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Volume Author/Editor: Leo Grebler

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Chapter Author: Leo Grebler

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The Selective Credit Controls of 1955

In early 1955, maladjustments following in the wake of the rapid expansion in home building became more and more evident. In January it was reported that rental vacancies were increasing as tenants were drawn into purchases of homes with little or no cash requirements. Indications of rising vacancies continued, and by spring there was substantial public discussion of "overbuilding." [1] Special surveys by local FHA and V.A. offices, which were initiated at that time, showed actual or emerging surpluses of new homes offered for sale in an increasing number of cities. As for rental housing, the average vacancy rate in FHA-financed projects at the end of March 1955 stood at 4.4 per cent as against 3.5 per cent the year before and 2.8 per cent in 1953. More significantly, 38 of the 75 field offices reported vacancy rates in excess of 5 per cent compared with only 24 the year before, and 12 offices showed vacancies of 10 per cent or more. Among the latter were field districts which included large cities such as Providence, Indianapolis, Little Rock, New Orleans, Oklahoma City, Fort Worth, Houston, and San Diego.[2]

Despite the inadequacy of data on the current state of the housing market and the difficulty of interpreting widely varying local conditions, it became obvious that the sale of the unusually large number of homes that had been started in the latter part of 1954 and early 1955 was difficult in many

[1] *House and Home,* January 1955, p. 39, and April 1955, p. 137. Cf. also the statement by Marriner Eccles on March 10, 1955: "... there are elements of real danger to the economy from overbuilding of homes made possible by excessive easy mortgage terms. ..." *Stock Market Study,* Hearings before the Senate Banking and Currency Committee, 84th Congress, 1st Session, May 1955, p. 464.

[2] Data supplied by the Federal Housing Administration. In some areas rental vacancies were concentrated in FHA war and postwar housing projects built near military or defense production installations and subject to changes in military programs. This fact complicated the interpretation of the rise in vacancies.

areas. Particularly in the West and the South where housing starts had increased most, builders offered cash payments for moving expenses and premiums of one kind or another in order to promote sales; one of the inducements was the "no-no down-payment" loan already referred to in the preceding chapter. These marketing practices, together with increasing vacancies, clearly indicated that the rate of housing starts in late 1954 and early 1955 (1.3 to 1.4 million units) could not be sustained for long at current prices for homes even on the very generous financing terms then available to home builders and purchasers.

Further maladjustments appeared in the form of shortages of a variety of building materials and of price rises. While the rate of housing starts leveled off after December 1954, expenditures for new residential construction, which are the more pertinent measure of pressures on resources, kept on increasing sharply throughout the first half of 1955. Already in January supply difficulties were reported for gypsum, composition sheeting, and plasterboard.[8] Later, cement, copper and brass products, and structural steel

TABLE 12

Index of Wholesale Building Material Prices, 1946-1957

(1947-1949 = 100)

Year	Annual Average	Month	1952	1953	1954	1955	1956	1957
1946	69.1	Jan.	117.8	118.5	119.6	122.1	129.4	130.5
1947	94.0	Feb.	117.9	118.7	119.2	122.5	129.6	130.5
1948	104.0	March	118.0	119.2	119.3	122.8	130.5	130.5
1949	102.0	April	118.2	119.9	119.0	123.4	131.3	130.7
1950	109.5	May	118.1	120.2	118.6	124.1	130.8	130.7
1951	119.6	June	117.8	120.5	118.5	124.1	130.6	130.7
1952	118.2	July	118.0	121.3	120.5	125.7	130.6	131.4
1953	119.9	Aug.	118.6	120.8	120.8	127.4	131.5	131.2
1954	120.2	Sept.	118.7	120.4	121.3	128.5	131.0	130.9
1955	125.5	Oct.	118.6	120.0	121.7	128.7	131.0	130.2
1956	130.6	Nov.	118.4	119.5	121.9	128.1	130.8	130.1
1957	130.6	Dec.	118.3	119.6	122.0	128.3	130.5	130.1

SOURCE: U.S. Department of Labor.

joined the materials in short supply, and construction delays became more frequent. Wholesale prices of building materials had begun to move up in the second half of 1954, and they increased—2.9 per cent between July 1954 and April 1955 (Table 12)—at a faster rate than prices of industrial com-

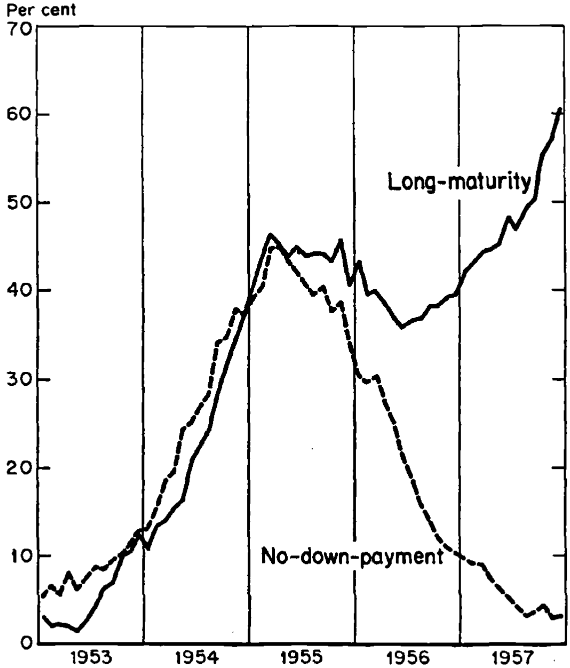
[8] *House and Home,* January 1955, p. 39.

modities as a whole. While construction costs rose only moderately (Table 7), the price of land apparently rose more sharply.[4] Thus, inflationary pressures in residential construction were apparent before the general advance of industrial prices in the summer of 1955.

Although the financial markets had become slightly firmer in the second half of 1954 and residential mortgage commitments had ceased to expand late that year, mortgage recordings and the home mortgage debt increased

CHART 3

No-Down-Payment and Long-Maturity Loans as a Percentage of All V.A.-Guaranteed Primary Home Loans Closed, Monthly, 1953-1957



Source: Table 26.

[4] For instance, the average market price of sites for new homes bought with FHA loans increased from $1,456 to $1,626 between 1954 and 1955 and again to $1,887 in 1956. (*10th Annual Report, Housing and Home Finance Agency, 1956,* Table III-38, p. 98). Cf. also the following data given by William C. Levitt. His firm purchased a tract of land on Long Island in 1949 for $2,500 per acre and sold it in 1951 for $4,500. When the property changed hands again one and a half years later, the sales price was $8,000. In a subsequent sale in 1954-1955, the price paid for the same land was $15,000. (*Mortgage Market Problems,* Hearings before a Subcommittee of the Senate Committee on Banking and Currency, 84th Congress, 1st Session, November 1955, p. 32.)

sharply and much of this increase occurred in the government-underwritten sector of the market, particularly under the veterans' home loan program. Reflecting earlier commitment and financing arrangements, credit terms on loans closed during the first few months of the year were progressively more liberal, as is evident from the further increase in no-down-payment and long-maturity loans to veterans (Chart 3 and Table 26). As lenders were unable to absorb the rapidly growing volume of mortgage loans and meet the rising demand for other long-term funds, they resorted increasingly to the use of short-term credit to help them fulfill the heavy commitments made earlier. This condition was dramatized in January 1955 when the press reported that the Prudential Insurance Company had made a "mortgage warehousing" agreement with a syndicate of 150 commercial banks in the amount of $350 million.[5] This was the first time an insurance company had been known to enter into a mortgage warehousing arrangement directly. It was also the largest single mortgage warehousing transaction ever reported, and the terms of 12 to 18 months were longer than usual.

These developments in the housing and mortgage markets coincided with the accelerated pace of general economic recovery. By late 1954, the recovery had made up but half the previous decline in industrial output. Outlays on plant and equipment and federal spending were still moving downward. The liquidation of inventories had just come to a halt. In the spring of 1955, however, expenditures for plant and equipment began to increase, and the decline in federal spending ceased. Private nonresidential construction was expanding, although less than the residential sector. Largely reflecting the booming automobile market, consumer purchases rose more rapidly. Stock prices continued to climb, and both commercial bank loans and consumer credit increased sharply. Thus, there was a swift convergence of expansionary forces.

The Federal Reserve authorities responded to the evolving business expansion with caution. The policy of "active credit ease" was changed to one of "ease" in December 1954. In January, the directive for open-market operations modified this policy further without, however, calling for a program of restraint, and stock margin requirements were raised. In April, discount rates were increased moderately from 1.5 to 1.75 per cent, and stock margin requirements were raised again. In May, the objective to "encourage recovery" was deleted from the directive for open-market operations. Throughout the second quarter of the year, these operations had little net effect on bank

[5] For a detailed description of this transaction, see *Investigation of Housing, 1955*, Hearings before the Subcommittee on Housing of the House Banking and Currency Committee, 84th Congress, 1st Session, October 1955 (Part I, pp. 129 ff.). Mortgage warehousing credit will be defined later when restraints on this type of credit are discussed.

reserves. A clear policy of restraint was not initiated before early August.[6] It was under these conditions that selective controls on housing credit were considered and put into effect.

Catalogue of Restraints

The first restraining action was taken on April 28 when both the Veterans Administration and the Federal Housing Administration issued regulations requiring that "closing costs," which cover legal fees and other charges associated with real-estate and mortgage transactions, be paid in cash by the borrower.[7] The tendency for builders to absorb these costs or for lenders to cover them in the amount of the mortgage loan, though not widespread, had been growing rapidly in 1954 and early 1955 as a result of intense competition among both mortgage lenders and builders. In the case of no-down-payment loans to veterans where this arrangement was most frequent, it enabled home builders to offer "no-no down-payment" loans, that is, the buyer was relieved of any cash outlay for the transaction. The new regulation probably resulted in a minimum cash outlay of about $200 to $250 in the case of homes in moderate price ranges, equal to about 2 per cent of the purchase price of the property.

At about the same time another, more significant action was taken. The field offices of the FHA and V.A. "were instructed to intensify their surveys of local housing markets, and to take coordinated steps to restrain Federal underwriting of mortgages in localities where housing surpluses were found to exist." [8] It had been standing practice of the Federal Housing Administration, virtually since the beginning of its operations, to curb the issuance of insurance commitments for "speculative" residential projects when local housing market analysis indicated actual or potential oversupply of new dwellings in an area. A similar approach was later adopted in the loan guaranty activities of the Veterans Administration. The restraints may be exercised for the entire locality or only for certain parts of it, and for housing of all types and price classes or only for specific submarkets, depending on local conditions. The rationing may range from complete suspension of new commitments to moderate reductions in the number of dwelling units on builders' applications. Its duration varies with the time required for the excess supply to be absorbed. To avoid any difficulties resulting from pub-

[6] *Forty-first Annual Report of the Board of Governors of the Federal Reserve System, 1954,* and *Forty-second Annual Report of the Board of Governors of the Federal Reserve System, 1955.*

[7] *Veterans Administration, Department of Veterans Benefits regulation 36:4312.* For FHA: *9th Annual Report, Housing and Home Finance Agency, 1955,* p. 45.

[8] *Economic Report of the President,* January 1956, p. 38.

licity, the localities in which such actions were taken have never been identified, nor has this method of restraint ever been described. Individual cases, however, have become known in the trade and have sometimes been reported in trade journals.

Against this background, the meaning of the action becomes clearer. In addition to more intensive survey work to keep the agencies abreast of local market developments, the measure apparently for the first time sought to assure coordination of FHA and V.A. policies at the local level. At about this time, both FHA and V.A. were reported to have reduced the issuance of commitments in a fairly large number of areas.[9]

In July, several additional actions were taken. On July 30, about coincident with the adoption by the Federal Reserve of a policy of general credit restraint, the Federal Housing Administration and the Veterans Administration issued regulations requiring an increase in minimum down payments on homes bought with FHA or V.A. loans and reducing the maximum maturity of such loans from 30 to 25 years.[10] In the case of V.A. loans, the new minimum down payment was 2 per cent of the purchase price of the property compared to zero before the regulation. In the case of FHA loans, the required down payment was increased from 5 to 7 per cent on the first $9,000 of value and from 25 to 27 per cent on amounts exceeding $9,000. For example, the minimum down payment on a $15,000 house bought with an FHA loan was $2,300 (rounded) instead of $2,000.

In the months immediately preceding these actions, veterans' home loans without down payment had increased to about 45 per cent of all home loans guaranteed by the Veterans Administration—the highest percentage ever recorded except for 1950. For loans on new or proposed construction, the share of no-down-payment transactions in the total had risen to 58 per cent. Loans with maturities from 26 to 30 years showed about the same sharp upward movement. In fact, most of the great expansion in V.A.-guaranteed lending during this period was in the form of no-down-payment and long-maturity loans (Table 26). A similar though less pronounced liberalization of terms occurred in FHA lending for which only annual statistics are available. Two-thirds of all FHA loans on new homes in 1955 were for 86-95 per cent of value, as against less than half in 1954; and 43 per cent of all loans on existing homes were in this class, compared to only 17 per cent in 1954.

[9] *House and Home* reported in its June 1955 issue (p. 136) that local V.A. offices were "rationing" the issuance of "certificates of reasonable value" to builders. In its July issue (p. 137), *House and Home* quoted the Commissioner of the Federal Housing Administration to the effect that the FHA, because of housing surpluses, was "holding up" commitments to builders in several areas.

[10] Veterans Administration Information Service, press release dated July 30, 1955. Federal Housing Administration, press release No. 55-57, dated July 31, 1955.

Average maturities increased from 22.9 to 25.6 years for loans on new homes, and from 20.1 to 22.7 years for loans on existing homes.[11]

Other restraining actions taken in July directly affected the volume of funds available for mortgage lending rather than the credit terms available to home purchasers. The Federal National Mortgage Association reduced the prices at which it offered to sell FHA and V.A. home mortgages held in its "management and liquidation" portfolio, so as to activate sales and sop up funds. As the mortgage market tightened and prices of loans in the secondary market fell, sales failed to respond, however, and the sales program was suspended in October.[12] The Association during 1955 was a net supplier of funds.

More significant than FNMA's abortive effort to raise the volume of its mortgage sales were warnings by the Federal Reserve Bank of New York and the Federal Home Loan Bank Board against excessive use of interim credit by mortgage lenders. The Federal Reserve Bank of New York cautioned commercial banks in its district against "possible abuses in the use of bank credit" in mortgage warehousing transactions.[13] The Chairman of the Federal Home Loan Bank Board, on July 18, urged the presidents of the Home Loan Banks to consider their lending program and stressed, among other things, that it would be desirable for member savings and loan associations "to curb their forward commitments." [14] Since savings and loan associations mainly make uninsured mortgage loans, this warning, as well as subsequent actions of the Bank Board, chiefly affected the conventional mortgage market.

While the lending operations of the Federal Home Loan Banks were described in the outline of federal housing credit programs (Chapter 1), mortgage warehousing arrangements require brief explanation at this point. Mortgage warehousing has been defined as "the granting of interim loans by commercial banks to nonbank real estate lenders." Its main purpose is to bridge the interval between the time a mortgage is originated and the time it is delivered to a permanent investor. During this interval, mortgage papers must be completed and usually a "package" of loans must be as-

[11] *10th Annual Report, Housing and Home Finance Agency, 1956,* Tables III-38 and III-43. The data reflect partly the liberalization of maximum FHA terms in the Housing Act of 1954.

[12] *9th Annual Report, Housing and Home Finance Agency, 1955,* p. 362 and Table 14.

[13] See the letter by the President of the Bank to Congressman Rains in *Investigations of Housing, 1955,* p. 119. Commercial banks in the Second Federal Reserve District held about one-fourth of the total volume of warehousing loans outstanding in August 1955. Cf. Jack Guttentag, "Mortgage Warehousing," *The Journal of Finance,* December 1957, p. 438, note 2.

[14] See *Mortgage Market Problems,* p. 51.

sembled for delivery to a portfolio lender. Mortgage warehousing is most common in connection with FHA or V.A. loans on new construction, and it is most frequently used by mortgage companies which rely heavily on bank credit for the assembly and temporary inventorying of mortgages before sale or assignment to a permanent investor. Thus, mortgage warehousing arrangements have become an important means of smoothing the home-financing process; and builders under the FHA and V.A. programs have become quite dependent on an adequate supply of this type of credit, as well as on short term construction financing and long-term mortgage loans to home purchasers—the first and the final phases of the complex chain of financing transactions associated with home building. The dependence on mortgage warehousing has probably increased during the postwar period, reflecting the larger scale of builders' operations and the resulting longer production period for individual projects, the greater importance of mortgage companies as originators of government-underwritten loans, and the growing tendency of mortgage lenders to make forward commitments which lengthen the period elapsing between their decisions to invest and the final disbursement of funds. Mortgage warehousing may also be used when mortgage originators are unable to place loans with portfolio lenders on terms acceptable to them and expect better terms at a later date. Or the demand for warehousing may come from permanent mortgage investors who, because of temporary overcommitment, wish to delay acceptance of mortgages ready for delivery. Finally, warehousing loans may be obtained by lenders when they find it advantageous to expand their mortgage investment program beyond the cash funds immediately available for this purpose. There are several types of such arrangements, and their legal forms vary a great deal.[15]

In September, the Federal Home Loan Bank Board supplemented its earlier warning against excessive borrowing by members of the bank system with a program of formal restraints. Members were advised that they should adjust their lending to available cash flows; Home Loan Bank advances for the purchase of mortgage loans and government securities were prohibited; and a "reasonable reduction" was to be required before renewal of outstanding advances.[16] These restraints were somewhat relaxed in October to enable member associations to make good on the large volume of loan commitments they had undertaken before the rationing program of September was announced, and to counteract a widespread impression that the

[15] For detail, see Jack Guttentag, *op. cit.;* Saul B. Klaman, *The Postwar Residential Mortgage Market,* Princeton for National Bureau of Economic Research, in press; and *idem, The Postwar Rise of Mortgage Companies,* National Bureau of Economic Research, Occasional Paper 60, 1959.

[16] *Mortgage Market Problems,* pp. 52-53 (Exhibit B); also, pp. 44-51.

doors of the Federal Home Loan Banks had been shut except for borrowings to meet emergencies.[17]

The following pages cover, first, the actions restraining credit extended to home purchasers under the FHA and V.A. programs and, second, the measures dealing with the use of interim credit by mortgage lenders themselves.

The Controls on Government-Underwritten Loans

The time sequence of restraining governmental actions and of movements in the mortgage and housing markets during the first half of 1955 suggests clearly that the halt in the expansion of residential building cannot be attributed to the selective housing credit regulations nor, for that matter, to the shift in Federal Reserve policy. By April, when the first controls on FHA and V.A. loans were initiated and general credit policy was changing cautiously in the direction of restraint, housing starts had been leveling off for about 3 months although they remained high; and expenditures for residential construction were bound to reflect this movement after the usual lapse of time. The end of the housing boom was rather associated, first, with a rate of output that was unsustainable at current house prices and consumer incomes, even on the very generous credit terms available to home purchasers through mid-1955,[18] and, second, with the reaction of financial markets to an increasing over-all demand for funds relative to supply during the second half of 1954.

By the same token, the fact that housing starts leveled off and the financial markets became firmer in late 1954 and early 1955 clearly indicated that market forces were already beginning to operate toward restraining the housing boom by the time the permissible terms of government-underwritten mortgage loans were tightened. Under these circumstances, the timing and rationale of the selective restraints on FHA and V.A. loans require more extensive discussion.

Timing and Rationale. It seems that the timing of restraints on government-underwritten housing loans in 1955 was conditioned by four main factors. One of these is the long production and marketing period in the building and sale of homes, which delayed the detection of serious market maladjustments. The second was reluctance to interfere with activity in a sector endowed with special public interest. Third, so long as the strength and depth of the general business recovery of 1953-1954 was uncertain, it was difficult, if not impractical, to adopt a policy that would have slowed down an important expansionary force. Fourth, the more powerful types of

[17] *Ibid.*, pp. 53-54 (Exhibit C).

[18] This statement is couched in terms of house prices rather than rents since more than 90 per cent of the new dwelling units started in 1954-1955 were in one- and two-family structures which are commonly offered for sale to owner occupants.

controls on housing credit were imposed only when a definite policy of general credit restraint was initiated. As policy-makers struggled with these matters throughout the first half of 1955, the "policy gestation period" was prolonged.

Among the many considerations controlling the imposition of selective credit restraints in times of peace, a necessary condition would seem to be evidence of impending, if not actual, serious maladjustments in the affected sector of the economy. Only a clearly unsustainable expansion would warrant such drastic action. As was indicated earlier, imbalances generated during the housing boom of 1954 became evident in the early months of 1955. To be sure, economic intelligence on current conditions in local housing markets was imperfect and, more important, forward indicators of market activity were poorly developed; it was only in the spring of 1955 that survey and other information of the FHA and V.A. field offices was utilized in such manner as to provide continuing guides to action for government agencies concerned with the development and coordination of stabilization policies. But the Economic Report of the President of January 1955 included the pointed statement that "history . . . warns us that activities which involve the discontinuing of a long future, as in the case of home purchases and the pricing of corporate shares, may be carried to excess in the course of a business expansion." [19] Also, the Open Market Committee of the Federal Reserve noted on March 2 that "there were some fears that in a few industries, including building, activity was reaching levels that could not be sustained." [20] Thus, there was an awareness of impending, if not already existing, maladjustments in the housing market.

That convincing evidence of such imbalances should not be notable earlier is worth comment, for it has a bearing on both the timing and the effects of selective housing credit policies. The planning, building, and marketing of homes by operative builders require considerable time. Once a house-building project is started, the construction period is usually only about four months, but if the prior steps in planning a site and obtaining financial commitments are considered, an additional two to three months may be involved, and the marketing of completed homes usually takes another two months except for sales made from model homes or during the construction period.[21] Thus, whether demand has come up to expectations cannot com-

[19] *Economic Report of the President,* January 1955, p. 25.

[20] *Forty-Second Annual Report of the Board of Governors of the Federal Reserve System, 1955,* p. 91.

[21] Cf. Marvin Wilkerson and Dorothy K. Newman, "FHA and VA Housing Statistics and the Housing Market," *Construction Review,* June 1957, p. 4. In the case of operations under the FHA and V.A. programs, "applications . . . usually precede actual start of construction . . . by about 3 to 4 months, and loan closings by about 5 to 7 months."

monly be determined until about six months after projects of operative builders are started or perhaps eight months after FHA or V.A. have issued commitments for government-underwritten financing. During the period under consideration, firm commitments by FHA on new construction and the V.A.'s valuation in its "Certificate of Reasonable Value" were valid for eight months but could be extended under special circumstances.

Applying these approximate time periods to the expansion of home building during 1954, it seems probable that the increased number of dwelling units started during the first half of 1954, when the rate of starts rose from a little over one million units to about 1.2 million, could be marketed without difficulty upon completion. Sale of the rapidly mounting volume of units placed under construction in the second half of the year, when the rate of starts increased further to over 1.4 million units, apparently proved to be more difficult, to judge from reports of rising inventories of unsold new houses. These homes, however, were not completed and marketable before late 1954 and early 1955, except for sales during construction. The crucial test of the strength of demand came only about a year after the expansion of residential building had begun. The relatively long period of planning, construction, and sale thus delayed the appearance of clear evidence of market maladjustments and, by the same token, militated against early restraining action through selective controls. This is an inherent difficulty in using the governmental credit programs for moderating short-term fluctuations in the housing sector, although improvements in economic intelligence initiated in 1955 should help meet it in the future.

Little more need be said about the second factor conditioning the timing of the restraints, i.e. the preferred status of housing among national objectives. Reluctance to interfere in this sector reflected perhaps not only the priority status of housing, but also the fact that "... the government is not yet prepared to act as decisively to check inflation as it is to check recession." [22]

Uncertainties about the economic outlook were not fully removed before the first few months of 1955. Thus, even if serious maladjustments in the housing sector had become evident at an earlier point, it is questionable whether selective credit restraints would have been initiated as long as there was slack in the economy generally. While it was clear in late 1954 that a substantial recovery was under way, it remained uncertain whether the impetus would be sufficient to lift business activity to full-employment levels. Increased investment in plant and equipment was in the offing, but the initial expansion in this type of expenditure was quite moderate although it was destined to become a dominant force in the general economic advance. Under these circumstances, an administration intent on fostering full recovery from a contraction would find it difficult to impose restraints on an

[22] Arthur F. Burns, *Prosperity Without Inflation,* Fordham, 1957, p. 41.

important sector of the economy and thus endanger the success of its policies to support economic growth.

If this observation is correct, one of the alleged virtues of selective credit regulations must be viewed with a degree of skepticism. It has sometimes been claimed as an advantage of selective controls that they can be used when a particular sector of the economy experiences the strains of unsustainable expansion while the economy generally is sluggish—a condition which makes it impossible or inadvisable to apply general credit restraints. If the experience of 1955 is any guide, this advantage of selective credit measures may be less real than appears. To be sure, stock margin requirements—another selective control—were raised in January 1955 and again in April before the policy of general credit restraint was adopted. But stock market credit is probably in a class by itself in the community's judgment so that its restraint may be more easily tolerated than restrictions on the types of credit that in the public mind are directly associated with production and employment.

The coincident timing of larger down-payment and shorter maturity requirements for government-underwritten loans and of the general Federal Reserve restraints in late July and early August 1955 highlights a related problem in the use of selective credit controls. Is the imposition of selective credit restraints feasible without a general monetary policy of restraint? The case at hand would seem to support the view that selective credit regulations "can serve most effectively . . . as supplements to controls of the over-all type,"[23] rather than as independent measures solely for the suppression of inflationary pressures in a specific sector of the economy. One of the two selective controls on government-underwritten loans imposed before late July 1955—the requirement that loan closing costs be paid in cash by the borrower—was of minor importance and significant mainly as a warning signal. The other—the restraint on the issuance of commitments by FHA and V.A. field offices—represented a customary action geared to local market conditions. In contrast, the simultaneous measures of July and early August—nation-wide adjustment of the permissible credit terms for government-underwritten home loans, the adoption of a policy of general restraint by the Federal Reserve authorities, and the warnings of the Federal Reserve Bank of New York and the Home Loan Bank Board against excessive use of interim credit by mortgage lenders—suggest a concerted effort even without assuming a "grand design." In practice, each of these steps may have been dependent upon the others. To what extent the various measures actually were additive and mutually reinforcing remains to be examined when the

[23] R. J. Saulnier, "An Appraisal of Selective Credit Controls," *American Economic Review, Papers and Proceedings of the Sixty-Fourth Annual Meeting*, May 1952, p. 262.

over-all effects of the selective regulations of housing credit are reviewed.

Our observations on timing offer also some insight into the rationale of the selective restrictions imposed during 1955. Basically, selective restraints may be initiated either because output in a particular sector is believed to be expanding at a clearly unsustainable rate or because its expansion, though considered sustainable, is held to absorb too large a share of total resources and thereby add to the inflationary pressures associated with a high level of aggregate demand, or both. It seems that both considerations were judged to be applicable in this case. If so, the question arises of the ways in which selective credit regulations can supplement a policy of general credit restraint. Selective credit measures may supplement general restraints if certain types of credit, for institutional or other reasons, are relatively unresponsive to over-all monetary actions.[24] This is generally not the case for mortgage loans; on the contrary, as will be shown in the next chapter, an over-all tightening of credit *in time* tends to bear heavily on the housing sector. Selective credit regulation may also supplement and reinforce general credit policy if it helps establish stricter lending standards more promptly and thereby accelerates the response to general monetary restraint. This result of selective regulation was probably operative in the case at hand. Even in a tightening capital market some lenders continued to make government-underwritten mortgage loans on liberal terms in order to obtain a larger yield through increased discounts from par, and their actions, through the forces of competition, affected the entire market. The maximum terms permitted for government-underwritten loans under these circumstances served as "yardsticks." More restrictive maxima apparently curbed the tendency toward generous credit terms more promptly, helped reduce the widening discounts in the secondary mortgage market which resulted from this tendency, and moderated the unsettling influence of high discounts on the market.

The "yardstick" effect of governmental maximum terms can be clearly observed in the operation of the G.I. loan program after July 1955. The reduction of the maximum maturity then imposed was rescinded in January 1956. In contrast, the simultaneous requirement of a minimum down payment of 2 per cent was retained until April 1958. Throughout 1956 and in a large part of 1957, the mortgage market was tight, more so, in fact, than in mid-1955. Under these circumstances, one would expect the restoration of the maximum maturity of 30 years to have slight if any effects; loans made at maximum maturities would show about the same downward movement as the loans made without down payment, i.e. reflect the attrition of mortgages for which guaranty commitments or applications had been made before

[24] This has often been claimed for consumer instalment credit. For a summary of opposing views on the subject, see *Consumer Instalment Credit,* Board of Governors of the Federal Reserve System, 1957, Part I, Vol. 1, pp. 365-366 and pp. 380-382.

July 30, 1955 and which therefore were exempt from the regulation. The facts revealed in Chart 3, however, are quite different. No-down-payment loans, which accounted for more than 40 per cent of all home loans in the spring of 1955, showed a declining share in the total during the rest of the year and then dropped steadily to about 3 per cent at the end of 1957 as the backlog of pre-regulation applications was worked off. Loans with 26-30 years maturity, which also accounted for more than 40 per cent of all loans through most of 1955, began to decline relative to the total in December and continued downward to nearly 36 per cent in June 1956. Thereafter, however, their share in the total increased rather steadily and reached over 50 per cent, or more than at the 1955 peak of liberal lending, in September 1957,[25] before the easing of the money market in the fall of that year. Thus, the restoration of the 30-year maximum maturity had an appreciable effect even under adverse conditions in the financial markets. By the same token, the restrictions of July 1955 on the permissible terms on FHA and V.A. loans tended to reduce the lenders' opportunity to acquire mortgages on marginal terms at the largest possible discount from par. To this extent, the selective restraints performed a purpose not necessarily nor so speedily met by general credit restraints and therefore reinforced the latter.

Another possible reason for supplementing general credit measures with specific restraints on a sector which thrives on government-supported credit stems from considerations of fiscal policy. Would it not be illogical as well as unseemly for the federal government to sanction no-down-payment and long-maturity housing loans while espousing general fiscal and monetary restraints, as it did in the spring and summer of 1955? [26] Why deny funds to credit-worthy businesses or curb meritorious federal spending programs when borrowing on government-underwritten mortgages is to be unchecked? Would the government not be guilty of irresponsible conduct of its fiscal affairs if it failed to take restraining action in an important economic sector

[25] The same tendency can be traced for V.A. loans at the maturity limit of 30 years. Mortgage loans with a maturity of 30 years were 30.6 per cent of all loans guaranteed by the V.A. in 1955, 29.5 per cent in 1956, and 33.9 per cent in 1957. (Data supplied by the Loan Guaranty Service of the Veterans Administration.) The *number* of long-maturity loans, of course, declined as did the total volume of V.A. loans during these years, but the point is that they declined less than the total. A differential movement of long-maturity and low-down-payment loans, though a much smaller one, is also observed in the annual data for FHA home loans. (Cf. *10th Annual Report, Housing and Home Finance Agency, 1956,* pp. 101 and 105.) It is possible that lenders are generally somewhat less concerned over long maturities than over low- or no-down-payment loans.

[26] This view is expressed, for example, in the following statement in a study of the United States Savings and Loan League: "It is unwise and unfair to restrain institutions making 70 per cent and 80 per cent loans while the government continues to promote, purchase and guarantee 90 per cent, 95 per cent and 100 per cent FHA and VA loans." (*Report of the Special Committee to Study the Federal Home Loan Bank System,* United States Savings and Loan League, 1956, p. 49.)

on which it had substantial influence? Regardless of whether such considerations were among those which prompted the initiation of selective controls of housing credit in 1955, they emphasize the fact that the growth of federal credit programs has created new problems of equity in economic stabilization policy—problems which will engage our attention at several later points.

Some Effects of the Restraints. Since they can never be segregated from other forces influencing the course of economic events, the effects of credit policies defy satisfactory measurement. In the case at hand, selective credit controls, general restraints by the monetary authorities, and plain market forces were all acting simultaneously to reduce the supply of funds for mortgages relative to demand and cut down the volume of residential construction. Time lags accentuate the difficulty in establishing anything resembling a causal relationship. The effects of relaxation or withdrawal of some of the selective restraints in 1956 and of offering positive relief to housing blended inseparably with the effects of the restraints initiated the year before and of the continued restrictive credit policies of the monetary authorities. Additional problems of measurement or even attribution will become readily apparent in the following pages. Yet, we cannot hope to learn from experience unless we make an effort to appraise the operation of selective credit regulations as best we can.[27]

Several circumstances combined to delay and weaken the effects of the restraints on government-underwritten mortgages. First, as was pointed out before, the controls were initiated when expansion in the housing sector was already terminated. Second, time lags precluded immediate or even early results. Third, the restrictions were moderate. Fourth, the shorter loan maturity requirement was rescinded in January 1956, just 6 months after it was put into effect, and only the additional down-payment requirement was maintained—until March 1957 for FHA loans and April 1958 for V.A. loans. The second and third items warrant further elaboration.

A large backlog of commitments issued and of applications received by FHA and V.A. before the restraints became effective was exempt from the regulation. The size of the backlog was not augmented by "leaks," nor was there general anticipation of controls as in the case of Regulation X, which was authorized by the Defense Production Act of August 1950 but placed in effect in several stages between October of that year and February 1951.[28]

[27] Cf. Saulnier, *op. cit.*

[28] The advance notice given to the trade in 1950, which led to large numbers of building projects being started in time to fall under the exemptions from the regulation, was caused by the need for drawing up a new, complex regulation controlling conventional mortgage loans, and also by the consultation with industry advisory groups that was required by the Defense Production Act. No such inhibitions applied to the regulations of July 30, 1955. For details on the lags of 1950, see Saulnier, *op. cit.*, and James J. O'Leary, "The Effects of Monetary Policies on the Mortgage Market," *The Journal of Finance*, May 1958.

The backlog was large because the volume of FHA and V.A. activity in the months preceding the regulation was extremely high and had increased so much that personnel shortage, particularly in the Veterans Administration, had slowed the processing of applications. While direct data on the backlog are not available, the flow of applications and commitments suggests that, in early August 1955, applications in process and commitments outstanding for houses not yet started covered about 250,000 new dwelling units. This number was about 4 times the 63,000 dwelling units started under the government programs in July, i.e. it was sufficient to maintain the high current rate of FHA- and V.A.-sponsored starts for 4 months. Another 250,000 units started earlier under the programs were probably under construction at that time. In view of the large backlog and the long time elapsing between new applications and housing starts, the first effects of the restraints of July 30 on the volume of starts could not be felt before the end of the year. This delay is illustrated in the slow decline after July 1955 in the share of no-down-payment and long-maturity loans in the total number of veterans' home loans closed on new homes (Table 26). In the case of loans on existing homes, however, the decline was much more rapid, reflecting a shorter transaction time in the absence of the construction and planning period. Thus, the restrictions were transmitted more readily to the market for existing homes than to the financing of new houses.

It may be noted parenthetically that the treatment of applications and commitments in the "pipeline" and, to that extent, the effectiveness of selective credit measures are not symmetrical in the cases of restraint and relaxation. In the former case, the exemption of backlogs, dictated by considerations of practicality as well as equity, blunts the impact of restrictions. In the latter, commitments already issued and applications pending may be recast to conform to the new, more liberal terms if borrowers and lenders agree to do so, on the grounds that it would be inequitable to discriminate against the earlier applicants (who, in any case, could withdraw their old applications and file new ones). Other things being equal, the effects of changes in maximum terms are therefore more delayed and weaker when terms are tightened than when they are liberalized.

In any event, the time lags in the processing of applications by federal agencies and, more basically, the long periods intervening between forward commitments by financial institutions and actual construction are bound to soften the effects of selective housing credit restraints, as well as those of general monetary restraints, and they pose difficult problems in the timing of such actions.[29]

As for the severity of the new terms, the combined effects of the increased

[29] Cf. O'Leary, *op. cit.*, and Mortimer Kaplan, "Recent Institutional Arrangements in Mortgage Lending," *The Journal of Finance*, May 1958.

down-payment requirement and the shorter maximum loan maturity were probably greater than critics who considered the restraints too weak suggested and smaller than many builders who were on the firing line asserted. The arithmetic of the change in maximum terms obviously does not tell the whole story. Some of the home buyers who had availed themselves of the lowest permissible down payment and the longest maturity under the law could have afforded purchase at more restrictive terms. Or, just as the easy terms permitted before the regulations of July 30, 1955 enabled buyers to command a larger amount of debt and a more expensive home, the restrictions may have had the effect, in part, of causing purchasers in a given income class and cash position to acquire more modest homes, rather than of eliminating them from the market.[30] With these reservations, the arithmetic results of the new terms can at least be illustrated.

The effects of the additional down-payment requirement are illuminated by sample data for home purchasers with V.A.-guaranteed loans in 1954 and 1955 (Table 13). Veterans buying new homes with no-down-payment loans in 1954 reported liquid assets averaging $920, or 8.6 per cent of the average purchase price of their property. Veterans who made down payments had liquid assets averaging $2,560 before purchase, or 20.3 per cent of the average purchase price. Nearly one-third of those buying without down payment had liquid assets of less than $300, and more than 60 per cent reported less than $600. The minimum down payment of 2 per cent required under the regulation of July, in conjunction with cash outlays for closing costs and other expenses involved in home purchase, would clearly have eliminated most purchasers in the group with less than $300 in liquid assets and probably some of the veterans with $300 to $600. This conclusion is supported by the fact that only 7.1 per cent of those buying a new home with down payment had liquid assets of less than $300, and about 18 per cent reported less than $600. The relationships are quite similar for purchasers of existing homes. Assuming that the 2 per cent down-payment requirement would have eliminated one-third of the no-down-payment purchasers, about 85,000 purchasers, or 13 per cent of all home buyers under the G.I. loan program, would have been excluded in 1955 (derived from Table 26). Thus, in spite of the innocuous appearance of a 2 per cent down payment, the effects were not negligible. No comparable data are available for buyers under the FHA program.

[30] On the effects of changing mortgage terms on consumers' ability to buy homes, cf. *Mortgage Market Problems*, pp. 79-80 and 155-156. For systematic treatment of the subject, see Ernest M. Fisher, *Urban Real Estate Markets: Characteristics and Financing*, National Bureau of Economic Research, 1951, p. 73 ff.; and Ramsay Wood, "Credit Terms and Demand for Residential Construction," *Study of Mortgage Credit*, Subcommittee on Housing of the Senate Banking and Currency Committee, 85th Congress, 2nd Session, December 22, 1958.

TABLE 13

Selected Characteristics of Home Loans Guaranteed by the Veterans Administration in 1954 and 1955 [a]

Item	Loans with Down Payment				Loans without Down Payment			
	New Homes		Existing Homes		New Homes		Existing Homes	
	1954	1955	1954	1955	1954	1955	1954	1955
Average purchase price	$12,580	$13,825	$11,615	$12,081	$10,685	$11,519	$9,235	$9,616
Average amount of purchasers' liquid assets	$ 2,560	$ 2,824	$ 3,085	$ 2,400	$ 920	$ 1,207	$1,015	$ 803
Asset-purchase price ratios	20.3	20.4	26.6	19.9	8.6	10.5	11.0	8.4
Per cent of loans made to veterans with liquid assets of:								
Less than $300	7.1	7.2	6.4	7.9	31.6	30.1	26.8	28.4
$300-$599	10.7	9.0	7.9	10.6	30.9	27.0	31.4	34.5
$600-$999	16.5	14.0	12.3	16.3	15.8	16.1	18.7	17.7
$1000-$1999	27.5	26.5	29.5	27.9	13.3	12.8	12.3	11.5
$2000-$4999	25.7	28.9	29.4	26.2	5.5	9.4	7.0	5.6
$5000 and over	12.5	14.4	14.5	11.1	2.9	4.6	3.8	2.3

SOURCE: "Special Study of G.I. Home Loans Guaranteed by the Veterans Administration" (mimeographed).

[a] Based on 2 per cent random sampling of loans submitted for prior approval of Veterans Administration. More than 70 per cent of all home loans guaranteed in both years were prior-approval loans.

The reduction of the maximum maturity of FHA and V.A. loans from 30 to 25 years raised the monthly debt charge from $5.07 per $1,000 of loan at 4.5 per cent interest to $5.56. On a $10,000 loan, which is close to the average amount of FHA loans in 1955 but somewhat less than that of V.A. loans, the difference would be about $59 a year. This seemingly small difference, however, is multiplied when translated into the income necessary to support the increased debt service under the income-qualification standards employed by the FHA and V.A. There is no generally applicable formula for the transformation, but it is reasonable to take a cue from the relation between average debt service and average income of new home purchasers under the FHA program in 1955. On this yardstick, the borrower's required income would average six and a half times the amount of debt service. Thus, if the latter increased by $59 a year, the required income would be raised by $373, a sufficient difference to disqualify an appreciable number of purchasers at the margin.[31] The effect of the reduced maximum maturity can also be illustrated by the amount of loan which a given monthly debt service will support. A debt service of $50 a month, for example, will carry a loan of $9,862 at 4.5 per cent interest if the maturity is 30 years, but of only $8,993, or nearly 9 per cent less, if the maturity is 25 years. The effect of shortening the maturity would be equivalent to increasing the required down payment by $869 in this case, other things being equal.

In summary, the "bite" of the reduced maximum maturities combined with a moderate increase in minimum down payments was not negligible although it was weakened by the late initiation of the restrictions, the large backlog of exempt transactions, and the restoration of the 30-year maximum maturity as early as January 1956. Nor can the effectiveness of the restraints be dismissed on the grounds that many mortgage lenders applied even stricter down-payment and loan maturity standards than those prescribed by the regulations. As was shown earlier, the maximum permissible terms serve as yardsticks even in a period of tightening credit, since the opportunity to acquire loans on the marginal terms attracts lenders eager to maximize yields.

Unfortunately, the effects of the direct local restraints on home building by the field offices of FHA and V.A. cannot be assessed in the absence of any record of these actions. It should be pointed out, nevertheless, that this method commends itself for several reasons. It can be applied locally where needed and thus can take account of the great differences in local housing market conditions. It can operate on those price or territorial or house-

[31] The average annual income of FHA borrowers buying a new house in 1955 was $5,969, and 11.2 per cent of the borrowers had incomes of less than $4,000. *9th Annual Report, Housing and Home Finance Agency, 1955,* Tables II-66 and II-70. For average debt service and monthly income of FHA borrowers, see Table II-70 in the same source.

type segments of area markets in which maladjustments exist or threaten, leaving the others undisturbed. Because the interests affected are scattered, adverse public reaction is minimized. The grounds for restraint in the issuance of insurance or guaranty commitments are clearly related to the risks to underwriting agencies that would result from local excess supplies of housing relative to current demand. These observations do not imply that nation-wide restrictions on maximum terms of government-underwritten loans are unwarranted under any circumstances. They do emphasize the need for more systematic exploration by FHA and V.A. of a method of restraint that is even more selective and flexible than ordinary selective credit controls applied across the board.

In the absence of systematic exploration and because coordination of FHA and V.A. actions at the local level had to be improvised, the exercise of local restraints in 1955 seems to have fallen short of the potentials of this method. If it is to be used more effectively in the future, five steps seem indicated: (1) a careful study of experience; (2) improvement of data and techniques used in local housing market surveys and analyses; (3) comprehensive and articulated criteria for initiation or removal of restraints by field offices so as to minimize unequal and therefore inequitable performance; (4) adequate supervision of field office actions by high-echelon headquarters personnel; and (5) standing procedures for coordination if field offices of several government agencies are involved.

TABLE 14

Outstanding Advances of the Federal Home Loan Banks, Monthly, 1953-1958

(million dollars)

Month	1953	1954	1955	1956	1957	1958
Jan.	683.4	750.8	716.8	1,246.0	1,037.9	906.0
Feb.	626.7	677.0	688.4	1,181.3	976.0	789.8
March	610.7	629.7	701.8	1,138.1	960.7	696.3
April	626.2	613.4	754.3	1,126.8	971.3	814.8
May	644.2	608.4	821.4	1,123.0	992.9	802.8
June	718.3	675.1	1,016.9	1,173.4	1,079.4	929.5
July	700.2	630.1	1,061.3	1,107.8	1,039.6	901.1
Aug.	746.2	658.6	1,187.0	1,116.4	1,072.1	938.8
Sept.	801.3	689.0	1,275.2	1,142.2	1,118.8	1,009.5
Oct.	818.7	707.7	1,344.2	1,148.2	1,131.4	1,083.1
Nov.	864.9	743.5	1,364.4	1,153.5	1,143.2	1,122.5
Dec.	951.6	867.5	1,416.8	1,228.1	1,265.2	1,298.3

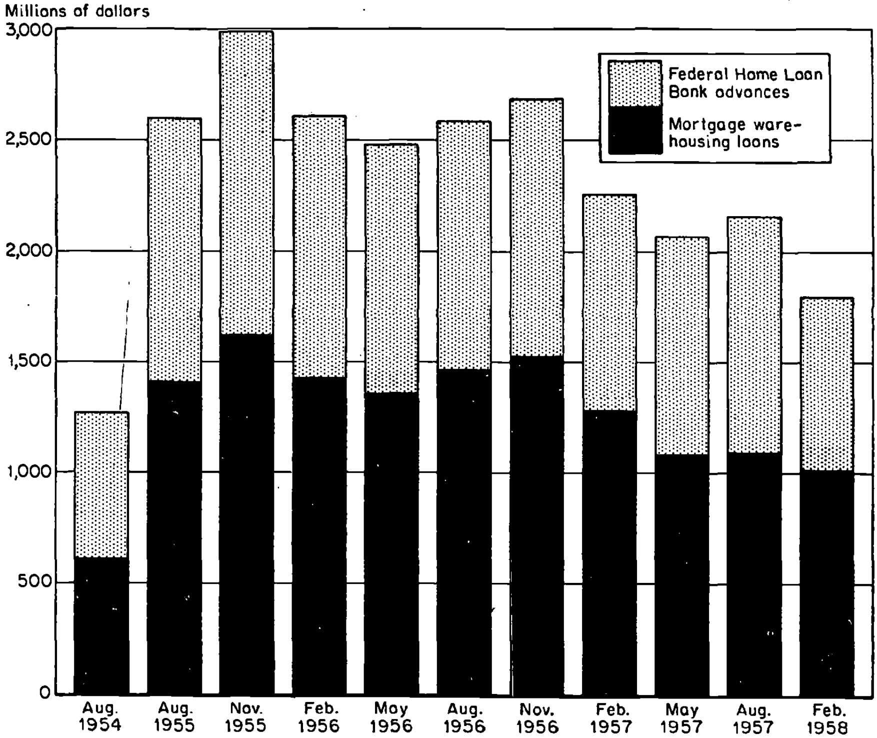
Source: Federal Home Loan Bank Board.

Curbs on Interim Credit to Mortgage Lenders

The restraints on the use of interim credit by mortgage lenders followed upon unusually sharp increases in borrowings from the Home Loan Banks and in mortgage warehousing loans extended by commercial banks. Advances outstanding of the Federal Home Loan Banks rose more than seasonally from $688 million in February 1955 to $1,061 million in July, when the Bank

CHART 4

Mortgage Warehousing Loans and Federal Home Loan Bank Advances Outstanding, Selected Periods, 1954-1958



Source: Tables 14 and 15.

Board issued its general cautionary memorandum, and again to $1,275 million in September when the Board formalized its restraints (Table 14). The strong demand for funds by member institutions of the Federal Home Loan Bank System was attributed to a large expansion of their forward commitments to builders. Builders had turned increasingly to savings and loan associations, the mortgage lending specialists, since other lenders, particularly life insurance companies and savings banks which have a larger variety of investment outlets and are therefore more responsive to changing demands in the capital market, had reduced their residential mortgage commitments. Mortgage warehousing loans by commercial banks had also increased rapidly in late 1954 and the first half of 1955, before the Federal Reserve Bank of New York intervened. The amount of the increase, however, was unknown until September when a special survey showed an expansion for weekly reporting member banks of the Federal Reserve System from $608 million in August 1954 to $1.4 billion a year later (Table 15). Together, these two types of credit rose between August 1954 and August 1955 by $1.3 billion, or more than 100 per cent (Chart 4).

The restraints on mortgage warehousing loans and on borrowings from the Home Loan Banks produced extreme reactions among trade groups. A leading spokesman for home builders was quoted to the effect that the action against warehousing credit might promote a "severe crisis in home building." Press reports gave the impression that the "Fed" wished to curb all forms of warehousing credit and had threatened to withdraw the discount privilege from errant banks.[32] The curbs on borrowings from the Home Loan Banks gave the impression that the doors of the banks had been shut, and those savings and loan associations which for many years had relied on the banks for advances permitting them to expand their mortgage investments felt they had been abandoned.

The acute reaction was provoked by a number of circumstances. In the case of warehousing loans, the failure to reveal the precise nature of the steps taken by the Federal Reserve Bank of New York and the absence of any dependable data on the volume of these loans before September contributed to confusion and to irresponsible exaggeration of the severity of the restraint. Until the president of the bank clarified the matter publicly by a letter to Congressman Rains, dated September 12 but published only in October,[33] it was not even clear whether the action had emanated from the Board of Governors in Washington or from one or several of the Federal Reserve Banks. In the case of borrowings from the Home Loan Banks, a temporary liquidity squeeze experienced during the summer and fall by members of the Bank System was the result of poor planning by both the member institutions and the banks themselves, lack of data (in this case on forward commitments by members, a deficiency that has since been corrected), and the overly cautious attitude of both the Federal Home Loan Banks and the Treasury on the issuance of additional obligations. The liquidity problem was accentuated by an unexpected ebb in the net flow of savings during the summer of 1955. From June to the end of the year, the banks had to float nine separate issues of obligations for a total of $856 million, in addition to selling government securities, in order to meet the demand for advances and the with-

[32] Guttentag, *op. cit.*, p. 438.
[33] See footnote 13.

TABLE 15

Mortgage Warehousing Credit Extended by Commercial Banks,[a] Selected Dates, 1954-1958
(million dollars)

Item and Type of Borrower	Aug. 1954	Aug. 1955	Nov. 1955	Feb. 1956	May 1956	Aug. 1956	Nov. 1956	Feb. 1957	May 1957	Aug. 1957	Feb. 1958
Loans outstanding											
Total:	608	1,408	1,623	1,425	1,354	1,465	1,526	1,280	1,079	1,089	1,009
Insurance companies	11	250	287	130	127	121	114	70	54	47	49
Mortgage companies	541	1,025	1,182	1,148	1,051	1,137	1,181	988	819	841	794
Others[b]	55	131	152	148	175	208	232	221	206	201	166
Unused firm commitments											
Total:	n.a.	1,295	1,225	1,131	1,131	1,064	776	786	754	746	673
Insurance companies	n.a.	183	151	118	106	110	96	75	64	66	18
Mortgage companies	n.a.	894	889	837	851	791	534	579	578	562	541
Others[b]	n.a.	219	185	176	173	163	145	132	112	118	114

SOURCE: Board of Governors, Federal Reserve System.

[a] Weekly reporting member banks in leading cities. Banks reporting less than $1 million of these loans and commitments in August 1956 and August 1957 were not asked to report in other surveys, but their August 1956 figures are included in the February 1957 data, and their August 1957 figures are included in February 1958 figures for comparative purposes. Detail may not add to totals because of rounding.

[b] Savings and loan associations, mutual savings banks, builders' and other organizations (other than banks) that make or hold substantial amounts of real-estate loans.

drawals of members' deposits. Inexperience with restraints in a credit reserve system hitherto geared mainly to promotion and expansion and incomplete mastery by the Federal Home Loan Bank Board of the art of communication compounded the difficulties.[34]

In any event, the restraints on interim credit had much more moderate over-all effects than the violent reaction in the trade suggested, although their impact on capital-deficit areas such as the West and Southwest was pronounced. Federal Home Loan Bank advances outstanding, which usually expand in the latter part of the year, were allowed to increase to more than $1.4 billion at the end of 1955. In spite of their reduction in the early months of the following year, which was partly seasonal, they remained at all-time peaks through July 1956 (on a month-to-month comparison) and continued at high levels to the end of 1957. Similarly, mortgage warehousing loans outstanding kept on rising after the "cautionary talks" of July 1955, largely because of previous commitments, and reached a peak of $1.6 billion in November. The decline by $269 million between November 1955 and May 1956 was quite moderate and gave way to a renewed (perhaps seasonal) increase between May and November 1956. Thereafter, mortgage warehousing loans dropped more sharply. Nevertheless, the volume of these loans, combined with borrowings from the Federal Home Loan Banks throughout 1956 and 1957, remained at a higher level than before the upsurge of interim credit in 1954-1955 (Chart 4).

More significant than the confusing circumstances surrounding the actions of the Federal Home Loan Bank Board and the Federal Reserve Bank of New York are two fundamental issues. One is the relation between stability in the mortgage and housing markets and changes in the volume of interim credit. The other is a reconsideration of the functions of the Federal Home Loan Bank System.

Since national resources were under strain in 1955, marked expansion of any type of bank credit had, of course, inflationary potentials, and it would be difficult to demonstrate that these were any greater for mortgage warehousing loans than for other bank loans. Disregarding the effects of the rapid increase of mortgage warehousing on the financial system and the economy as a whole, what if any were its specific unstabilizing consequences in the housing and mortgage markets? The consequences can best be identified, first, as the stimulation, during a period of strain on resources, of residential construction and home purchase activity beyond the flow of savings channeled into the housing sector and, second, as the depressing influences of

[34] Cf. *Mortgage Market Problems,* pp. 44-57; the address of Walter W. McAllister, Chairman of the Federal Home Loan Bank Board, before the 63rd Annual Convention of the United States Savings and Loan League at Miami Beach, November 7, 1955; *Report of Special Committee to Study FHLB System;* and *Blueprint for the Future,* National Savings and Loan League, 1957.

subsequent liquidation of interim loans when permanent investors would reduce their current mortgage lending in order to absorb the mortgages delivered from the "warehouse." As a general proposition, one may assume that a given level of final mortgage lending under existing institutional arrangements requires a certain amount of interim credit so as to synchronize the complex processes of building and financing homes. If the relative fluctuations of interim credit are no greater than those of final lending and if its volume is moving in the same direction as the latter, this type of credit may be said to have a neutral effect on stability in the mortgage and housing markets. If interim credit fluctuates more sharply than final lending and moves in the same direction, however, interim credit tends to have an unstabilizing effect. This was the case during the period 1954-1955. Between the summer of 1954 and late 1955, mortgage warehousing credit rose by more than $1 billion, or 167 per cent, while the net flow of funds into residential mortgages increased by $19.6 billion, or 24 per cent.[35] The relative importance of mortgage warehousing loans in the expansion of funds available to builders and home purchasers appears in even sharper relief when they are compared to gross lending activity. Assuming an average annual turnover ratio of 2, Klaman estimates the gross volume of interim credit extended during 1955 at $3 billion, or 13 per cent of the total amount of mortgage loans made for the purchase of new or existing houses and equal to 30 per cent of the amount of FHA and V.A. loans made during that year.[36]

In contrast, the effects of the subsequent liquidation of mortgage warehousing loans were quite moderate. If the minor and irregular movements between November 1955 and November 1956 are ignored, the volume of such loans declined by a little over $500 million between November 1956 and February 1958. Other things being equal, this is the amount by which permanent investors presumably reduced their current net lending on residential mortgages in order to absorb the loans delivered to them at the end of the warehousing period. Since the net flow of funds into residential mortgages during the year 1957 alone is estimated at $9.1 billion (Table 3), the liquidation effect presumably was one of modest proportions.[37]

The restraints on borrowings from the Home Loan Banks served to raise

[35] The residential mortgage debt stood at $81.1 billion at the end of June 1954 and at $100.7 billion at the end of 1955. (Cf. Saul B. Klaman, *The Volume of Mortgage Debt in the Postwar Decade,* National Bureau of Economic Research, Technical Paper 13, 1958, Table 1.) These dates come closest to those for which figures on mortgage warehousing loans are available.

[36] Klaman, *The Postwar Residential Mortgage Market,* Chapter 7.

[37] This would be true even if the $927 million (net) of mortgages acquired by the Federal National Mortgage Association in 1957 (Table 4) was deducted from the total net flow.

a host of questions on the very purposes of the Federal Home Loan Bank System. Is it the system's function to help promote stability in the mortgage market and maintain general economic stability, or should it simply seek to accommodate its members and leave the accomplishment of these larger objectives entirely to the Federal Reserve System? Is it discriminatory for the Home Loan Banks to restrain their members, while other types of mortgage lenders are not subjected to specific restrictions? How can their purpose of providing a liquidity reserve be reconciled with their function of supplying funds for expansion of their members' mortgage investment programs? And what reforms are required to prevent a recurrence of the 1955 liquidity squeeze? [38]

These points can only be touched upon in the context of this essay. Neither the Federal Home Loan Bank Act nor the hearings preceding it provide a clear-cut expression of Congressional intent as to the broad philosophy of the Home Loan Bank System. It is noteworthy, however, that the majority report of the House Banking and Currency Committee, in recommending the enactment of the Federal Home Loan Bank Bill of 1932, anticipated that the system would "regulate the supply of mortgage credit in a way that will discourage building booms and support normal construction year in and year out." [39] Moreover, the question was not whether the Federal Home Loan Bank Board was exercising prerogatives of the Federal Reserve System, but whether it should be allowed to work at cross-purposes with general monetary policies. As for discrimination through restraint, access to a reserve bank has always been considered a privilege rather than a right, and the restrictions on borrowings from the Federal Home Loan Banks were only one of several measures affecting all types of mortgage lenders.[40]

In a study attempting to distill the lessons drawn from the 1955 experience, several measures were suggested to avoid a recurrence of the liquidity difficulties encountered at that time. It was proposed that members of the Bank System be required to obtain advance commitments for certain types of borrowings from the Home Loan Banks, that long-term advances be made from proceeds of the banks' long-term obligations and only to the extent that such lending is consistent with national credit policy, that interest rates on

[38] Cf. *Report of the Special Committee to Study the Federal Home Loan Bank System; A Program to Revitalize the Federal Home Loan Bank System,* Savings Association League of New York, May 1958; McAllister, address cited in footnote 34; and Gordon W. McKinley, "The Federal Home Loan Bank System and the Control of Credit," *The Journal of Finance,* September 1957. For an informative description of the Federal Home Loan Bank System, see *The Federal Home Loan Bank System,* 1952.

[39] *Report No. 1418,* House of Representatives, 72d Congress, 1st Session, Creation of not less than 8 and not more than 12 Federal Home Loan Banks, p. 10.

[40] For a contrary view on most of these points, cf. McKinley, *op. cit.*

long-term advances be used more effectively to influence the volume of borrowing, and that the liquidity requirements for both member savings and loan associations and the Federal Home Loan Banks themselves be strengthened.[41] The latter objective was accomplished in part by new liquidity standards for the banks, which were established by the Federal Home Loan Bank Board in December 1955. The standards prescribed, among other things, an increase in required liquidity reserves from 20 to 75 per cent of members' deposits and a new liquidity reserve for unanticipated demands for advances. Also, longer-term (five-year) obligations of the banks totaling $290 million were issued in 1958 to provide funds for five-year advances to members.[42]

Among other possibilities, serious consideration should be given to using the interest rate on advances as a means of rationing this type of credit before the blunt, cumbersome, and sometimes inequitable instrument of quantitative restrictions is employed. The Board's regulation of September 1955, which seemed to prohibit new advances by the Home Loan Banks except for emergencies resulting from large withdrawals of savings from member institutions, not only had a pronounced shock effect but required prompt revision to allow for a variety of unanticipated circumstances. A modification in October permitted a member association to borrow if it used half of its net inflow of savings and of loan repayments to meet previous commitments. In December, members were allowed new borrowings up to 5 per cent of their savings accounts, provided their outstanding borrowings did not exceed 10 per cent of these accounts.[43] Although this revision and subsequent similar actions were designed as relaxations of the original rule, they maintained the quantitative, across-the-board character of restrictions. The Federal Home Loan Banks did raise the interest rates on their advances by about .5 per cent between June and October 1955, and further increases followed. But the rates were increased at that time to keep them in line with the higher cost of borrowed funds to the banks themselves rather than to

[41] *Report of Special Committee to Study FHLB System; Blueprint for the Future;* and *Program to Revitalize FHLB System.*

[42] Letter of the Chairman of the Federal Home Loan Bank Board to the author, dated June 25, 1958, and memorandum of the Office of Director, Division of FHLB Operations, to the Home Loan Bank Presidents of December 9, 1955, amended in memoranda dated June 14, 1957, and February 28, 1958. According to the letter, the effectiveness of the increase in reserve requirements was demonstrated in 1957. From June 13, 1957 to October 3, 1957, member deposits in the banks decreased by $119 million and advances to members increased by almost $154 million, resulting in a total fund requirement of nearly $273 million. To meet this demand it was necessary to raise borrowings by the banks, in the form of consolidated obligations, by only $93.8 million.

[43] *Mortgage Market Problems,* p. 53 (Exhibit C), and press release of the Federal Home Loan Bank Board of December 13, 1955.

discourage borrowing; the rate adjustments were slow and moderate; and the chairman of the Bank Board expressed lack of faith in the restraining effects of higher interest rates.[44]

General Appraisal

All in all, the foregoing review warrants the conclusion that the selective regulations of housing credit made a moderate and short-lived contribution to the restraint of home building and mortgage lending, together with other forces operating in that direction, which were mainly the limitations of housing demand relative to supply in early 1955 and the tightening of financial markets and restrictive general credit policies later. By the same token, the selective measures can be credited with having had a moderate part in correcting specific maladjustments in the housing and mortgage markets inherited from the previous expansion of residential construction, that is, in helping to avoid general overbuilding and an excessive spread of easy credit terms for home purchase that might have threatened the stability of a large component of the nation's private debt structure.[45]

That the selective credit measures of 1955 made a contribution to economic stability over and above the results obtained from the general policy of credit restraint is best illustrated by specific cases. As was shown, the maximum permissible terms on government-underwritten loans had a "yardstick" effect on the terms which investors in such loans were willing to accept. Without the restriction of these terms, some lenders, even during the period when less funds were available, would probably have continued making a larger volume of no-down-payment or low-down-payment and long-maturity mortgages than they actually did; and they might have been prepared to reduce their liquidity position even further than they actually did in order to accomplish this objective.

In the case of mortgage warehousing transactions, the relatively large profits which attracted commercial banks into this type of lending would probably have caused an even greater and more prolonged expansion if the Federal Reserve Bank of New York had not intervened. Some of the banks engaged in mortgage warehousing had perhaps reached a saturation point in the summer of 1955.[46] But other banks were just becoming alert to the

[44] *Ibid.*, p. 57. The Chairman of the Home Loan Bank Board, in discussing this matter, characterized a .5 per cent increase in the interest rate as "very, very high." Interest rates on advances ranged from 2.25 to 3.5 per cent in June 1955 and from 2.5 to 4 per cent in October (data furnished by the Federal Home Loan Bank Board.)

[45] The evidence of more balanced market conditions developing in late 1955 and thereafter will be discussed in the next chapter.

[46] A representative of the Chase Manhattan Bank testified in October 1955 that his institution had "shut down" its mortgage warehousing business because "we reached the volume of mortgage credits that we felt we could properly and judiciously carry until we had some run offs." (*Investigation of Housing*, p. 108.)

opportunities for profit from multiple fees as well as from the interest charges on warehousing loans and the various kinds of commitments associated with them;[47] the demand by builders and mortgage companies for warehousing credit was pressing; and banks may have been more willing to exchange cash for the highly profitable and often self-liquidating mortgage warehousing loans than for other types of credit.

As for borrowings from the Federal Home Loan Banks, their increase would probably have been greater had it not been for restraining action by the Bank Board, although the form of restraint exercised in the fall of 1955 is subject to question. The savings and loan association is a case *par excellence* of "compartmentalization" in the capital market. This type of institution, being a mortgage lending specialist and having in most instances no established access to credit other than that available from the Home Loan Banks, is much less susceptible to yield differentials on alternative investments, shifting demands in the capital market, and Federal Reserve policies than are other types of lenders. General credit restraint affects the ability of savings and loan associations to borrow only indirectly and to the extent that it influences the capacity of the Home Loan Banks themselves to float obligations, while the cash and short-term security holdings of the banks serve as buffers against any marked impact of such restraint. Thus, restrictions on borrowings from the banks can be expected to have effects over and above those attributable to general Federal Reserve policies.[48]

It seems reasonable to conclude, then, that the selective measures of 1955 helped to reinforce the general policy of restraint, in addition to moderating imbalances in the housing and mortgage markets. To be sure, there were side effects, which weakened the "bite" of the selective regulations. In spite of the restrictions on borrowings from the Federal Home Loan Banks, which affected mainly conventional mortgage lending, and in the face of the general monetary restraints, activity in the conventional mortgage market was about the same in 1956 as in 1955, and the entire drop in total mortgage lending occurred in the government-underwritten sector (Table 2). Similarly, the number of new dwelling units started with conventional loans declined only fractionally between 1955 and 1956, while starts under the

[47] For the connections between mortgage warehousing transactions and mortgage lending commitments, cf. Guttentag, *op. cit.;* Kaplan, *op. cit.;* and Klaman, *The Postwar Residential Mortgage Market,* Chapter 7.

[48] The view that selective controls result merely in shifts in the supply of funds to various sectors of the economy without affecting the aggregate supply fails to take proper account of institutional factors in the mortgage and general capital markets exemplified by these illustrations. For a recent exposition of this view, see Milton Friedman, *"Consumer Credit Control as an Instrument of Stabilization Policy,"* in *Consumer Instalment Credit* (Part II, Vol. 2, Board of Governors, Federal Reserve System, 1957, p. 85). An opposite view is expressed by Guttentag (*op. cit.*).

government programs fell sharply (Table 1). The forces producing these differential movements will be examined later in detail. At this point, it is worth noting that the general credit restraints failed to reduce appreciably conventional mortgage lending. In contrast, the volume of government-underwritten mortgages turned down sharply as they were subjected to selective regulations, although their decline was reinforced during the course of 1956 by the noncompetitive interest rates on these mortgages.

Another side effect, but one that did not impair the effectiveness of the selective restraints on FHA and V.A. loans, was a change in the price mix of new homes. According to sample surveys, the median proposed selling price of new homes increased from $12,300 in 1954 to $13,700 in 1955 and to $14,600 in 1956. This increase exceeded the rise in construction costs and reflected in part the building of houses with more floor area and of better quality.[49] Also, land prices had advanced more than construction costs. But a contributing factor in the changing price mix was the dimmed prospect for successful marketing of lower-priced houses, for the sale of such houses depends largely on the availability of low-down-payment and long-maturity FHA and V.A. mortgage loans, which was reduced, among other things, by the selective regulations.

Finally, there remains the question of the effects of these regulations on the use of national resources. To the (moderate) extent that the selective controls contributed to the decline in residential construction expenditures after mid-1955, it may be said that they tended to restrain the sharply increasing pressures on over-all resources. Alternatively, they may have served to free resources for other uses, especially for nonresidential private and public construction which draws in part on types of materials and labor also employed for residential building and which was expanding rapidly in the latter part of 1955 and in 1956. Quite apart from the matter of social priorities, it has been suggested that this side effect, under the conditions of that period, may have been undesirable for economic reasons because it had an inflationary rather than restraining influence. It has been maintained, for example, that "what was termed deflationary action—holding down mortgage funds—may have freed money for really inflationary effects." [50] The alleged reasons are mainly that: (1) a reduction of new building forces more families to turn to existing homes and bid up their prices; (2) most housing costs are little affected by moderate increases in the volume of home building; and (3) the price of equipment for the expanding business invest-

[49] Kathryn R. Murphy, "Characteristics of New 1-Family Houses, 1954-56," *Construction Review,* April 1957.

[50] Robinson Newcomb, "Federal Expenditures for Housing and Urban Redevelopment," *Federal Expenditure Policy for Economic Growth and Stability,* Joint Economic Committee Print, 85th Congress, 1st Session, November 5, 1957, p. 849.

ment "might not have risen as much and the price of homes might have risen less" if funds had been channeled into residential construction instead of business investment goods.

Apart from the fact that these are presented as possible rather than necessary or proven or even likely consequences, the reasoning seems strained. For one thing, both general and selective credit restraints applied to purchases of existing as well as new homes. Second, there is no evidence that existing homes represented an unusually large proportion of the total sales of homes in 1956, when the 1955 restraints on housing credit were becoming effective.[51] Third, whatever limited price information there is available shows that prices of existing homes increased less than those of new ones, giving no support to the assertion that bidding for older property intensified relative to the supply. The average purchase price of new homes bought with V.A. loans increased by 4.6 per cent between 1954 and 1955 and by 7.3 per cent between 1955 and 1956, as against increases for existing homes of 3.2 and 5.4 per cent, respectively. The average FHA estimated value of new homes bought with FHA loans rose by 10.0 per cent between 1954 and 1955 and by 12.4 per cent between 1955 and 1956, while the value of existing homes in 1955 was the same as in 1954 and the increase from 1955 to 1956 was only 6.1 per cent.[52] Fourth, building materials prices and construction costs were, in fact, quite sensitive to the increase in home building in 1954-1955, as they were in previous periods of residential construction booms, partly because the price of lumber, an important component in home building, is highly responsive to changes in demand. Between January 1954 and July 1955, wholesale building materials prices advanced by 5.1 per cent (Table 12) and lumber prices alone by 8 per cent, while residential construction costs rose by 3.5 per cent (Table 7). These increases occurred in a period when the upsurge in residential building accounted for most of the expansion in total new construction. Land costs advanced even more sharply.[53] Because of changes in efficiency or builders' profit margins, these cost movements do not necessarily represent the movement in final prices to home purchasers. Nevertheless, they indicate severe pressures on resources which the limited

[51] Cf. "Residential Real Estate Markets," *Federal Reserve Bulletin,* April 1957.

[52] For V.A. data, cf. "Financial Characteristics of G.I. Home Loans Closed in 1956," *Construction Review,* November 1957. For FHA data, *10th Annual Report, Housing and Home Finance Agency, 1956,* Table III-38. The value changes were associated in part with changes in the physical characteristics of homes bought during this period. Thus, in the case of new homes bought with FHA loans, the median "calculated" area increased from 961 square feet in 1954 to 1,064 square feet in 1956, and the median number of rooms rose from 5.4 to 5.7. In the case of existing homes, these characteristics remained more stable (*ibid.*). Nevertheless, if bidding for existing homes had substantially intensified relative to supply, one would expect to find a more pronounced increase in their values than the available data indicate.

[53] Cf. footnote 4.

short-term improvements in average efficiency or reductions in profit margins could not be expected to offset.[54]

[54] For an evaluation of the effects of credit policies on the allocation of resources to housing and other sectors, see also Warren L. Smith, "The Impact of Monetary Policy on Residential Construction, 1948-58," *Study of Mortgage Credit.*