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CONFIDENTIAL

REPORT OF THE 4-MEMBER COMMITTEE APPOINTED FEBRUARY 26, 1951

Introduction

The President's memorandum of February 26, 1951 to the Secretary of the Treasury, the Chairman of the Board of Governors of the Federal Reserve System, the Director of Defense Mobilization, and the Chairman of the Council of Economic Advisers stated: "I am requesting the Secretary of the Treasury, the Chairman of the Federal Reserve Board, the Director of Defense Mobilization, and the Chairman of the Council of Economic Advisers to study ways and means to provide the necessary restraint on private credit expansion and at the same time to make it possible to maintain stability in the market for Government securities."

The present problem of restraining the expansion of credit must be attacked under conditions differing vastly from those of any other inflationary period in the Nation's history. To a large degree the problem is fashioned by the continuing influence of the tremendous accumulation of public debt during World War II, and by the imminent task not only of refunding the large portion of that debt which matures in the near future but also of undertaking new financing. Conditions in the market for Government securities become, therefore, a compelling consideration. Within this framework, nonetheless, restraints must be exerted on overall credit expansion, particularly for nondefense purposes, in order to keep combined Government and private demands within the bounds of available supplies of goods and services and yet not interfere with the maximum

possible expansion of output in vital lines.

We submit to you in the present report (I) a brief review of current problems of credit control, as they have emerged in the postwar period and as we face them in connection with the national defense effort; (II) a review of the accomplishments in these fields since your memorandum of February 26; (III) a summary of credit controls available under permanent, expiring, and proposed legislation; and (IV) our conclusions and recommendations with respect to further needed actions.

I. Current Problems of Credit Control

During World War II, because of the large Government deficits, banks and other financial institutions and many other investors bought large quantities of Government securities. In the postwar period, Federal Reserve use of traditional instruments to restrain credit was conditioned by the objective of maintaining a market for these securities without a substantial and general increase in interest rates. This latter objective limited the effective use of open market operations for purposes of counteracting inflation. The possible restrictive effect of increases in reserve requirements was also limited by the large holdings of Government securities by banks and other institutions.

General credit control again became a matter of national concern when new inflationary pressures developed after the initiation of the expanded defense program. Various measures were adopted by the Federal Reserve and other Government agencies in this period to restrain credit

expansion. Nevertheless, the needs of public debt management, the large available supply of liquid assets, and the increased accent upon full employment and production, continued to limit the Federal Reserve System's pursuit of a more effective policy of credit limitation.

The period since the outbreak in Korea has been characterized by anticipation on the part of consumers and business concerns of the effects of the expanded national security program. This anticipatory buying was financed in a variety of ways. Credit expansion was one of the available means which financed the enhanced demand, and the support policy was one of the factors which facilitated credit expansion. Commercial banks and other financial institutions were in a favorable position to extend credit, since they could always sell Government securities and the Federal Reserve System stood ready to make purchases whenever other investors were not ready to buy at prevailing prices. While any feasible Federal Reserve policy could not have prevented individuals and business concerns from financing their purchases, a stronger policy of credit restraint could have made it more difficult and would have reduced the total amount. Part of the credit extended, of course, was necessary, and as a result the American economy today is better stocked and better tooled for tackling a large defense production program than it was at the time of the Korean outbreak.

The fact that some credit extension serves a highly useful purpose in the defense effort, while other is less useful or even harmful under present circumstances, makes it desirable to use credit controls as selectively as possible. While selective credit controls, such as

consumer credit, real estate credit, and credit for securities markets, have a continued usefulness in the mobilization period, general credit curtailment, or a general rise in interest rates, does not have so selective an impact in relation to defense priorities. General credit control is, however, essential to reinforce the effectiveness of the voluntary and other efforts of restraint. The objective of a discriminating credit policy is further aided by Government agencies through loan guarantees, tax amortization, and direct financial aid to defense-related activities. Supplemented by such programs, general credit controls are an effective instrument in the program of mobilization and stabilization. They must, of course, be reconciled with the Government's requirements for refunding and new financing.

Credit policy will be modified in character and intensity as the mobilization effort passes through various stages. We are now shifting from the preparatory to the production phase of the defense effort. In the preparatory stage, private credit expanded while Government budgets showed a surplus. Expenditures for the defense programs have now commenced to increase substantially and as long as these expenditures are not financed on a pay-as-we-go basis the Treasury will be faced with the need for deficit financing in addition to large refunding operations. There is at the same time no certainty that private demand for investment and credit will subside. At the peak of defense production direct controls of materials may curtail private credit demands. But physical controls are still in the development stage and their full effect cannot be foreseen. We are facing therefore a period in which we have to deal with both the problem of federal financing and the need for controlling private credit expansion.

The large existing inventories and the fluctuations in the public's appraisal of the seriousness of the international situation may create a temporary relaxation in the demand for credit. Such a relaxation, however, may be of short duration only, and the slightest darkening of international relations may set in motion another wave of buying.

Even if requirements of national security should remain high for a considerable time, we hope that an increase in total output may, after a few years, permit a relaxation or modification of physical controls. We would then enter another stage, still fully within the period of mobilization, during which some expansion in the production of consumer goods and in private investment might lead to a renewed growth in demand for private credit. In that event, our chief reliance must be on fiscal, monetary, and credit policy.

II - ACCOMPLISHMENTS

There has been a substantial record of accomplishment since the President appointed this Committee on February 26, 1951.

On March 4, the Treasury and the Federal Reserve System announced that they had reached "full accord with respect to debt-management and policies to be pursued which would affect the successful financing of the Government's requirements and, at the same time, would minimize monetization of the public debt".

On March 4, the Treasury announced the offering of a new investment series of 2-3/4 percent long-term non-marketable bonds in exchange for the outstanding 2-1/2 percent marketable bonds of June 15 and December 15, 1967-72. Subsequently, during the time allowed investors for the exchange, more than 13.5 billion dollars of the outstanding amount of 19.7 billion dollars of 2-1/2 percent marketables were offered in exchange for the new non-marketable. Of the total exchange, 5.6 billion dollars were owned by the Federal Reserve Banks and Government investment accounts, and of these approximately 20 percent was acquired in the few weeks prior to the Treasury's announcement and during the period in which exchange was permitted.

Since March 5, prices of outstanding Government securities have been permitted to decline, a number of the issues falling below par. An important result of this action has been the effect in the markets for mortgages and new capital issues.

It is still too early to appraise conclusively the effectiveness of this measure. It may be noted that, beginning in April, the rate of expansion in bank loans began to slacken. But this change may also reflect seasonal factors in the demand for credit, the softening of consumer demand that became apparent in that month, and voluntary credit restraints then undertaken, as well as the decline of security prices. It appears that new commitments by insurance companies and savings banks to purchase mortgages have been reduced. Some plans for new securities to be issued have been withdrawn or postponed and others have had to be revised, although the total volume of new issues has continued very large. The new tone in the market may have an important effect upon many new offerings that were, or might otherwise have been, contemplated.

4. On March 9, a Program for Voluntary Credit Restraint was instituted by the Board of Governors of the Federal Reserve System, pursuant to Section 708 of the Defense Production Act of 1950, after consultation with the Office of the Attorney General and with the Federal Trade Commission. This program is now in full operation and includes major financial institutions throughout the nation. The program has set up a national committee as well as regional committees covering all sections of the country.

The national committee has issued three bulletins, the first dealing with means of restraining inventory financing, the second with the principles to be followed in financing capital expansion programs and the third with State and local government financing.

These bulletins, together with the Statement of Principles of the Program, have been distributed to all financing institutions participating in the Program to provide a common guide for combatting inflationary loan expansion in their respective fields. Other bulletins, as may be appropriate and helpful, will be issued from time to time. Meanwhile financing institutions are requesting the regional committees for opinions as to the desirability under present conditions of loans in debitable classes. These opinions are being relayed to all committees to insure uniform policy nationwide.

While there has not yet been time to build up a body of statistical information to enable the Committee to analyze thoroughly the effects of the Program, there are indications that the initiation of the Program has had a salutary effect on the trend of credit.

Endorsements of the Program and pledges of wholehearted cooperation have been received from many representative industry groups. Under these circumstances, those connected with the Program are most encouraged, and it is the Committee's view that the authorization for this unique cooperative effort as one means of restraining the further expansion of private credit should be continued.

On March 12, the Director of Defense Mobilization appointed five task forces from among the personnel of the Treasury, Board of Governors of the Federal Reserve System, the Council of Economic Advisers, and the Office of Defense Mobilization to implement the joint studies of these agencies undertaken in response to the President's memorandum.

On March 23, the Director of Defense Mobilization wrote the Secretary of Commerce, referring to the President's memorandum of February 26, 1951, and suggested that the Business Advisory Council of the Department of Commerce undertake a program to complement the Voluntary Credit Restraint Program. The implication of the letter was that efforts of lending institutions to limit credit expansion would be more effective if borrowers exercised restraint in their requests for financing. As a result, the Business Advisory Council has undertaken a continuing nationwide program to bring to the attention of lenders and borrowers the fact that the success of the Voluntary Credit Restraint Program rests equally on both of them.

On May 7, the Director of Defense Mobilization wrote the Governors of all States, the Mayors of all major cities and financial officers of principal counties and other political subdivisions. He requested that all State and municipal projects, which necessitated borrowing and which were postponable, be postponed. In particular, he asked that every proposed borrowing by a State or municipality of \$1 million or over, before being consummated, receive the approval of one of the regional committees appointed under the Voluntary Credit Restraint Program.

III - CREDIT CONTROLS AVAILABLE UNDER PERMANENT
LEGISLATION, EXPIRING LEGISLATION AND PROPOSED LEGISLATION

The following summary indicates the more important actions for credit restraint that can be taken under existing legislation, that can be employed if expiring legislation (notably the Defense Production Act of 1950) is extended, and that could be initiated if new legislation were passed in conformance with the recommendation made by the Committee. Such a classification clarifies the problem and indicates the responsibilities of the several branches and agencies of the Government in implementing a program designed to achieve credit restraint and stability in the market for Government securities.

1. Permanent Legislation

- (a) The Federal Reserve System has power to change rediscount rates.
- (b) The Open Market Committee of the Federal Reserve System has the authority to conduct open-market operations in Government securities and such transactions can be undertaken with a view to stabilizing the market for such securities and tightening or relaxing credit conditions.
- (c) Existing legislation would permit the Board of Governors of the Federal Reserve System to raise reserve requirements of central reserve city banks very slightly above existing levels.
- (d) Under existing legislation the Board of Governors can amend Regulations T and U so as to raise margin requirements for listed securities to 100 percent, and restrict

withdrawals and substitutions of securities in margin accounts.

- (e) Section 5 of the Trading with the Enemy Act of 1917, as amended, and Section 4 of the Emergency Banking Act of 1933 authorize the President, by Executive Order, to regulate and limit the issuance or credit. While these powers should not be exercised except in an extraordinary emergency, the statutory authority appears to be sufficient.

2. Expiring Legislation

- (a) Section 708 of the Defense Production Act of 1950 provides the legislative basis for the present Voluntary Credit Restraint Program.
- (b) Regulation X of the Board of Governors of the Federal Reserve System, which governs the extension of real estate construction credit, stems from authority granted the President under Section 602 of the Defense Production Act of 1950; he in turn is permitted to utilize the services of the Federal Reserve System in this connection. Present authority would permit the Board of Governors to restrict the use of real estate construction credit substantially more than has already been done. Should the proposed change in the Act be enacted, (H. R. 3871 and S. 1397,

82nd Congress, 1st Session, Section 106) it would be possible to restrain the use of real estate credit in the purchase of existing structures.

- (c) Section 601 of the Defense Production Act of 1950 authorizes the Board of Governors of the Federal Reserve System to exercise consumer credit controls in accordance with Executive Order 8843 (August 9, 1941). Regulation W of the Board of Governors restricts the use of consumer credit; the use of such credit could be tightened substantially beyond the degree currently permitted.

3. Proposed Legislation

- (a) As noted above, Section 106 of H. R. 3871 and S. 1397 would permit restrictions on the use of real estate credit in connection with the purchase of existing structures.
- (b) Section 611 of H. R. 3871 and S. 1397 would permit the President, whenever he determines that speculative trading on boards of trade causes or threatens to cause unwarranted changes in the price of any commodity, to prescribe rules governing the margin to be required with respect to speculative purchases or sales for future delivery. The provisions of Section 21 of the Securities and Exchange Act of 1934 are made applicable in administering and enforcing this provision.

- (c) Reserve requirements of commercial banks have been raised virtually to the limits of existing authority.

It is recommended that, as an emergency measure legislation be sought to empower the Reserve authorities for a limited period to impose additional reserve requirements, either increasing the authorized percentages or in some other appropriate way that will have a minimum adverse effect on the Government security market. The refunding and new issue operations of the Treasury in the last half of this calendar year alone amount to in the neighborhood of 50 billion dollars. Under these circumstances, it is imperative that any additional requirements for bank reserves imposed by the Federal Reserve should be such that they do not have a disruptive effect on the market for Government securities.

In view of the emergency such requirements should apply to all insured banks. The feasibility of permitting non-member insured banks to hold the additional reserves in balances with their correspondents should be explored.

The Task Force on supplementary reserve requirements has considered various plans for reenforcing existing bank reserve requirements and has reported that two plans offer the greatest promise, namely;

- (1) The loan expansion reserve plan and
- (2) the primary (securities feature) reserve plan, which provides for

additional required reserves and gives a bank, under conditions to be prescribed by regulation, the option of holding the additional reserves in the form of cash or Government securities.

The provisions of these plans may be summarized as follows:

Loan Expansion Reserves. - Every insured bank receiving demand deposits, other than a mutual savings bank, would be required to maintain additional reserves equal to a percentage, to be prescribed by the Board of Governors of the Federal Reserve System, of that part of its loans and investments in excess of a certain prescribed base.

In computing loans and investments, all assets of the bank would be included except (1) cash, (2) balances due from banks, (3) direct obligations of the United States, and (4) such special types of assets as the Board might prescribe from time to time.

Primary Reserves and Government Securities. - Either in substitution for or in addition to the requirement discussed above, an insured bank receiving demand deposits, other than a mutual savings bank, might be required to maintain additional reserves equal to a limited percentage of its demand deposits, in addition to the deposit balances now required.

Such percentages could be different with respect to banks in central reserve cities, reserve cities, or elsewhere.

In lieu of such a deposit balance, a bank under certain conditions, could count Government securities either at an amount equal to the dollar amount of the deposit balance which the securities replace or at some lesser figure. For example, the Board might prescribe that, for reserve purposes, \$1.50, or \$2.00 or \$2.50 in securities might be equivalent to \$1.00 of cash.

Within a few days the Board of Governors will ask the Congress to consider definitive legislation providing for supplementary requirements.

IV - CONCLUSIONS AND RECOMMENDATION

Conclusions:

The measures thus far adopted make up the beginning of an effective program of credit restraint. There is, however, no assurance that these measures will prove sufficient to deal with the inflationary situation that may be anticipated as the national security program expands. Additional measures are needed to contribute to the anti-inflationary program and at the same time maintain stability in the market for Government securities.

In general, the additional measures which should be taken are: the extension and reinforcement of the Voluntary Credit Restraint Program, whose work this Committee wholeheartedly endorses; the enactment of legislation to permit continuation and some broadening of selective credit controls; an emergency increase in the authority of the Board of Governors to require, in case of need, supplementary reserves for all insured banks. With a view to the possibility that all other anti-inflationary measures fail, or that needed powers may not be obtained in time, plans should be readied for the imposition of mandatory limits on total credits extended by banks and other financial institutions (excepting essential loans) if, in an extraordinary emergency, such controls should become necessary.

Recommendations:

1. That Section 708 of the Defense Production Act of 1950, which provides the legislative basis for the Voluntary Credit Restraint Program, be extended.

2. That close liaison be maintained between the Office of Defense Mobilization and the Voluntary Credit Restraint Committee. The Voluntary Credit Restraint Committee cannot exercise the most informed judgment regarding lending policy unless it is guided by up-to-date criteria of the shifting requirements of the defense program.

3. That the cooperation of such bodies as the Council of State Governors and the United States Conference of Mayors be enlisted by the Voluntary Credit Restraint Committee to help postpone issues of State and municipal securities to finance deferrable expenditures.

4. That the appropriate government agency consider whether financing institutions, not now included in the Voluntary Credit Restraint Program, be included in it.

5. That Government loan and loan guarantee agencies should follow policies consistent with those of comparable private lending institutions as set forth in the Statement of Principles of the National Voluntary Credit Restraint Program. If the policies of the two groups of lenders are not coordinated the Voluntary Program might be undermined. This subject is more fully treated in the forthcoming report of the Director of the Budget, the Director of Defense Mobilization and the Chairman of the Council of Economic Advisers on the policies of Government lending agencies that was requested by the President to complement the work of the present committee.

6. That Section 601 of the Defense Production Act of 1950, which provides authority for Regulation W of the Board of Governors restricting the use of consumer credit, be extended.

7. That Section 602 of the Defense Production Act of 1950, which furnishes the legislative basis for Regulation X of the Board of Governors regulating the extension of real estate construction credit, be extended and that the proposed change in the Act (Section 106 H.R. 3871 and S. 1397, 82nd Congress, 1st Session), which would make it possible to restrain the use of real estate credit in the purchase of existing structures, be enacted.

8. That Section 611 of H.R. 3871 and S. 1397 be enacted, which would permit the President, whenever he determines that speculative trading on boards of trade causes or threatens to cause unwarranted changes in the price of any commodity, to prescribe rules governing the margin to be required with respect to speculative purchases or sales for future delivery.

9. That the Congress be urged to act promptly and favorably on the proposals for emergency additional bank reserve requirements, when these are advanced by the Board of Governors of the Federal Reserve System.

10. That mandatory control of credit be imposed only if the problem to be solved is most serious, and only after a demonstration that more moderate measures are too slow in their impact, or too uncertain in operation, or are otherwise inadequate. While we do not propose the imposition of such mandatory controls at this time, detailed plans for their imposition, in the unfortunate event they become

necessary, should be prepared.

11. We have pointed out in this report that credit controls must play an important role in a program of economic stabilization that is in accord with the necessities of the defense program and the Government's financial requirements. We wish to point out with equal emphasis that neither selective nor general credit controls can, in themselves, assure such economic stabilization. Economic stabilization requires, first and most importantly, a pay-as-we-go tax program. Any failure in this respect aggravates immeasurably the problems of economic stabilization. Even with adequate fiscal and credit policies there still remain inflationary pressures during the expansion of the security program. During that period, therefore, direct controls, such as allocations and price and wage controls, are essential. Only in a rounded program in which each control measure contributes its share can we accomplish the purposes of mobilization and stabilization.

_____ The Director of Defense Mobilization, Chairman

_____ The Secretary of the Treasury

_____ The Chairman of the Board of Governors
of the Federal Reserve System

_____ The Chairman of the Council of Economic Advisers