

REGULATION W -- ITS ROLE IN ECONOMIC STABILITY

by

R. M EVANS

Member
Board of Governors
of the Federal Reserve System
Washington, D. C.

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I am very glad to be here today to discuss with you consumer instalment credit. A quarter of a century ago, a member of the Federal Reserve Board would not have been invited to discuss this subject before a meeting of your Association. In fact, your Association would probably not have held a public meeting to discuss instalment credit. In respectable financial circles, consumer instalment credit was regarded as a threat to the American institution of individual thrift and therefore as a taboo subject.

In all likelihood, the total volume of retail and instalment cash loan credit outstanding twenty-five years ago did not greatly exceed a billion and a quarter dollars, and this represented a very rapid growth from the early Twenties. A very creditable and pioneering study of such financing, made in that period under the auspices of your Association, failed to win endorsement for publication. About the same time, too, the supervisory authorities through their bank examiners undertook a spot check of the activities of banks in the field, with the thought that some bankers might be dangerously transgressing the bounds of legitimate banking business, as it was then considered, by encouraging credit spending at the expense of thrift.

I mention these few facts to remind you that, while it is no longer news for the bankers and a Federal Reserve Governor to be discussing the subject together in open meeting, it is still something of a novelty. We have not done it enough since the banks acquired an active interest in consumer credit and since the Board itself came to have some recognized responsibilities for the soundness of credit conditions in the area. I particularly welcome this opportunity, therefore, to be here today to talk about a type of financing that has only, in relatively recent years, become of concern to commercial bankers and to Federal Reserve bankers.

When an economy reaches the stage where it has a surplus of production over immediate survival wants, it employs that surplus in the output of durable goods. In the first instance these goods are more largely producers' items. When development has reached the point where the stock of producers' wealth is reasonably ample, the surplus tends to be composed increasingly of consumers' goods. We can generalize this observation by saying that advance in the standard of living of the people generally finds more and more expression in the possession and enjoyment of durable goods.

From the standpoint of economic welfare, we can all agree that this is a highly desirable trend. But it is not without its costs to the economy at large. Durable goods are capable of a long span of service and users can postpone replacement or purchase for an indefinite

period. In addition, their unit costs are high and instalment credit financing is often required for their purchase. Durable goods demand tends to be unstable because of changing employment and credit conditions or because of the psychological whims of buyers. This instability of durable goods demand transmits itself into general instability. We can accept as a virtual truism that the richer a nation is in its stock of durable goods, the more unstable its economy is likely to be.

These broad observations about the role of durable goods in economic stability are not without their relevance to our subject of discussion this morning. The Congress in the Employment Act of 1946 declared that "it is the continuing policy and responsibility of the Federal Government ... to promote maximum employment, production, and purchasing power." If this policy is to be carried out, we shall have to solve the problem of unstable durable goods demand and output.

Instability in this area, it is true, has not been a problem since before the recent war, but we have been passing through a wholly abnormal period of war and postwar prosperity. We would be very foolish indeed if, on the basis of so exceptional a period, we should discard one of the well-taught lessons of economic history. If we are to make progress towards greater economic stability, we need to keep firmly in mind the sources of instability that have been made plain to us through painful experience.

This problem of unstable durable goods production is of vital importance to all of us. We have attained riches unrivaled by any other civilization the world has ever known. Our vast wealth is more widely shared than has been true of any other economy. We have developed mass production of consumer durable goods and we have invented and developed a financing mechanism -- instalment credit -- for the mass distribution of such goods.

It can be fairly said, I think, that without instalment credit the mass distribution of durable goods would not have been possible. It can also be said in all fairness that, if our mass production economy is to sustain its expansive character, we will need to have concurrent expansion of consumer instalment financing. I mean this, of course, as a long-run trend. The instalment credit problem is one of instability in the short run.

I regard the consumer instalment credit problem in the short run as one of instability because of its relationship to durable goods sales and because that is what the record shows. Instalment credit has reflected wide swings accompanying business fluctuations ever since we have had a fairly good record of its volume. This is not to argue that instalment credit has been the sole or even the major cause of those

swings but merely to assert that it has been an important factor. The use of instalment financing has increased aggregate consumer demand during upswings and decreased aggregate consumer demand during downswings. These immediate effects, largely in the durable goods area, have been accompanied by secondary impacts on total output and employment in the economy. As a net result, unregulated consumer instalment financing has accentuated general economic instability.

One reason why instalment credit has made for instability is the tendency in boom times for sellers to expand their sales by easing down-payment and contract maturities rather than by reducing prices and improving quality and service. This encourages competitors to do the same. This competitive relaxation in credit terms fosters an unsound credit structure in the instalment business as a whole. Lenders eventually become loaned up or over-extended. When they get into this situation under boom conditions because of easy credit terms, it is not healthy for the economy.

Another reason for the unstabilizing effects of instalment credit is that individual consumers are tempted to incur debt beyond their means. Easy credit terms prove far from easy to the consumer who must forego other essential consumption in order to meet the discipline of regular and costly payments. It should be remembered, too, that even a light burden of instalment debt when incomes are at boom levels may be too heavy when a depression comes. Instalment credit is a financing medium for the masses, and at the present time probably one out of every three lower-and-middle income family is indebted for instalment payments. A surfeiting of the market for instalment credit through too easy credit terms cannot fail to have, at some point, far-reaching repercussions on sustained consumer buying of durable and other goods.

When total production in the economy is at or close to its maximum limit, consumer instalment credit is unstabilizing because it contributes to inflationary pressures. This occurs for two reasons. First, a large part of instalment credit is financed directly or indirectly through bank credit. When bank credit expansion adds to an excessive money supply, it feeds inflation because more money, in the form of bank deposits, comes into existence to bid for the same amount of goods. Second, the credit dollars paid for consumer durable goods do not stop circulating when received by producers of those goods. They continue to circulate and become income and money demand for others. Thus, when output is already at maximum levels, expansion of instalment credit cannot call forth more goods. It can only swell demand in relation to supply. This inevitably means rising prices, not only of consumer durables but of other consumer goods as well.

So much for background comment on consumer instalment financing. You are all familiar with the war and early postwar developments

in this field and with the birth, demise, and resurrection -- at least to June 30 -- of Regulation W. I need not remind you that when the previous Regulation W was discontinued by Congressional action, there was a fairly widespread feeling in business circles that postwar conditions of abnormal consumer goods demands had largely run their course, that inflationary pressures had been substantially spent, and that, in any case, instalment credit lenders in their own interest could be counted on to adhere to conservative financing practices. This appraisal of the economic situation proved to be premature. Within a few months after wartime Regulation W expired, inflationary tendencies again became dominant. A vital factor in the inflationary development was the expansion of all forms of credit, including consumer instalment credit. Accompanying these trends there was a marked liberalization of instalment credit standards

In the face of these conditions and the threat of continuing inflation sustained by credit expansion, the Congress, in the special session last summer, enacted legislation to permit the Federal Reserve System to restore Regulation W and also gave the System increased authority over the reserve requirements of member banks. Armed with this authority, the System was able to broaden its program of credit restraint. That program included somewhat higher short-term interest and discount rates, maintenance of high margin requirements on stock trading, reimposition of Regulation W, and higher reserve requirements for member banks. Regulation W as reintroduced was merely one part of a policy of wide scope. This is important to remember because it would be a mistake to regard Regulation W, alone, as a cure-all or a sufficient instrument, by itself, to assure sound credit conditions. Considered in this setting, Regulation W, as reinstated last September, had the following primary and subsidiary purposes: (a) to restrain inflationary credit spending for consumer durable goods; (b) to reduce the threat to future instability of excessive instalment debt; (c) to prevent financial positions of lenders from becoming dangerously over-extended; and (d) to supplement and reinforce a general program of anti-inflation monetary restraint. The regulation was given the same general form that the previous regulation had when it lapsed about a year earlier.

The coverage and terms of the new Regulation W were designed to be restrictive enough gradually to eliminate excessive further expansion in instalment credit. It was not the objective, as had been made clear before Congressional Committees, to force a contraction in outstandings. The Board felt that under the conditions then prevailing, the aim should be to slow up the growth in these outstandings. In adapting the regulation to this end, the Board consulted extensively with the trade, either directly or through the twelve Reserve Banks and their twenty-four branches. Very careful study was given to conditions and practices in the durable goods and instalment financing fields as well as to conditions in the economy generally.

Since the present program of credit restraint was initiated, of which Regulation W is only one part, there has been an over-all abatement in inflationary pressures. The slowing down has been general. It cannot be said to be localized in consumer durable goods lines, although the indications are that some of these lines have been affected. Instalment credit growth has slackened but has by no means ceased.

These are salutary developments. They are in part attributable to general credit policies, including Regulation W, but they are doubtless due also to other economic factors. In any case, it is very desirable to have a more balanced economic condition emerge. Our problem has become somewhat different from what it was last fall. The problem now is to bring about and then maintain a condition of reasonable balance between forces of inflation and forces of deflation, in short, to maintain stability at high levels of economic activity.

As you are all aware, Regulation W has recently been modified to take account of the somewhat changed economic situation, particularly in the credit area affected by the regulation. A regulation of this sort, which applies to one particular type of credit, has the advantage of being selective. It can be tightened or relaxed in accordance with conditions in this credit sector, without necessarily signifying a final judgment as to the broad economic outlook. Accordingly, if it turns out later that instalment credit is again expanding excessively, the terms of the regulation can be made more stringent. Conversely, if economic conditions and the trend in the instalment credit area turn in the opposite direction, the terms can be relaxed.

Credit policies are intended to be flexible methods of contributing to a balanced, stable progress. If changes in policies are found to be desirable to meet altered conditions, it is the responsibility of the credit authorities to make those changes. Necessarily, decisions as to policy changes have to be related to the over-all credit and economic situation. Studies of changing economic conditions are continuously being made by the Reserve System and, through the Reserve Banks and branches, the Board is constantly and closely in touch with shifting currents of activity in commerce, industry, and agriculture.

We are always glad to have the benefit of discussions with those affected by the Regulation. We hope that you will always feel free to consult with us either personally or through your Associations' representatives. Federal Reserve officials are genuinely appreciative of the cooperation and help we have had from your Association and its officers in connection with Regulation W and also, of course, in connection with other matters of mutual concern.

In concluding my comments to you on Regulation W, I should like to emphasize the fact that it is not the explicit purpose of Regulation W to protect anyone who gives or receives consumer credit or to regulate competitive trade practices. At the same time, the Regulation does have certain desirable by-products. Their tangible effects are fewer credit losses for business, fewer cases of family distress because of excessive or improvident consumer indebtedness, and credit competition that accords with sound credit standards.

There is the philosophy of rugged individualism which holds that it is not the business of Government to protect businesses or individuals against their own folly. There is also a contrasting philosophy that regulation which helps to bring about greater economic stability is entirely consistent with democratic and capitalistic institutions and with the objective of the greatest good for the greatest number. Such regulation should, of course, impose a minimum of governmental interference. I am for such regulation -- not for regimentation.

We should recognize that instalment credit -- carried to undesirable extremes -- can endanger our economy and our social system. "Credit" is merely a more palatable name for "debt."

Mr. John J. Schumann, Jr., president of one of the large sales financing companies, spoke with profound wisdom when he stated in 1947, (I quote):

"'Easy' credit terms are not easy. They are expensive. Every instalment buyer or borrower should understand that simple basic fact. As we have pointed out repeatedly in the past: the cheapest way to buy a car is to pay with one's own cash. The next cheapest way is to pay down as much as possible and pay off the balance as soon as possible. The most expensive way is to pay down as little as possible and string out the balance as long as possible. The sound way to buy a car on time payments is to buy it on the most conservative terms one can comfortably afford.

"A person who buys more credit than he needs is simply throwing money away. A person who contracts to pay beyond that which he can comfortably afford is begging for trouble and will probably get it."

Excessive debt means living beyond our means. The individual whose future income is heavily mortgaged loses that spirit of self-reliance which we all recognize as the backbone of our nation. Instead of the satisfaction and confidence that come with building up a nest-egg of savings, he has the misery of trying to keep his head above an

engulfing ocean of debt. If he loses his job or has sickness in his family, he is without resources. Having already used up his borrowing power, he has no place to turn -- no place save one: his Government. Multiply that by several million people and you have an appalling problem on your hands.

You may say that he should not have overcommitted himself, that he should work out his own salvation. True. But we may as well frankly face the fact of what very probably will happen. Since society encouraged the misuse of instalment credit, society -- acting through Government -- will find itself trying to salvage the situation. We saw something of mortgage moratoriums and Government intervention in the 1930's. But with millions overextended in instalment credit, the 1930 experience could be mild by comparison. That would not be a pleasant prospect.

Please do not misunderstand me. I am not an alarmist. I am not criticizing the reasonable use of instalment credit. But when we are calmly considering the subject together I think we should realize where the mass abuse of instalment credit can lead. Those who oppose moderate restraints on consumer credit, as represented by Regulation W, would do well to consider carefully the responsibility or risk they may be assuming. Regulated credit is far better, to my mind, than socialized credit.

The Federal Reserve Board of Governors, as you know, has concluded that reasonable regulation of consumer instalment credit on a continuing basis will make for sounder credit conditions and for greater economic stability. We have made this recommendation to the Congress, with the President's endorsement, only after extended experience and study. We would prefer, as you would, to have no regulation of instalment credit terms. Certainly, we do not seek responsibility for the regulation -- it is at best an onerous task. We believe, however, that the economic record in support of Regulation W, flexibly administered for the purpose of preventing excessive expansion or excessive contraction of instalment credit, is clear.

The Reserve Board is under no illusions as to the potency of Regulation W in contributing to economic stability. By itself, it is not and cannot be a panacea, a guarantee of economic stability. For that matter, it does not have sufficient impact either to prevent a boom or to prevent a bust. But it is unquestionably a useful tool, supplementary to reserve requirements and other available instruments, to influence credit conditions in the interest of economic stability. In recommending legislation to continue Regulation W, the Board has tried to put the legislative issue in this light.