular circumstances of the time, does not gainsay the possibility that a multiplication of "protected" economic sectors or of activities clothed with special public interest and supported by federal credit programs may produce more severe limitations on monetary policy in the future. If small business, capital spending by state and local governments, and international loan programs as well as housing and farm credit should be increasingly sheltered from the effects of general restraints, restrictive monetary policies might be in danger of losing much of their force, or such severity would be required that execution would become impossible. Also, a growing volume of insured, guaranteed, or merely government-sponsored long-term obligations issued under proliferating federal credit programs might accentuate the already serious problems of managing the federal debt. If the amount of such offerings should exceed by far the limited demand of institutional and other investors for low-interest assets, the Treasury would find it even more difficult to float its own long-term bonds, or interest rates on both direct and indirect federal obligations would have to be raised substantially. These observations emphasize the urgent need for more systematic consideration of the role of federal credit programs generally in fiscal and economic stabilization policy.[41]

[40] "An Unwise Housing Policy," editorial in the *New York Times*, August 8, 1957.

[41] Cf. *Economic Report of the President*, January 1958, pp. 57-58.