

POSTWAR BANK CREDIT PROBLEMS

by

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President Leggett, members, and guests of the National Association of Supervisors of State Banks:

Because of our common problems and responsibilities, I appreciate this opportunity to participate in your proceedings. In the chaotic world of today, groping for answers to the overriding problems of economic security and enduring peace, we can find comfort in the strong and healthy position of our banking system. At the same time we must be fully aware of the dangers which the present vigorous inflationary forces may threaten for the banking system.

INFLATION, THE CONSEQUENCE OF WAR FINANCE

Postwar inflation, with its severe distortions in the structure of prices, wages, and profits, is primarily due to the enormous wartime increase in our money supply. The banks of the country, including the Federal Reserve Banks, in helping to meet the needs of war finance, brought about this increase. In the six years from the middle of 1940 to the middle of 1946 the Federal Government spent nearly 400 billion dollars, most of which was for national defense and war purposes. Much less than half of this amount was met by tax receipts and the balance of about 225 billion dollars was borrowed. During this six-year period commercial and Federal Reserve Banks together increased their holdings of Government securities by 90 billion dollars, and savings institutions, businesses, and individual investors purchased the remainder of the securities sold.

Commercial bank holdings of Government securities have been reduced somewhat since the postwar peak by the Treasury's debt retirement program, but they are still more than four times as large as in 1940. In expanding their portfolios of Governments, banks did not decrease their holdings of other assets. As a matter of fact, the total of their loans, other securities, reserves, and other cash has increased since 1940 by about 21 billion dollars. As a result of this credit expansion, commercial bank deposits increased by 70 billion dollars.

* Address by the Chairman of the Board of Governors of the Federal Reserve System to the National Association of Supervisors of State Banks, Washington, D. C., Sept. 25, 1947.

In addition, currency in circulation showed a growth of 20 billion dollars.

This expansion in bank credit and consequently in the money supply was made possible by the large excess reserves which were held by the banks at the beginning of the war, and by the additional reserves that were provided by the Federal Reserve through an increase of over 20 billion dollars in its holdings of Government securities.

It is inevitable that in financing a war, business and individual holdings of money and Government securities increase. The reason for this is that people are paid for furnishing the goods and services which are needed to carry on the war and are not available for purchase by business and consumers. Consequently, incomes expand more rapidly than consumption can be increased. Unless taxes are raised sufficiently to absorb all of the surplus income, savings must increase, and they must be held largely in the form of bank deposits, currency, or Government securities. To the extent that the Government expenditures are not met by taxes or the sale of securities to nonbank investors, the balance must be absorbed by the banking system, which results in expansion of the money supply.

If the public had attempted to spend their entire excess income, prices would have risen very rapidly. However, due to the willingness of the public to save during the war period and due to the effective harness of wartime controls that were put into effect, prices rose but little during the war. By the end of the war vast holdings of money and other liquid assets had been accumulated and large deferred demands had been built up. At the prevailing level of prices, demand was far in excess of any supplies that could be made available within any short period of time.

It should have been apparent that if these forces were permitted free play, a sharp rise in prices would result. The people of the nation, however, not fully realizing the dangers in the situation, made clear their wishes that controls be removed. Business wanted freedom from allocations, price controls, building permits, rationing, and business particularly wanted repeal of the excess profits tax.

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Farmers wanted release of all controls affecting agricultural products. Labor wanted removal of restraints on higher wages. Bankers generally sympathized with the desires of all these groups to remove controls. In response to these public pressures, wartime controls, such as allocation of raw materials, building permits, price and wage restrictions, as well as the excess profits tax, were prematurely abandoned.

We are currently witnessing the results of this national policy. With demand for goods already large because of high levels of current income and with a huge backlog of domestic and international demand reinforced by huge accumulations of liquid assets after five years of war, price inflation was inevitable. The country is now suffering the consequences of having placed our reliance upon the restoration of a competitive price situation to bring about necessary postwar readjustments in an abnormal period when effective demand far exceeds available supplies.

As a result, the economy is caught fast in a serious wage-cost-price spiral. Short farm crops at home and abroad have intensified this spiral. International crisis, in part the result of our rising prices, is imposing on us obligations that can only be discharged by actions that will increase our inflation difficulties. Yet we should not allow what is left of European democracy to perish through starvation and communism. Nor can we ultimately solve our problem of inflation without the restoration of Europe's vast productivity to help take care of the world's needs. The danger that faces us is that inflation will go on unchecked and end, as inflations always have ended, in economic collapse.

The higher the spiral of inflation is wound by further general price and wage increases, by further rapid expansion of private debt, and by failure to reduce public expenditures for all purposes that can be eliminated or postponed until the emergency has ended, the more serious the inevitable readjustment is certain to be. The longer the ultimate reaction is postponed, the longer it will take to reach a stable condition of employment and production. Readjustment in our domestic situation is overdue, and the sooner it can be brought about, the better it will be for the nation and the world.

COST OF MAINTAINING THE PEACE

We spent nearly 350 billion dollars to win the war, and we shall need to spend substantial, al-

though much smaller amounts, to keep the peace. Large parts of the world have been devastated and, even in those parts left intact, the customary processes and channels of trade and commerce have been destroyed or upset. People in nearly all nations have vast holdings of money and large deferred demands for the necessities of life, and supplies of nearly everything to meet these demands are inadequate. The money they have, however, cannot be used to make purchases from countries which have goods for sale, and they have little else to offer in exchange. When people are thus upset, they are susceptible to the lure of political panaceas and are likely to generate feelings of hatred toward others more fortunate than they. This state of mind is a threat to stability and peace in the world.

In the two fiscal years from July 1946 to June 1948 we have budgeted expenditures of more than 25 billion dollars for the maintenance of our national defense. We have provided altogether since the end of the war foreign grants and credits of approximately 16.5 billion dollars, which is only two-thirds of our military budget for the first two postwar fiscal years. Surely this is a small amount to make available for helping to win the peace, when compared with our vast expenditure of 350 billions used to win the war.

It cannot be denied or ignored that continued large loans and grants to foreign countries are either a heavy current burden upon our taxpayers or a strong inflationary force on our economy, but so are our even larger military expenditures, which are considered by many as necessary for maintaining peace.

We should be fully aware of the costs and risks of providing foreign aid and make adjustments in our policies accordingly. We cannot be lavish in aid to other countries without suffering the consequences of inflation, heavier taxation, or the reimposition of controls. Countries receiving assistance should recognize the burden that is being imposed on our economy, and it is imperative that they take measures to assure the most effective use of their own resources as well as of those received from us. If these requirements are met, it would be shortsighted, as well as highly selfish, for us to deny aid needed to prevent starvation and to reconstruct productive capacity in other countries. Our reason for denying the aid would be that we wanted to increase our already large consumption in order to counteract inflation. Yet

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the best remedy for inflation is more production, and the greatest unused productive resources now lie outside of this country, but they cannot be effectively operated by starving people devoid of equipment and supplies.

RESPONSIBILITY OF FEDERAL RESERVE SYSTEM

What bearing, you may wonder, does all this have upon our common problems and responsibilities of bank supervision? The Federal Reserve has a close interest in these matters, because we are responsible for providing the reserves that support our entire money and credit system. We must constantly consider whether the existing supply of bank credit is redundant or inadequate. This judgment must be based upon the needs and behavior of the economy. There is not time here to discuss the specific objectives, standards, and various other considerations that provide the basis for these policy decisions. The Board of Governors, the Federal Open Market Committee, composed of the Board and representatives of the Federal Reserve Banks, the operating officials of the Reserve Banks, and the Federal Advisory Council in giving advice, must constantly keep in mind the impact of Federal Reserve policies on the economy.

International affairs are of importance to us because of their general impact on our domestic economy and more directly because the net resultant of all international financial transactions is reflected in gold movements. Gold, together with Federal Reserve Bank credit, supplies the basic reserves of our banking system. The interest and responsibilities of the Reserve System in this field are recognized by the Congress in including the Chairman of the Board of Governors as one of five members of the National Advisory Council. This Council has responsibility for supervising and coordinating the international financial policies of the Federal Government.

CHANGED POSITION OF BANKS

Because of their interests and responsibilities, the Federal Reserve authorities are greatly impressed with the changed position of banks that has resulted from war. These changes will affect the duties and responsibilities of all bank supervisory agencies. The vast volume of deposits and currency not only offers a threat of inflation for the economy as a whole, but it may create serious problems for individual banks. With our system of 14,000 separate

banks, shifts of deposits from bank to bank necessitate corresponding shifts of assets or other adjustments. For this reason our banking system requires a high degree of liquidity and these requirements have been enlarged by the great wartime growth and broad distribution of bank deposits.

Another problem confronting bank supervisory agencies is the great existing potential for further expansion of credit. Generally in the past banks could not expand their loans and investments, except when new funds came to them or unless they were willing to borrow. When one bank lost funds, it had to borrow or liquidate assets. While for individual banks that situation still exists, the very large holdings of Government securities now held by banks makes it easy for them to shift to other assets that seem more attractive.

When banks sell their Government securities, in the absence of any other buyer, the Federal Reserve is obliged to purchase them. Otherwise, the Government securities market would decline and might collapse. This would not only greatly increase the cost of carrying the public debt, but would seriously endanger our entire financial structure, in which Governments now occupy such an important place.

When the Federal Reserve System acquires additional Government securities, new reserves are created; these reserves pass to other banks and ultimately may provide the basis for an expansion in credit amounting to six to ten times the reserves made available. This ability of the banking system to bring about the creation of new reserves without borrowing is a new element in the credit situation. With an active demand for loans, it can be a powerful inflationary force. The Board has long recognized this problem, discussed it fully in its Annual Reports to Congress for 1945 and 1946, and presented proposals for its solution. Most of you may be familiar with the substance of these reports; time does not permit a full discussion of them here. Up to date little support has been received for the Board's suggestions, and nothing whatever has been done to put the Board in a position where it could restrain inflationary expansion by the banking system.

Another potential for credit expansion is the large flow of gold that is now coming into this country. This inflow has already amounted to nearly 2 billion dollars this year. Since the middle of the year total loans and investments of commercial banks have been expanding at a rate equiva-

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lent to 10 billion dollars a year. If this should continue it would* provide an inflationary force more than double the anti-inflationary effect of the prospective surplus in the Federal budget for this fiscal year. It would equal the inflationary impact of the unprecedented surplus of exports over imports in this country's foreign trade during recent months. Under present circumstances, it does not appear possible for the Federal Reserve System to check this credit expansion by selling Government securities and thus absorbing bank reserves.

Banks have been the beneficiaries of wartime developments. Their assets have increased tremendously and these assets are perhaps more liquid and less subject to depreciation than at any previous time of active business. Bank earnings have grown more rapidly than expenses, so that profits are relatively large, and capital structures have been enlarged. Finally, their large holdings of Government securities make it possible for banks to shift readily to any other more attractive assets that may be available.

Banks can also suffer the consequences of unpleasant economic developments, as they have at times in the past. Some of the most disastrous of these developments have occurred during my career as a banker and businessman and during the careers of most of you. Banks are most seriously affected when they have helped to bring about the conditions by undue expansion of credit followed by rapid liquidation.

Although present inflationary developments are largely the result of war finance, in the past two years expansion of private credit has become a factor of increasing importance. Conditions are favorable for a further substantial expansion of private credit that may contribute further to excessive inflation and lead to disastrous consequences for the economy. Such a development would endanger the healthy position of our banking system.

WHAT CAN SUPERVISORS DO?

As I have indicated, the existing general monetary and credit powers of the Federal Reserve are inadequate for preventing such a development. Nor can bank supervision, in view of its limited scope and of the inflationary forces already generated, be expected to *prevent* further inflation. We can, however, understand the nature of the problem and use our influence to discourage banks from contributing to it. This would help to diminish

resulting undesirable effects upon banks. What specifically can be done?

(1) Maintenance of a high degree of liquidity should be encouraged; banks should be discouraged from reducing their large holdings of Government securities and cash assets in order to acquire less liquid and more risky assets.

(2) Supervisors should take a critical attitude toward any expansion of loans, unless they contribute directly to increased production and movement of goods. This attitude should apply particularly to consumer credit, real estate loans based on inflated values, loans to carry excessive inventories, and any loans for speculative purposes.

(3) As long as banks maintain their present large holdings of cash and Government securities, most of them are adequately capitalized. Banks with low ratios of capital to risk assets, however, should build up their capital. If banks persist in increasing their risk assets, they should be required to enlarge their capital accordingly by retention of earnings. If retained earnings are not sufficient, then additional stock should be sold.

It is important for us to keep in mind that future losses of banks are determined by current policies. While each individual loan of a bank may appear sound taken by itself, the practices of banks in the aggregate may contribute to generally unhealthy conditions. In an unsound economy, banks in general cannot remain sound. Our banks now appear to be in a position to withstand the severe economic storm that is threatening. This is not the time for them to remove their storm shutters or venture out into the gale.

In summary, I would reassert that the wartime increase in money and incomes relative to the supply of goods and services has created an inflationary development with severe distortions in prices, wages, and profits. Readjustment in our domestic situation is overdue. The sooner it can be brought about, the better it will be for the nation and the world; the longer it is postponed, the more severe will be the inevitable readjustment.

We are faced with a choice between unattractive alternatives. We must decide how much we are going to spend preparing for the next war and for other purposes that might be eliminated or deferred. At the same time we need to determine how much we are going to make available to maintain peace through provision of vital food and needed pro-

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ductive facilities to the starving and destitute Western European democracies. It should be recognized that we cannot continue to spend as much as we have been for all of these purposes, in the presence of other strong inflationary pressures in the economy, without severe costs and risks.

We are on the horns of a dilemma. We simply cannot reduce taxes ^{materially} drastically and at the same time assist Europe. We cannot expand domestic credit, both public and private, for the purpose of having all we want and assist Europe and avoid inflation. We must give up something or we are going to pay much more dearly in the long run. If we desire to preserve democracy and peace in the world, we must assist in feeding the starving people in the democracies of Europe and help them to get into produc-

tion because it is only by their production that we will be relieved and more will be available in this country. If controls are needed to do that, we should have controls. If the public understands the problem and voluntary rationing can do it, of course that is the desirable way to do it. We have got to deal with the economic facts of life as they are. As bank supervisors you can try to see to it that the banks of this country put some pressure on credit expansion and stop this inflationary growth that they are responsible for collectively, though individually they may not be aware of it. If you want public authorities to have control over credit expansion, consider the recommendations of the Board in its annual reports of 1945 and 1946 before it is too late.

