BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON 25, D. C.

Z-2171 (On office copies only)

ADDRESS OFFICIAL CORRESPONDENCE TO THE BOARD

November 26, 1947.

Dear Sir:

The Board of Governors has requested me to send to each of the members of the Federal Advisory Council a copy of the Board's reply to the statement submitted by the Council with respect to the rapid expansion of bank credit. Accordingly, a copy of the reply is attached.

The Council's statement has been submitted to the Joint Committee on the Economic Report as requested by the Council. The Board's reply has also been given to the Committee.

Very truly yours,

S. R. Carpenter,
Secretary.

Enclosure

TO THE MEMBERS OF THE FEDERAL ADVISORY COUNCIL

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BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
November 25, 1947

RELATION OF BANK CREDIT AND INFLATION

Reply by Board of Governors of the Federal Reserve System to statement issued by Federal Advisory Council

The Federal Advisory Council, composed of one banker from each of the twelve Federal Reserve Districts designated under statutory authority to advise the Board of Governors of the Federal Reserve System, was recently asked by the Board for an expression of the Council's views as to the present credit situation. The Board stated that it "is very much concerned about the rapid expansion of bank credit. The Board, therefore, desires to have the views of the Council as to the further steps that might be taken to correct this serious situation through monetary or fiscal means."

The Council's reply, which has been released for publication by the Board and presented to Congress by the Chairman of the Board, states that the Council finds "nothing in bank loans themselves to suggest that growth of loans has been an active inflationary factor. It rather appears to have been a reflection of the very high level of business activity and high prices." While the Council shares the apprehension of the Board with respect to inflation dangers, it believes that "the causes of inflation are largely outside the sphere of monetary policy". Nevertheless it recognizes that "the Reserve System has a special responsibility for bank credit and in this situation should take all reasonable care to assure conservative credit policies." The Council expresses the view that in this special area present powers are ample, without new legislation, to place all restraints on credit expansion which the System and the Treasury may consider necessary.

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Recent credit expansion

The rapid expansion of bank credit, about which the Board is concerned, is indicated by the growth of bank deposits held by businesses and individuals at all commercial banks in the United States, which increased by 14 billion dollars from the end of 1945 to the end of October this year. The growth exceeded 3 billion dollars in the last four months and is continuing. This growth was on top of a nearly three-fold wartime expansion in deposits and currency which was greatly in excess of needs and has been an important basis of postwar inflationary pressures.

The basis of this continued expansion in bank deposits has been primarily the growth in bank loans, which has been at a more rapid rate than at any time in American banking history, amounting in the aggregate to 10 billion dollars since the end of 1945. Other factors in the deposit increase have been an addition of nearly 2 billion dollars to bank holdings of securities other than those of the Federal Government and gold acquisitions amounting to about 3 billions.

These increased loans have been made to businesses, to holders of real estate, and to consumers. Only loans on securities have declined. This decrease is due to liquidation of loans made to purchase Government securities in war loan drives, but loans on other securities have also failed to advance. This is an exceptional situation for a period of inflationary development and is in large part due to the Board's regulation of margin requirements.

It is true, as the Council points out, that banks have reduced their holdings of Government obligations as loans have increased. This decline, however, followed a temporary peak reached during the Victory Loan Drive and resulted almost wholly from Treasury use of its excessive balances

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at banks temporarily built up to a high level during the drive. It has not had any effect in reducing private deposits.

Inflationary impact of bank loan expansion

The Board agrees with the Federal Advisory Council that the basic causes of inflation lie primarily outside of the area of current monetary and banking developments. However, the Board believes that all possible measures and policies should be adopted by Government, business, farmers, and workers to produce more, consume less, and save more, and to avoid cost- and price-raising actions. Furthermore, the Board considers that the most effective means of diminishing the basic causes of inflation is maintenance of the largest possible surplus in the Government's budget. This important means of dealing with the problem is entirely ignored by the Council.

The Board also recognizes that individual banks in making loans are no doubt being guided by the aim of meeting the necessary and constructive needs of borrowers, and that many banks are aware of the dangers in the present situation and are exercising some restraint on borrowers. Expansion in lending has to a large extent been necessary to supply working capital needed by business to maintain or increase production at rising prices. As accumulated cash balances are drawn down funds must be borrowed. Consumers also borrow to supplement incomes and purchasers of homes borrow more than sellers repay because of advancing real estate prices.

In the Board's opinion it is not correct to contend that because inflation calls forth an increased demand for bank loans, these loans do not contribute to inflation. The economy now is caught in a partly self-generating spiral of rising wages, costs, prices, and profits supported by

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active use of previously accumulated liquid assets and by expanding bank loans. Credit is contributing to the continuation of inflationary pressures. As was well stated, in a recent Monthly Letter of the National City Bank of New York:

> "Rapidly accumulating debt is both a cause and a consequence of the inflationary pressures, for in a wage-price spiral, business constantly needs more and more money to keep going and this leads to the incurrence of more and more debt by business and more and more spending by the individual. To check this kind of spiralling--which is to the ultimate benefit of no one and to the injury of all--is not simple."

Although each loan, taken separately, may aid in the production and movement of goods, yet in view of the limited supplies of goods available, a loan to one business or individual to finance the purchase or holding of goods permits the borrower to bid against someone else who has or is able to obtain funds. Credit expansion thus is called for by price increases and provides the basis for further increases. This process, unless checked by positive limitations on the available supply of credit, could easily lead to catastrophic collapse.

Bankers, businessmen, farmers, wage earners, who in their operations unwittingly contribute to the rising spiral of inflation, cannot individually be held responsible for its course. That course is the result of reliance on the free-enterprise, competitive price system in a situation where demand, supply, and price are not in equilibrium and where a rise in prices can be prevented only through the maintenance of a harness of controls by Government.

For these conditions, the bankers are not responsible either individually or as a group. Their job is to meet the credit needs of

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their communities constructively, competitively, and profitably; they are not individually in a position to refuse the legitimate, sound credit demands of their customers. They find themselves in a situation in which they can readily meet unlimited credit demands from the public and in which the public's credit demands are vigorously sustained. That situation was created by war, by the necessities of war finance, and by premature abandonment of controls, thereby releasing inflationary pressures. Responsibility of the individual banker for developments can go no further than observance of prudent policy in the extension of credit and the maintenance of proper soundness of loans and liquidity and safety of individual banks.

Responsibility of Government for credit expansion

The Federal Advisory Council states that Government agencies have been making loans that banks refrained from making. Except in the field of foreign lending, the volume of loans by Government credit agencies is very small relative to the volume of bank loans and the total has not increased. It is true that some of the activities of Government agencies, furthering objectives set forth by Congress, have encouraged unhealthy credit expansion in the field of housing, primarily to aid veterans. Foreign lending by the Government has expanded because of the urgency of restoring production abroad and the difficulties and inadvisability of obtaining private credits for these essential purposes.

The Council refers to the Board's request for authority to guarantee loans in cases where credit is needed but cannot be obtained from banks. The Board wishes it clearly understood that it is requesting

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merely an amendment of an existing provision of law, for the purpose of rescinding a power which the Reserve Banks already have to make loans and revising somewhat their power to guarantee loans. Under existing conditions these powers are not likely to be used but some such power will be needed at times in the future to provide for small business a source of capital, which large corporations can obtain through sales of securities in the market. Amendment of existing law has been recommended to enable the System to return certain funds to the Treasury and this provides an appropriate opportunity to make other long-needed revisions. With reference to this bill the Federal Advisory Council expressed its views on November 18, 1947, as follows:

> "The Council is cognizant of the investigation of the activities and powers of the Reconstruction Finance Corporation now being made by a Congressional Committee. Until Congress has determined whether the Reconstruction Finance Corporation should be continued, and, if continued, what powers to make or guarantee loans should be given it, the Council feels that no action by Congress should be taken on Senate Bill 408. The Council feels that Senate Bill 408 should be considered only as an alternative to legislation continuing the present loan and guarantee powers of the Reconstruction Finance Corporation. If the Congress should decide to continue the Reconstruction Finance Corporation without greatly curtailing its loan and guaranteeing powers, the Council would be opposed to the passage of Senate Bill 408. The majority of the Council would prefer Senate Bill 408 to the continuation of the Reconstruction Finance Corporation powers, but it should also be noted that a minority of the Council is against giving any guarantee or commitment powers to the Federal Reserve Banks under any circumstances, as proposed in Senate Bill 408."

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Means of restricting inflation

The Board cannot agree with the Council's view that the Reserve System and the Treasury have ample powers to place all restraints on credit expansion that the System may consider necessary. As the Board has pointed out in its Annual Reports for 1945 and 1946 and in other statements, banks are in a position to provide any additional credit demanded by borrowers and the System cannot prevent such expansion. This is the case because commercial banks of the country now hold 70 billion dollars of United States Government securities, any part of which they can readily sell in order to obtain funds to make loans.

When banks sell Government securities, the Federal Reserve, which provides the ultimate market for Government securities, must purchase them in the absence of other buyers in order to prevent a breakdown of the securities market. Federal Reserve purchases create bank reserves which can be expanded by the banking system into more than six times as much in loans and investments.

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The Council suggests that the System can restrain inflationary credit expansion through use of existing powers, including authority to increase the discount rate, to sell securities in the open market, and to raise reserve requirements at central reserve city banks. None of these powers can be used effectively if banks continue to sell Government securities to the Reserve System and thus create additional bank reserves.

In fact attempt to use these powers would increase sales of Government securities in the market by banks and others. If the System refused to purchase any more securities, bond prices would decline sharply. The threat of such a policy would induce a wave of selling of marketable bonds, and if prices on these bonds declined there might be widespread redemptions of savings bonds, which are redeemable on demand. The Reserve System would have to purchase securities in order to meet the drains on the Treasury, and new reserves would thereby be created.

Recent measures by the System and the Treasury to raise interest rates on short-term Government securities have diminished somewhat the inducement to banks to sell short-term securities and to purchase longer-term higher-rate issues. Higher rates on short-term securities, however, have but little, if any, influence in discouraging banks from selling them to make loans. Moreover, a recent increase in capital demands has put some pressures on the long-term securities market, and has resulted in a decline in bond prices. This places a limit on the extent to which short-term rates may be permitted to rise without causing an undue drop in Government bond prices.

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The Board has proposed a means of curbing the ability of banks to create additional reserves by selling Government securities to the System and of reducing the amount of credit expansion that may be possible on the basis of reserves thus created or arising from a continued gold inflow. This proposal calls for granting to the System a temporary authority to require all banks to hold a special reserve in Treasury bills, certificates and notes or in certain cash assets, in addition to present basic required reserves.

This measure would enable the System to impose some restriction on undue credit expansion without depriving banks of earning assets. It would permit a rise in lending rates to new private borrowers without raising the interest cost on the outstanding debt of the Government, which is not now increasing. It would not prevent banks from meeting essential credit needs of the economy but would discourage unrestrained expansion of credit for any purpose.

Use of an instrument such as the one proposed would enable the System to curb credit expansion with much less burden on banks and less threat to Government credit than would result from attempt to use effectively any of the existing powers mentioned by the Federal Advisory Council.

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STATEMENT OF
FEDERAL ADVISORY COUNCIL
ADDRESSED TO THE
BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
NOVEMBER 18, 1947

Inquiry of Board

The Board is very much concerned about the rapid expansion of bank credit. The Board, therefore, desires to have the views of the Council as to the further steps that might be taken to correct this serious situation through monetary or fiscal means.

Answer of Council

The Council has reviewed the question of the volume of bank credit both in the aggregate and as shown in the banks with which they are familiar.

We do not know what "serious situation" in bank credit the Board has in mind. For the past year the total volume of bank credit (i.e. the available amount of bank money) as measured by adjusted demand deposits has shown only a moderate increase. As bank loans have increased, the banks have decreased their investments.

We find nothing in bank loans themselves to suggest that growth of loans has been an active inflationary factor. It rather appears to have been a reflection of the very high level of business activity and high prices.

To a large extent growth of loans is a direct result of government policies. For example, an increase of nearly 4 billion dollars in the real estate loans by insured banks since the end of the war reflects directly the purchase of FHA and GI mortgages in the housing program.

The Reconstruction Finance Corporation is encouraging bank lending by guaranteeing risky loans.

Commercial loans are influenced by high prices and active movement of agricultural and manufactured products for the foreign aid program.

High wages and high costs of materials have meant that business needed more money to take care of its customers.

There is nothing in the figures or our experience to suggest that there exists any substantial lending for speculation or for unnecessary uses. Loans for carrying securities are much reduced.

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In this period the government, through various agencies, has been making loans that the banks refrained from making because of their speculative nature. The Reserve System itself is asking for more power to guarantee loans on the presumption that bank lending is too cautious.

The causes of our present inflation are not in current banking policies but are found in the great war-time expansion of buying power together with unusual events and public policies since that time. Among recent inflationary causes may be listed the following:

The foreign aid program

A cycle of wage increases in excess of increases in either the cost of living or productivity

A shorter working week

A short corn crop

Veterans bonuses and relief payments

Agricultural price subsidies

U. S. Government spending of 36 billion dollars a year

Housing subsidies

In the face of these developments a substantial increase in bank loans was inevitable and the banks have shown restraint. The dangers in the present situation are understood by bankers and there is hardly a bank in the country which has not been warning its customers against over-expansion. The loans being made are mostly for direct production.

The first thing to do is to reconsider government policies which are inflationary and especially excessive government spending and subsidies.

We recognize that even though the causes of inflation are largely outside the sphere of monetary policy, the Reserve System has a special responsibility for bank credit and in this situation should take all reasonable care to assure conservative credit policies.

In this special area we suggest that the System and the Treasury already have large powers, without new legislation, to place credit under broad restraints.

One of these powers is the discount rate which is a recognized instrument for serving notice on the public of the need for restraint in the use of credit.

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Similarly by open market operations the System can control the reserves of the member banks and limit their lending power.

The Board also still has the power to raise reserve requirements in Central Reserve Cities and so tighten money.

The Treasury by the pricing of new issues and the handling of its balances has great influence on the rate and volume of money.

In the past year the System and the Treasury have used these powers effectively.

The money markets and the policies of business men are today so sensitive to action of these sorts which the Reserve System and the Treasury take that present powers are ample to place all restraints on credit expansion which the System and the Treasury may consider necessary.

The Council wishes it clearly understood that it shares the apprehension of the Board of Governors with respect to inflation dangers. It does, however, most strenuously object to the singling out of the increase in bank loans as a principal contributing factor; and it has attempted to point out above, the vastly more important elements of inflation - of which bank loans are a barometer.

This is not to say that there have not been unwise bank loans in some cases. After all, banking is a form of human endeavor, operated by human beings. It would be amazing if there were not some errors in judgment. But we submit that, on the record, there is no evidence of bank credit expansion beyond that which could be expected under all the circumstances. There is every evidence that loans are today doing a wholesome and constructive work in their intended place in the economy.

The Council has studied the increase in consumer credit in relation to the termination of Regulation W. While consumer credit has increased substantially, much of this reflects the availability of automobiles and household appliances. There is so far too little experience on which to judge the effect of the termination of Regulation W. The American Bankers Association is undertaking with considerable success to ensure maintenance by banks of sound lending standards. This effort towards voluntary cooperation seems to the Council the sensible and the democratic method of dealing with this problem, both with respect to the banks and other lenders. The Council is opposed to legislation giving the Board new regulatory powers in this matter.

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Suggestions in the President's message to Congress with respect to credit control indicate the possibility that the Federal Reserve Board may present to Congress the proposal in its 1945 Annual Report for a required bank reserve of short term government securities. The Council therefore wishes to state its views on this proposal.

The proposal as we understand it is that banks should be required by law to maintain, in addition to cash reserves, reserves of short term government securities in a percentage relationship to deposits, to be fixed from time to time by the Federal Reserve Board.

The Council is unanimously opposed to this scheme for the following reasons:

1. It is impractical. The operations of banks are so different, reflecting as they do adaptation to the varying needs of their communities and customers, that no percentage of short term government security holdings can be applied fairly or practically to all banks. Any percentage high enough to offer any measure of restraint on a substantial number of banks will have disastrous effects on many other banks, compelling them to liquidate sound and necessary loans and thus actually check production. The very banks which have served the business in their communities most aggressively and helpfully would be hardest hit.

2. Such a plan would substitute the edicts of a board in Washington for the judgments of the boards of directors of 15,000 banks throughout the country as to the employment of a substantial part of the funds of their banks. This is a step towards socialization of banking.

3. As indicated earlier, the Federal Reserve System and the Treasury already possess large powers of credit control not now being fully used. Such new powers as those proposed are not necessary.

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