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CONFIDENTIAL FEDERAL RESERVE MATERIAL

ON REGULATION W

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REGULATION W

The Board's primary concern--not only in its administration of Regulation W, but in the discharge of all its responsibilities--is to promote high and stable production and employment, and at the same time to preserve the soundness of our money. Long before the outbreak of hostilities in Korea, you will recall that the Board clearly indicated its grave concern over the inflationary forces which were on the move throughout the economy. The unprecedented expansion of private credit in practically every form during 1950 was feeding these forces. Even with national income at record levels, purchasing power was being supplemented with credit dollars.

The result was more intensive bidding for nearly every type of commodity. Prices went higher and higher. General Marshall's recent testimony before the Senate Banking and Currency Committee provided dramatic evidence of the devastating effect of the inflationary process in 1950 on the defense procurement program. This inflation in 1950 was primarily a private credit inflation. I am sure this group understands that in dealing with the problem of credit inflation the Board of Governors must consider not only developments in markets for articles subject to Regulation W but also credit conditions in the economy as a whole.

I

During the recent hearings before the Senate and House Banking and Currency Committees a number of charges were made against Regulation W. Perhaps the most serious charge was that it discriminates

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against low-income groups by making it impossible for them to buy cars, particularly new cars. The person with a low income is always at a disadvantage when he competes in the market place with those who have more money. Unfortunately, the impression is often created that there is something magic about instalment credit which adds to or stretches one's income. Of course, nothing could be further from the truth. The use of credit in itself costs money and the longer the period for which the credit is used, the more it costs.

The validity of this charge of discrimination should be weighed in the light of two facts: first, persons in the low income brackets usually buy used cars; and second, the buyer of a used car in the present market and under present terms, in the large majority of cases, is in a better position than he was in the market which existed before the regulation was reimposed.

On the first of these points, data from the Board of Governor's annual Survey of Consumer Finances show that three-fourths of all persons with incomes of less than $5,000 who bought a car during 1950 bought a used car. Statistics for those with incomes of less than $2,000 are even more conclusive--only about 1 in 10 bought a new car, and the rest bought used cars. Essentially, then, when we are talking about the low and middle income groups, we are talking about people who customarily buy used cars.

Another significant fact was developed from the Consumer Finances Survey on this question of discrimination against the lower income groups. Those with incomes of under $2,000 in 1950 were found

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to have accounted for twice as large a proportion of total automobile sales in the fourth quarter when Regulation W was in effect as they did in the first six months of the year.

What has happened in the market for used cars since last August? Prices of used cars have dropped substantially since the regulation was reissued on September 16. Some used car prices have dropped from $100 to $200 below the ceiling prices established at the levels prevailing in January during the height of the second Korean-stimulated buying wave.

It is not unreasonable to assume that if the terms for used cars were relaxed prices of used cars would rise again and might very well press against the ceiling levels established under OPS regulations. From the point of view of the consumer, an increase of as much as $100 in the average price of used cars would offset the apparent benefit of the longer maturity provision in reducing monthly payments.

To measure consumer reaction to Regulation W University of Michigan interviewers asked people contacted during the Consumer Finances Survey in January and February how they felt about the Government regulation that controls instalment credit.

To get a meaningful answer to this question, it was first necessary to find out what proportion of the population had heard of the regulation and knew something about how it worked. Roughly 60 per cent of all those contacted were sufficiently familiar with the regulation to describe one or more of its essential features--an unusually high ratio of public awareness. Of this group, about 8 in

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every 10 persons thought the regulation was a good thing; about 1 in every 10 was opposed to the idea of the regulation and about 1 in every 10 took a neutral stand neither favoring nor objecting to it. Even among those with incomes of less than $2,000--the alleged victims of this so-called discriminatory regulation--approximately 78 per cent of those families who were familiar with the regulation approved it in principle.

II

Another charge is that the reduction of $364 million in consumer instalment credit from the end of September to the end of March has been more than offset by a rise of some $400 million in wholesale credit to carry inventories. While the Board of Governors has no quarrel with the statistics used it does question the conclusion drawn.

The Board of Governors estimates that in the absence of Regulation W the total amount of consumer instalment credit would have reached 15 billion dollars by the end of March. The fact that the balance outstanding on that date was only 13 billion dollars means according to our estimate that the regulation has accomplished a reduction of 2 billion dollars. Thus, the inventory credits of some 400 million dollars are but a fraction of the consumer instalment credit they are supposed to be offsetting. Absence of the regulation would have added this 2 billion dollars to consumer purchasing power.

Absence of the regulation would have had another significant effect which in turn would have reacted on the volume of inventory credit. I refer to the effect which 2 billion dollars of additional

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credit would have had on prices of cars to consumers and on inventory values. Fewer cars might have been retained in inventory but each one would have carried a higher inventory value. It is at least possible that an increase in inventory credit would have eventuated in the absence of the regulation and that this increase would have represented fewer cars in dealers inventory at higher prices.

Some of the recent increase in dealers' inventories of new and used cars should be regarded as a healthy development, because stocks were abnormally low in the Spring and Summer of last year, especially following the post-Korean buying wave. The new car buyer is certainly in a more favorable buying position at the present time than he has been at any time during the past year—especially if he may have a preference for a particular make or model and is not desirous of buying an elaborate assortment of accessories and extra equipment.

III

Instalment credit is often represented as such a small proportion of national income that it is of relatively little importance in the problem of inflation. This comparison--outstanding instalment credit to consumer disposable income is not pertinent to the question of dealing with the inflationary impact of rising volume of instalment credit. The problem of inflation as it relates to consumer instalment credit is centered in the <u>expansion</u> of purchasing power which results from an excessive increase in such credit.

For example, consumer disposable income in the third quarter of 1950 was $1.4 billion greater than in the second quarter. During the

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third quarter, consumer instalment credit outstanding expanded $1.2 billion. Thus, instalment credit added to the purchasing power of consumer--to the demand for goods--an amount almost as great as the entire increase in disposable income. Regulation W was adopted to curb this substantial addition to inflationary pressures by limiting the expansion of consumer purchasing power in the form of credit dollars.

The rise in instalment credit during 1950 was equal to more than a third of the increase in privately held money supply in that year. It was roughly 40 per cent as large as the total of new corporate security issues. The $2.6 billion rise in this type of credit is in contrast to a small but significant cash surplus or net deflationary effect so far as the operations of the Federal Government were concerned. While these comparisons do not provide a systematic measure of the inflationary pressures arising from the expansion of instalment credit in 1950, they do indicate that it was an important inflationary force at work in the economy, and not an insignificant one.

It seems a little incongruous to talk as some witnesses before the Banking and Currency Committees did on the one hand about the automobile and other durable goods industries as major segments of our economy and then on the other hand to say that Regulation W is essentially a tail-wagging-the-dog approach. The Board of Governors has steadfastly maintained that the regulation of consumer instalment credit is a supplemental instrument of credit regulation. The Board has adhered to the same position with respect to Regulations U and T and X. Furthermore, the Board has consistently held that these regulations

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were not intended to carry the entire burden in our present fight against inflation. It has stressed the importance of general credit controls at every opportunity. The significant results to date lend strong support to the view that these regulations and the general credit controls are working effectively to limit inflationary tendencies.

IV

Considerable emphasis was placed on a claim that Regulation W is forcing people to retain their prewar cars thereby endangering their lives and the lives of others because these old cars constitute an increasingly serious menace to traffic safety. In the first place, the position of the car buyer today is considerably improved over what it was before the regulation was reimposed last Fall. Secondly, according to estimates of the Automotive Safety Foundation, in roughly 9 of every 10 accidents the cause is due to some failure of the driver rather than any mechanical failure of the car. Speeding, reckless, drunken driving--the principal marauders of the highways--are all traceable to the man behind the wheel and not to the age of the car he is driving. Even where a mechanical failure is the principal cause of an accident, in the great majority of cases this is the result of improper maintenance and can not be blamed on the age of the car.

From a study of traffic accident statistics one may seriously question whether old or new cars are the worse traffic menace. According to figures of the Metropolitan Police Department, two of every three cars involved in traffic accidents in the District of Columbia are postwar cars although the total number of registrations of postwar

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and prewar cars in the District is about equal.

V

The final point on which I want to comment is the contention that the field of consumer instalment credit is bearing more than its share of anti-inflationary controls. As you know, the Board of Governors has by no means confined its anti-inflationary efforts to the field of consumer instalment credit. Probably some of the real estate interests and home builders feel that we have gone further with Regulation X to cut back the extensions of real estate credit than we have in the consumer instalment credit field. Likewise, some of those who have been adversely affected by results of changes in the Board's policy regarding open market operations feel they are being hit unduly hard. Banks who have been required to keep higher reserves feel the pinch in the form of reduced earnings.

In conclusion, the Board of Governors has felt that the magnitude of the problem with which we have had to deal has required drastic across-the-board action. It would be unrealistic to think we could stop the inflationary spiral underway during most of 1950 without some unpopular effect. We must come back to the fact that the consumer dollar is buying more in the automobile and durable goods field today than it would have bought without the imposition of consumer credit controls.

The Board of Governors believes that the regulation should be administered flexibly--that it should be relaxed when economic conditions warrant and tightened as such conditions may require. The question of

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when to make such changes is essentially a matter of judgment in which honest men may reasonably differ. The difficult problem we face is to sift the evidence to determine whether the underlying facts justify relaxation of the regulation.

The Board, in a recent analysis of the consumer durable goods field found a general softening of consumer goods markets. Such a weakening or softening, the Board regards as evidence that the anti-inflationary program is in part accomplishing its purpose. Relaxing the requirements of the regulation at this time would be moving in the opposite direction and encouraging a resumption of inflationary tendencies.

Up to the present moment the Board of Governors has not felt that the situation, considered in the light of the most reasonable assumptions with respect to overall developments during the coming months, justifies relaxation of the regulation.

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