Mr. Eccles

CONFIDENTIAL

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

MEMORANDUM

January 11, 1949

To: Informal Group Selected to Consider Questions Relating to Regulation W

Subject: Policy Change in Regulation W

From: Mr. Thomas, Mr. Leonard, and Mr. Young

The attached staff report analyses recent tendencies in the general economic situation (Part I) and specific tendencies in the instalment credit and consumer durable goods sector (Part II). The main conclusions of the report and their implications for Regulation W are presented below.

Background Comment.

Since the end of the war, effective demand on the part of business, consumers, and Government has been so strong as to result not only in practically full employment but also in sharply rising prices. This broad inflationary movement, however, has not been continuous. On several occasions it has appeared that inflationary pressures were waning and that the immediate business outlook was one of general price weakness and rising unemployment. Such evaluations were being made, for example, in the spring of 1947 and again in the first quarter of 1948. Each of these periods was ended, however, by a renewal of the inflationary spiral. The past few months again have witnessed an abatement of inflationary pressures and again there is a fairly widespread belief that some downward readjustment is under way, although some of the underlying forces of inflation continue.

General Economic Outlook.

Taking into account recent indications of developing weakness in the business situation, underlying factors of continuing economic strength and such new factors as changes in Federal expenditures and tax programs, bargaining for a fourth round of wage increases, adjustments required in business inventory positions, and expanded reliance on farm support prices, the following expectations and possibilities seem reasonable:

(1) A renewal of increases on a broad front in wholesale prices and in the cost of living during the next six months is highly unlikely.

(2) In view of the underlying factors of strength in the economy, substantial deflation and recession also appear unlikely. In other words, prospects still are good for sustained high levels of employment with average prices stable or perhaps declining somewhat as piecemeal adjustments continue to be made. In some lines, moderate reductions in production and employment along with significant price declines are likely, but these should be largely offset by expanding production and employment and rising prices in other areas, thus leaving levels of activity much the same as at present. This expectation is tentative and subject to revaluation both because of the recency of the change of trends and the relatively small magnitudes of the changes involved.

(3) The expansive forces contributing to the growth of inflation during the past three years now may be so nearly expended that a cumulative downturn might supplant, sometime this year, the condition of piecemeal adjustment which we have had for the past three years.

(4) With the economy generally as delicately balanced as it now appears to be, the outlook beyond the middle of the year is especially clouded. Changes in Government policies in the domestic and international fields, as yet unknown, may well exert a decisive influence on the course of economic activity. Substantial enlargement of the defense or foreign aid programs could provide the stimulus for a renewal of the inflationary spiral.

Refunds on National Service Life Insurance, scheduled for fall, will undoubtedly strengthen consumer demand. An unfavorable crop this summer might also strengthen inflationary pressures. The money supply and total volume of liquid assets are still large in relation to the economy's needs and the ownership distribution of holdings is still broad.

(5) In the absence of important changes in Government policies in fiscal and other areas, the likely alternatives for the short-run future ahead appear to be: (a) relative general stability with further piecemeal adjustment in prices, output, and employment, or (b) general prosperity with little change in, or slowly falling, prices, accompanied by a gradual increase in credit and accumulation of durable goods, which might eventually turn into a speculative expansion and ultimately a marked recession (as in the 1920's), or (c) a recession, beginning sometime this year, brought on by the wearing out of the postwar boom in domestic capital investment, consumer durables, net exports, and the accumulation of maladjustments in prices, incomes, and investments.

Specific Tendencies in Instalment Credit and Consumer Durable Goods

(1) A noticeable slackening has taken place in the rate of growth of consumer instalment credit, especially since the reimposition of Regulation W, reflecting in part reduced volume of new credit and in part acceleration of repayments. The slowing down in volume of instalment credit has characterized each major segment of the instalment business -- automobile, other retail, and cash loans.

(2) At the end of the year, total instalment credit outstandings exceeded 8 billion dollars, nearly a third more than a year earlier, and about one-quarter more than the prewar peak. Total consumer credit amounted to nearly 16 billion dollars, or one-third more than the prewar record and one-seventh above a year ago. Throughout the postwar period there has been a tendency in all categories of consumer durable retailing towards a rising proportion of time payment to total sales, and this tendency was further continued in 1948.

(3) Available evidence suggests that in the major sector of instalment credit -- new passenger car financing, Regulation W has had the direct effect of increasing average downpayments from 47 to 49 per cent and decreasing average maturities from 20 to 16 months. Average monthly payments have apparently increased from 73 to 89 dollars. Differences in these effects appear, of course, among the various car-price classes.

(4) Another impact in the automobile field, attributable in some part to Regulation W, has been a sharp decline in the prices of used cars, particularly prices of recent models. Premium prices are still obtainable on many "used" new cars, especially in lower price brackets.

(5) Retail sales of consumer durables, particularly of household appliances and used cars, exhibited a marked weakening in the fourth quarter of 1948, and total retail sales showed distinct signs of leveling off. Levels of dollar sales, however, are substantially above prewar years. With respect to all categories of durable goods, dealers appear to face a problem of maintaining sales volume at prevailing prices for the first time since the war.

(6) Factory production of most consumer durable goods has continued at high levels, but with recent flagging sales, there has probably been some inventory accumulation at wholesale and retail levels. In 1948 output of a few household lines was moderately below 1947.

(7) Employment in consumer durable goods industries has also continued at high levels, but there are currently more frequent reports of temporary lay-offs, actual or prospective. Generalization of recent tendencies is difficult because of varying seasonal and other production conditions in the several industries.

(8) Equity positions in the sales finance business were under strain prior to Regulation W and subsequent developments have brought only slight, if any, improvement in financial positions. Partly under pressure of limited funds, some sales finance companies have apparently been placing greater emphasis on automobile financing, causing dealers in appliance lines to rely more heavily upon their own resources and on bank financing. Furniture dealers continue to rely on their resources supplemented by bank financing. Reports indicate that sales finance companies are especially concerned about the volume of funds they have tied up in dealer stocks, and are tending to limit the volume of "wholesale" paper they are willing to handle for individual dealers. Such policy "rationing" of dealer financing has an immediate impact on factory sales, output, and employment.

Alternative Policy Actions.

In view of the uncertain general economic situation and outlook, together with recent tendencies in the instalment credit and consumer durable goods area, consideration might be given to three alternative courses of Regulation W policy.

(1) No change in policy at this time. The case in favor of this course may be found in the continuing full-employment position of the economy, the existing high production and consumption levels in the consumer durable goods sector, the generally strained position of the instalment financing business, continued expansion in the already record levels of total consumer indebtedness, and the uncertainty as to the meaning of the scattered weaknesses which have appeared. Such a policy course would be consistent with apprehension over the excessively high prices currently prevailing and the dangers of further inflationary developments expressed in the President's State of the Union Message and Economic Report, and also with the President's legislative program for economic stabilization.

(2) A policy of limited relaxation. The competitive and highly fluid character of consumer credit and the need for maximum simplicity in regulating day-to-day operations of many sellers and lenders makes it difficult to single out narrow segments of the Regulation W field for tightening or relaxation. With further careful study, it might be possible, however, to work out for new cars and higher priced used automobiles (the area most subject to criticism at the moment) some limited relaxation in maturities where unpaid balances exceed $1,000. Such a relaxation, which might be from 18 months to 24 months, would not necessarily require a change in other maturities. (The longer maturities might, perhaps, be permitted only in those cases where the downpayment is 40 per cent instead of 33 1/3 per cent.) Another possible relaxation, suggested by recent weakening in sales and instalment credit tendencies for Group B articles, would be a reduction in downpayment requirements for these articles from 20 per cent to, say, 15 per cent. This relaxation would

present no administrative difficulties. In view of the President's messages and legislative program, a limited relaxation of Regulation W along these lines might be difficult to justify at this time in terms of anti-inflation objectives. It is conceivable, however, that such a limited relaxation to be effective for a predetermined short time might be justified on seasonal grounds without conflicting with anti-inflation objectives.

(3) A general easing of the Regulation. This course of policy might be argued on the theory that, with recent tapering off of inflationary tendencies, the restraint imposed by Regulation W has largely served its purposes. This argument assumes that, with some softening in the situation, effects of the Regulation are to make for further weakness and further contends that, with at least some possibility of moderate downturn which might become a cumulative recession, easing of the Regulation should be prompt and vigorous. It would be implied that, if later developments showed a recovery of strength, the terms could again be tightened. However, such a course of policy would seem to be premature in view of the possibilities that: (a) recent softness in automobile retailing may reflect more seasonal and model change-over influences than sharply reduced demand; (b) weakness in the economic situation may not become much more serious than already shown; and (c) underlying strength and possible optimistic developments could easily convert scattered weakness into general strength with inflationary features. The policy would also run counter to positions on the economic situation already taken by the Administration.

Concluding Comment.

Although prospective economic tendencies are highly uncertain, there is probably not enough indication in recent weaknesses in the consumer durable goods field and in the economy generally to justify the third alternative course of policy. The first alternative would appear to have the strongest support in current and prospective economic tendencies. A case might be made, however, for the second alternative, but exact specifications for a limited relaxation would have to be worked out carefully in order to avoid unduly complicating the Regulation.

Business and consumption tendencies will need to be watched carefully during the next few months, and if signs of downturn multiply, the question of a comprehensive relaxation of Regulation W terms will need to be reviewed.

Attachments