Mortgages and The End of The Depression

THE man in the street—the man who never owned a piece of property or knew anything about how real estate transactions are financed,—has been reading a lot recently about the daily stories of bank closings. "Frozen assets" has become a term of trenchant significance to everybody who has a dollar deposited in a bank. It is realized that somehow there is a relationship between these unliquidatable assets and the present business depression, and that their thawing out must be a prerequisite to the return of prosperity. An analysis of the nature of these assets will reveal how cogent this relationship is, and will indicate how natural economic forces are at present operating to right the economic maladjustment.

Nature fights its own battles.

It is the unsalability of the collateral upon which presumably profitable loans were made that causes "frozen" assets. The borrower is unable to pay interest on the loan, and the bank finds no market for the collateral given as security; thus the principal of the loan is impaired. The bank is then in the position where it cannot collect either the interest or the principal, and must continue to carry the loan on its books as an asset with the hope that changing trade conditions will create a demand for the collateral. If the depositors, whose money was loaned, do not demand their money, the bank can continue in this condition of suspended animation.

The question then arises as to whether the collateral will ever, or within a reasonable time, be worth the amount that has been loaned on it. If the banker's judgment of the intrinsic value of the collateral was tinged with a guess as to its future value, then the collectibility of the loan is dependent upon how soon, if ever, his prognosis will prove correct. Therefore, it is the loan upon speculative values that is the plague of bankers and other lenders of money.

Now, of all loans, those made on land values are in the most speculative class. Even a cursory analysis of the methods of financing real estate operations shows that the element of speculation is inherent and hardly divorcible. Since the collateral for such loans is represented by mortgages, we have only to consider how loans are made on these documents to see how expected increases in land values—or unearned increment—must influence the judgment of the lender.

The builder buys a lot for, let us say, ten thousand dollars. That amount may represent the present economic value of the lot; that is, the value that attaches to a piece of land because of the present, not expected, press of population in that particular locality. However, it is only in times of depression that land is sold for its true economic value, and as in such periods very little building is done, very little land is sold. As a general rule the seller anticipates in his price the value that will accrue to the lot b virtue of expected increases in population. The sellin price of a piece of land is really a capitalization of its an nual rental value for a period of approximately twent years, taking into account the increases in this annua rental value due to expected or proposed socially create improvements in the neighborhood, such as a park, street car line, a subway station, a school. In fact th very structure which the builder proposes to put upon th lot he is buying boosts its price, and he is, in a sense, bid ding against himself. It is important to remember, there fore, that the selling price of a lot almost always include its expected future value; and this is speculation. Wha part of the ten thousand dollars which our builder mus pay for his lot represents speculative value depends o the conditions at the time of the sale; the shrewdness the buyer, the exclusive character of the lot, the nee of the seller for cash, and so on. For the purpose of ou inquiry it is sufficient to know that speculative land valu enters into the price paid.

The builder expends twenty thousand dollars for structure on this lot. We shall assume that he borrow for this purpose only fifteen thousand dollars—a sum modest it would interest the most conservative bank giving, of course, a mortgage on both land and buildi as security. To prove our point we are taking the mo ideal case, where the builder invests his own capital to t extent of fifty per cent of his enterprise, which is very ra indeed. But, if we can show that the bank is speculati in this rare case, we shall readily realize how much mo "frozen" are its assets which consist of ordinary real esta mortgages.

It must be borne in mind that while land value m appreciate, building values always depreciate. Al while rising land values increase the borrowing capaci of the owner, lenders are very prone to overlook or mi mize the crumbling character of the other part of the curity. So long as our builder is able to pay the inter on the mortgage, no matter what the source of the mone the banker will not question the quality of the collater To be sure, the fact that the neighborhood has beco more desirable, and that the land has therefore enhanc in value, will enable our builder to either increase his fi mortgage or to place a second, even though the buildi has become dilapidated and antequated. In due time borrowings are mainly or entirely based upon the va of the land, the building having reached the point wh replacement may be more desirable than upkeep. T bank has its money loaned on land values, more or l speculative; the earning capacity of the building, wh should be the only source of payments on the mortga gradually but surely diminishes. When payments the mortgage cease the bank forecloses, and finds it owning a non-income producing lot and an expense-p ducing building. The depositors' money is "froze The original fifteen thousand dollar loan may have b creased to twenty-five thousand—it usually is; the origi-il ten thousand dollar lot may have doubled in value. ill the bank takes a loss, and the only hope of the land-vning bank is to induce another builder to put a revenue-oducing structure on the land. And, as an inducement, e bank increases its first mortgage—again speculating ı the future value of the lot.

So, we see that even in so rare an instance as where the erator invests his own capital to the extent of fifty per nt of the cost of land and improvement, eventually the ortgage loans will be based to a considerable extent on eculative land values. This is due in part to the in-itable wiping out by nature of the value of the improve-ent, but mainly to the bankers' fetish that land is a good vestment. It is true that land is a good investment r those who can hold it for many years, until the increase population creates an actual value equal to or in excess the speculative value originally included in the price; it a bank should not tie up its depositors' money for nerations. It is true that land cannot be destroyed; it land values are always in a state of flux. In every g city cases can be shown where so-called "hundred" r cent" locations have in a few years become less valu-le due to some change in the trend of population; a new tery of travel, an influx of undesirables into an aristo-atic neighborhood, or the mere moving of one big com-rcial institution to another part of the city. Mort-ge loans readily expand with increases in land values, even with expected increases, but do not contract as idily. The security back of every mortgage loan is to me extent a speculative land value.

In the vast majority of real estate transactions, the rtgage loans are very much in excess of the amount vested by the operator, and clever manipulators have en known to finance large building enterprises with nkers' money only. So that at the very inception of real estate transaction the bank is speculating in land lues. At that very moment the "freezing" of bank ets begins.

Speculation in land values during prosperous, or even rmal periods is quite safe, for the very simple reason it industry and labor are dependent for their existence the use of land. The first requirement of a business a place in which to do business. And again, all the ngs the business uses in its operations come from the l. Also, the employees must have homes, food, rai-nt— and Mother Earth provides everything. The re industry flourishes the greater the demand for land, d, therefore, the higher its price. As the price of land es up mortgage money is more easily obtainable.

Every dollar loaned on the value of land is a tax on in-stry, for it is industry that pays the interest on mort-ges. When business is good, when labor is employed, returns are sufficient to bear this burden. As the rden increases, profits and wages decrease. The ninishing return to capital and labor causes both to demand less land to live on, and less of the products of the soil to use. This is exactly what happens during times of depression. When business concerns start to retrench they seek reductions in rents, and their demands are met either by their present landlords or by others who have already lost their tenants. Workers out of jobs move into the homes of relatives who are still able to pay the rent. When wages are reduced the laborer finds it neces-sary to curtail on his food, and the farmer cannot pay the interest on his mortgage.

When these things happen, as they are happening now, a period of deflation of speculative land values sets in. Since secondary mortgages are based upon land values almost entirely, they are the first to go. These mortgages are sometimes beld by banks, but more often by individual investors; but, as it is not uncommon for these mortgages to be hypothecated with banks, it is these "safe" institu-tions that carry as assets on their books many second and third mortgages, as well as firsts. All the money thus advanced is secured by unearned increment only—a very uncertain and evanescent quantity. Land does not pay interest. When bankers learn that only improvements produce revenue, and that these improvements constantly deteriorate in value, they will have learned the first lesson in avoiding "frozen" assets.

Perhaps the most poignant example in recent times of the effect of land speculation by banks was that afforded by the rise and fall of mortgage values in the agricultural states since the World War. For many generations the hope of our wheat farmers had been "Dollar Wheat"—that is, a market price of one dollar per bushel. Along came the war, and the price of wheat was "fixed" at $2.65 by Hoover. The dream had been more than doubled in realization. The farmers were not only elated by the unheard of profits, but they dreamed the dream of all who acquire large amounts of wealth, that of ceasing to be producers and of becoming landlords. Aided and abetted by the bankers they proceeded to the realization of this new dream. For farms which cost them a few dollars per acre, or which they had inherited from forebears who settled on land grants, they found buyers willing to pay hundreds of dollars per acre. Multiply, say, four hun-dred dollars by six hundred and forty (only one section) and you have an amount on which the interest is sufficient to keep a family in luxury in any metropolis in the world. No more work. What a grand and glorious feeling for the man who all his life got up at five in the morning to do his chores. But the war, unfortunately, did not last, and wheat dropped and dropped until it acquired the soubriquet of "two-bit" wheat. At these low prices the purchaser or tenant could not pay the interest on the mortgage made when the land was "sold" at four hundred dollars per acre. The banks foreclosed and became the owners of acreage now worth maybe one tenth of what they had advanced on it. Of course they were insolvent. That's what always happens to banks which speculate too freely in land. And, by the way, it is these insolvent bankers, and the landlords they created, who are clamoring most loudly for "farm relief"—relief from losses due to their wild speculation.

It might be argued that "frozen" assets do not consist of mortgage loans only. Well, what are the other kind of loans that a bank makes? It makes loans on commercial paper—that is, on the promise of a business man to repay when his assets, such as bills receivable and marketable merchandise, are turned into cash. Any one familiar with sound banking methods knows that a loan of this kind is made only upon evidence that the maker of the promisory note is in possession of at least twice as much in liquid assets as the amount of the loan, that he has a thriving business, that such business has a record of achievement and a reasonable promise of continuance, that he is a man of integrity and proven business judgment. How much more secure is the bank in making such a loan than one on speculative land values? In one case the bank is risking its money on a living, vibrant institution, represented by a human being who is dependent for his livelihood and success upon the continuous good-will of the bank; in the other case the bank has for its security an inanimated and evanescent quantity. How many bankrupts have, long after their discharge, paid up old bank loans? A man who intends to stay in business cannot afford to let the bank lose money on him; to him the banker's smile is as manna from heaven. But, who cares when a bank loses on a mortgage loan?

Comparatively little of the "frozen" assets from which banks are now suffering is in the form of commercial paper —and that little is due either to the lack of judgment on the part of the bank, or perhaps the personal interest of the banker in the borrowing company. But, there is another form of investment which is a matter of as great concern as mortgages; upon analysis there will be found a great similarity. It is that very safest of all investments to bankers—the bond. Now, a bond (except a government bond, which is a mortgage on its taxing powers) is in essence only a mortgage on real estate. This fact is very apparent in the case of a railroad bond. As for bonds issued by industrial corporations, these could never be marketed if the corporation did not own some kind of real estate—a building, a mine, an oil well, a right of way. This is attested by the prominence given to these holdings in the prospectuses issued by the corporations when offering the bonds for sale. It is true that a bond is first mortgage on the entire business of the corporation —just as any mortgage is a lien on both the building and the land value. And an industrial bond has an advantage over a mortgage in that there is a more ready market for it; most bonds can be sold at a price at all times. But in times of depression the price is low because the holdings the bond represents have depreciated in value, a fact of which the buyers are well aware. Plant-equipment and inventories are worth what it would cost to replace them at the present market, and public accountants upon who figures financial statements are issued are very caref for their own reputations not to overvaluate these iten But when a corporation needs money, and it does wh it creates a bonded indebtedness, its officers' guess as to t value of its realty holdings is likely to be quite optimist This optimism is the speculative value of its realty, and embodied in the bond. Bonds are low now because tl speculative value is being liquidated.

When a man loses his money in a game of chance, his hoping and wishing cannot recoup his lost fortu To make a "come back" he must go to work; he mu produce new wealth. If he wishes to try his luck aga he may be more successful. But his original money gone forever. And so, speculative values that are bei wiped out now are lost forever. The money that is bei lost now in mortgage loans will never, never come ba This is so because the values upon which these loans w made were non-existent; they were hoped-for values tl would accrue to the land when, or if a growing a industrious population would create them. But the which these very loans imposed upon the industry of population diminished their ability to make use of t land, and lessened thereby their demand for it. He the expected value, as represented by these mortgag never materialized. The loans were made on hope— the hope has vanished. The loans are vanishing. these vanishing assets aggregate more than the ban surplus capital and other assets, failure results.

There is no way out of it. Much is being heard of pl whereby capital might be loaned to banks that pos an abundance of "frozen" assets. This would sim delay the debacle, not prevent it. The ownership of th "frozen" assets would be for a time transferred to government; the thawing is inevitable. It would t large increases in population, and the industry of at le a generation, to create the land values on which th loans were hypothecated. It is doubtful if any plan c templating the tying up of capital for so long a pe is feasible.

Nor is it desirable. The liquidation of land specula is a prerequisite to the resumption of industry. To turn again to fundamentals, labor and capital must h land on which to go to work. Nothing can they do w out this primary source. It becomes evident, there that cheap land (and by the word "land" econom mean all natural resources) is the greatest incentive industry. Perhaps the best omen for the return of p perity is the present liquidation of speculative land va through the wiping out of mortgages. The wiping of mortgages, or that part of them which represent sp lative values only, will bring the rent of land dow where labor and capital will not be burdened with a hibitive exaction of tribute, for the mere privilege of g to work. Since going to work is the cure for, in fact very antithesis of, depression, it is obvious that we ca get out of our present economic doldrums until the process of liquidation shall have been completed.

That this process of liquidation is being rapidly completed is evidenced most forcibly in the case of agricultural lands. There land values have fallen almost, sometimes quite, to the point of extinction. It is not uncommon for foreclosed farms to be sold at a price that does not represent the cost of the improvements; the land is thrown in "to boot." I do not refer to farms in the Dakotas, or in Texas, where the inflation did not reach the ridiculous heights it attained is southern Minnesota or in Iowa. Even in the glorious Hawkeye State, where farms sold during the boom years at over five hundred dollars per acre, sales have been made during the past year at fifty dollars per acre—all improvements, of course, included. Because such prices plainly indicate that they are below the cost of labor values, it is very apparent that site values have dwindled to the point of non-existence. We have "free" land.

There can be no question as to the complete liquidation of farm land inflation. No such "reductio ad absurdum" test can be applied in the case of city lands, because there the presence of a congested population is an ever present economic force that prevents the absolute disappearance of values. But the almost total cessation of real estate transactions in all cities seems to indicate that deflation has been practically completed. For, if real estate transactions are most plentiful on a rising market, and decrease with a falling market, then it follows that a stagnant market indicates a total collapse of values. When good buildings in desirable locations are being sold for less than the cost of reproduction, the differential represents only a shrinkage in the site value. The inflation is gone.

That is the hope for an early revival of business. A study of the conditions preceeding each of our previous economic depressions shows that wages fall first; commodity prices follow; the drop in land values, whether in sale prices or rentals, is last. Wages have fallen to a point where they hardly provide a mere existence for the worker. Commodity prices are below the cost of production. Now we have almost "free" land in our agricultural sections, and in the cities "hundred per cent" locations are being rented to merchants on a percentage of their sales. Thus we have the complete trilogy of declining returns attendant upon our former periods of hard times, and heretofore antecedent to a revival. Unless there are forces in our present collapse that are fundamentally different and more disintegrating than those present in the past, we should now see a gradual rise in wages, commodity prices and, of course, land values. As land values rise inflation will naturally follow, and the groundwork for another periodic depression will be prepared.

FRANK CHODOROV.

THE banker innocent of trying to evade his income tax would be much too innocent to protect his depositors.

False Prophets

IN searching out the cause of our country's course into economic chaos we are indebted to Attorney Selden P. Spencer, of Missouri, and to his speech before the American Bar Association wherein he advises us that:

"It was the American lawyers in the Revolution who, as Governor Colden officially announced, were the 'authors and conductors of the present sedition' and when that 'present sedition' had developed into a free and independent nation, every step of the way of its constant progress has been guided and directed by the American lawyer, active alike in the formation of public opinion and in the enactment and enforcement and interpretation of laws. That position of influence the lawyer has always had in this country.

"In the legislative department, he always has been and probably always will be predominant both in number and in influence.

"In the executive department of government, every President with the exception of three has been either a lawyer or a soldier and of the twenty-seven who have filled that high office, twenty have been lawyers.

"In the judicial department he is supreme, for when the lawyer as advocate and the lawyer as judge has finally submitted and decided questions at issue, no power on earth can change the result and the question at issue may involve any right of the individual, the legality of legislation, the very existence of the government itself. . . . . .

"Such power is given nowhere else in the world to members of our profession as is vested in the American lawyer."

In claiming for the profession of law all credit arising from the nation's ostensibly firm foundation and apparent progress (up to 1928) there is, or should be, naturally included all responsibility for untoward developments.

Attorney Spencer goes on to quote the eminent lawyer, Lawrence Maxwell, of Cincinnati, Dean John H. Wigmore of Chicago, and the distinguished jurist Andrew A. Bruce of North Dakota; one of whom said:

"We are on sure ground in urging the supreme importance of a broad, general education as an essential part of the lawyer's equipment."

Another said: "the modern law school education calls for mature and well-trained students. More emphatic and obvious than this the professional work at the Bar and on the Bench requires well-educated men."

The third, after referring to the "struggles and ideals and the traditions" which have made our institutions, said:

"A man cannot be a real lawyer, he cannot lead in the great social advance, unless he knows and understands these things. I know of no better place to learn them than in the cosmopolitan American college."

From the Bar Association report of 1919 we learn that forty-seven "leading" law schools were then, and have been for many years, annually turning out these thousands of super-trained and ultra-intelligent lawyer-leaders. Despite this dumping of brains onto the commercial and social, or economic, market the industrial crash of 1929 culminated the preceding centuries of body-politic stomach pains—and the crash came without the slightest deference to, or awe for, the "constant progress (which) has been guided and directed by the American lawyer."

If we may consider the Great American Depression