Statement of the Board of Governors

of the

Federal Reserve System

on the

Defense Production Act of 1950

Presented to the

Committee on Banking and Currency

of the

House of Representatives

July 24, 1950

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The Defense Production Act of 1950 would carry out the steps toward economic preparedness recommended by the President in his message of July 19 to the Congress. Because of the responsibilities which the Congress has placed upon the Board in the credit and monetary area, we are especially interested in those provisions of the bill relating to the guarantee of defense production loans and the regulation of consumer and real estate credit. We are, therefore, addressing this statement primarily to the reasons why we believe that these provisions should be promptly enacted as a part of the broad legislation needed to meet the present situation.

## Guarantee of Defense Loans

Section 301 of the bill would authorize the President to reinstitute a guarantee program similar to the V-loan program operated by the Federal Reserve System during World War II. The proposed program would be confined to the guarantee by the national defense procurement agencies of loans made by banks and other financial institutions to contractors to finance the production of defense materials needed by the United States in the present emergency. This program is not to be confused with various proposals advanced in post-war years for the peacetime guarantee of business loans.

The financing problems of contractors engaged in defense production, particularly where they are small and medium-size, are unique in character. The loan guarantee mechanism here proposed provides an effective solution of these problems. Contracts for essential defense materials often require much larger financing by contractors than they are able to command under ordinary financing practices. It can make possible maximum participation by numerous smaller business enterprises in the Government's defense production program, particularly those who do not themselves have direct Government contracts but whose work as subcontractors is essential for prompt performance on the larger prime contracts. It can also make practical the awarding of more Government contracts, requiring unusually large working capital or expansion in plant and facilities, directly to relatively small and medium-size concerns. Without such financing, these concerns would not be able to make a full contribution to defense production. Finally, where great speed is essential in the performance of Government contracts, the mechanism can serve to expedite the consummation of loans with a promptness which is not always possible under usual procedures.

The loan guarantee proved to be an eminently successful means of encouraging the extension of private credit for facilitating production under Government contracts during World War II. The guarantee program of that period--the so-called V-loan program referred to earlier--was set up under Executive Order of the President in March 1942. Under that program, loans for war production were guaranteed by the Armed Services through the agency of the Federal Reserve System. The twelve regional Federal Reserve Banks and twenty-four branches, with experienced personnel and close daily contacts with financial institutions, afforded an already existing and well-adapted organization for making such guarantees promptly available to contractors throughout the country. The Board of Governors in Washington acted as the coordinating agency in the administration of the program.

During the course of the V-loan program, bank loans to war contractors, both large and small, amounting to about $10-1/2 billion were approved for guarantees by the Armed Services through the agency of the Federal Reserve System. Over 90 per cent of the number and one-third of the amount of these guarantees were on loans to small and medium-size businesses; that is, businesses with total assets of less than $5 million. Notwithstanding the great volume of loans handled, the program was self-supporting; receipts of the Treasury from the program exceeded expenses and losses by $23 million by the end of 1949. Without the program, the production of war materials would have required more Government financing through direct lending and other means.

For the reasons indicated, the Board feels that the program of guaranteed loans which would be authorized by Section 301 of the bill would constitute an essential part of any plan for expediting deliveries under defense production contracts. If the President should see fit again to utilize the Federal Reserve System for this loan guarantee program, the Board and the Federal Reserve Banks would immediately direct their facilities toward its vigorous and expeditious administration. With the experience gained by the System under the V-loan program during World War II and with personnel both at the Board and at the regional Reserve Banks who participated in the previous operations, it would be possible to develop and put into effect within a very short time the new program of guaranteed loans contemplated by this bill.

Regulation of Consumer and Real Estate Credit

Section 401 of the bill authorizes the President to regulate consumer and real estate credit. Under such authority minimum down payments on purchases, maximum maturities, and other standards appropriate to limit credit extension could be prescribed. Section 402 of the bill would strengthen the President's authority to curtail Federal financing programs in the housing field when the national interest so requires. We regard these as important provisions of the proposed legislation.

Consumer credit regulations were administered by the Board of Governors from September 1941 through October 1947 and again from September 1948 through June 1949.

Such regulations as might be necessary in the real estate credit field under Section 401 would have to be designed to meet the special needs of this area. They would have the general purpose of supporting and supplementing the President's program of cutting back on Federally guaranteed and insured mortgage credit.

Authority for restrictions on consumer and real estate credit should be provided for use to the extent necessary as an essential part of the program for conserving resources for defense and protecting the economy against inflation. This authority would help to prevent current and potential demand from exceeding supply in the areas affected. Accordingly, it would help to reduce inflationary pressure upon prices in these areas. It would help to make materials and manpower more readily available for the national defense and military effort, including the materials and manpower necessary to expand our total productive capacity.

The present international situation not only increases greatly the Government's demand for the goods and services of our economy, but at the same time accelerates private demand. These two additional factors of demand are imposed on a condition of already very high demand, employment, and prices. Even before the attack by the Communist North Koreans on June 25, prices were rising and we were in a potentially inflationary situation. Because of developments of the past few weeks, it is imperative that steps be taken to reduce or defer civilian demands and to lessen inflationary pressures.

The state of public psychology has already stimulated consumer buying and the accumulation of business inventories. In the week ending July 15 department store sales rose to a level 24 per cent above a year ago, with increases ranging from 12 per cent in the Richmond District to 39 per cent in the Dallas District. Sales of automobiles and houses have risen to record levels.

Prices of 28 basic commodities, which had risen 7 per cent from January 3 of this year to June 23, advanced sharply after the invasion of South Korea--10 per cent in one month. The all-commodity index of wholesale prices, which had risen 4 per cent by June 20, has since jumped 3 per cent further. Consumer prices began to rise in March and recently the advance has been further accelerated. Consumer prices are now higher than at any other time, except for a short period in the latter part of 1948.

Unless prompt action is taken, the country will face serious problems of gray markets and spiraling prices. Not only would this situation upset our economic balance but it would add to the difficulty in procuring the manpower and materials necessary for the military effort.

One of the major factors in the expansion of private demand is the growth of mortgage and consumer credit. Since the end of 1945, as shown on the attached chart, consumer credit has been increasing by about $3 billion a year. The increase in the past twelve months was $3.5 billion and in May was about $500 million, the largest increase on record for that month. This was before the Korean crisis precipitated the present buying spree.

The most important segment of total consumer credit is instalment credit, especially for the purchase of durable goods. During the past year instalment credit rose nearly $3 billion and accounted for 83 per cent of the increase in total consumer credit. The role which instalment credit has been playing in the growth of demand is illustrated not only in the amount of the expansion but also by the relaxation in the terms under which such credit is extended. Reports of declines in the required down payment are widespread and the average period of repayment has lengthened progressively.

The current record rate of residential construction involves the greatest increase in mortgage credit which the country has ever experienced. Home mortgages made by all lenders in the first half of 1950 amounted to about $6-1/2 billion or at an annual rate of $13 billion as shown on the attached chart.

The net increase in mortgage debt outstanding during the first half of 1950 (after regular amortization and other repayments) was about $3 billion, bringing the total outstanding on June 30 to about $40 billion. The home mortgage debt of this country has more than doubled since the end of the war.

Expansion of consumer and mortgage credit contributes not only to the current demand for labor and materials that go into housing and durable consumer goods, but also augments the demand for all other goods. The purchasing power created by consumer and mortgage credit enters the income stream where it adds to the competition for goods including materials vital to the national defense.

Growth of consumer and mortgage credit increases the volume of money and other liquid assets. Expansion of bank loans for such purposes adds to the growth of bank deposits. Bank holdings of both consumer instalment paper and mortgage paper are rising rapidly and are thus adding to the total supply of money which is already so large in relation to current output as to provide a constant inflationary threat. Restriction of consumer and mortgage credit, therefore, would help to keep within bounds the quantity of money and other liquid assets in the hands of the public.

In normal times consumer and mortgage credit play a very important and desirable role in our economic system. Without such credit widespread home ownership and mass distribution of durable goods would not have been possible. If our mass production economy is to sustain its expansive character in normal times, we will need to have expansion of mortgage and consumer financing. However, in order that such financing may be of greatest value it is important that it be used most fully when industry is in a position to meet the demands created. When industry is already occupied to capacity and important resources must be diverted to the defense effort, the creation of new credit can not increase the general availability of goods. On the contrary it contributes to inflation and economic disorganization. If mortgage and consumer credit is appropriately limited now it will be in a better position to play a necessary and desirable role whenever adequate productive capacity is once more available to meet freely consumer demands.

Regulation of consumer credit should and can be flexible. The previous regulations were tailored to fit prevailing conditions, with coverage and terms suited to changing circumstances. To illustrate, in the fall of 1941 the regulation applied only to instalment credit relating for the most part to consumer durable goods of substantial unit cost--automobiles, refrigerators, and the like. When the country entered the war the regulation was enlarged in scope in keeping with the general mobilization which took place. It covered practically all consumer durable and soft goods and instalment, single payment, and charge account credit. After the war, late in 1946, the scope of the regulation was made even more limited than when it was originally applied.

The decentralized character of Federal Reserve System operations proved well adapted to the administration of consumer credit regulation as well as to the V-loan guarantee program. Through our twelve Federal Reserve Banks and twenty-four branches, located in every region of the country, we were able to tap quickly and effectively the informed opinions of small as well as large business.

In our experience with the administration of consumer credit regulation, the business community gave us excellent cooperation. Various trade associations took an active part in acquainting businessmen and the public with credit regulations, and they cooperated to the fullest in helping to assemble needed technical information. Large and small financing institutions responded generously to our requests for information and advice. State and Federal supervisory authorities also gave us valuable assistance during the course of their regular work.

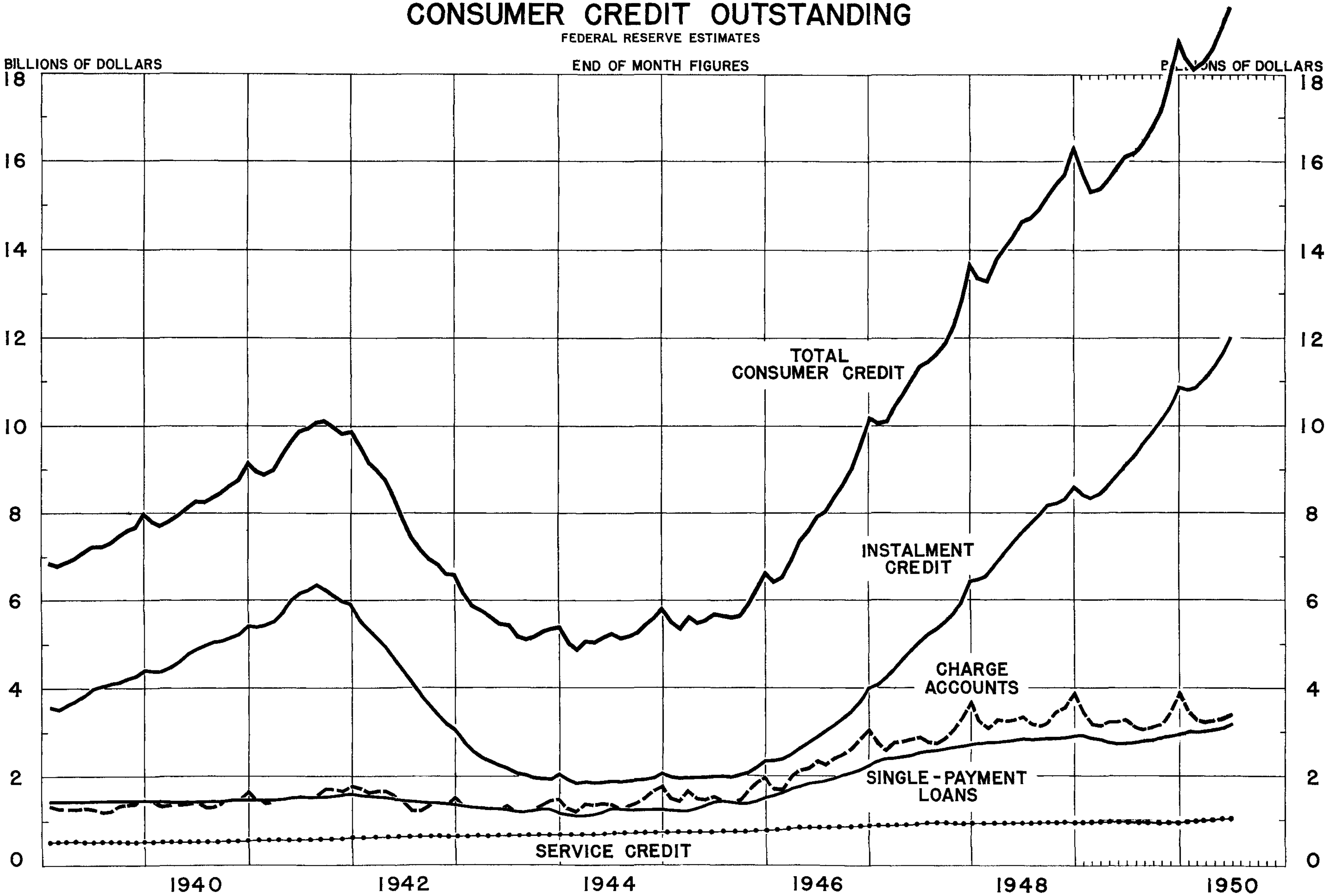
With respect to real estate credit, there should be an equally practicable approach. The full cooperation of leaders in the mortgage financing field should be enlisted to design a regulation, similarly flexible and adapted to the changing economic situation.

The commercial banks play a strategic role in the real estate credit market. Any regulation of such credit will have significant effects on general credit conditions in which the Federal Reserve System is primarily interested.

The need to strengthen our economic defenses is no less than the need to strengthen our military defenses. We can not afford to risk disrupting our economy by leaving it unduly exposed to the inflationary pressures that are inherent in large defense expenditures. Prompt action is imperative. As the President said in his message on the present situation: "We must be sure to take the steps that are necessary now, or we shall surely be required to take much more drastic steps later on."

# CONSUMER CREDIT OUTSTANDING

FEDERAL RESERVE ESTIMATES

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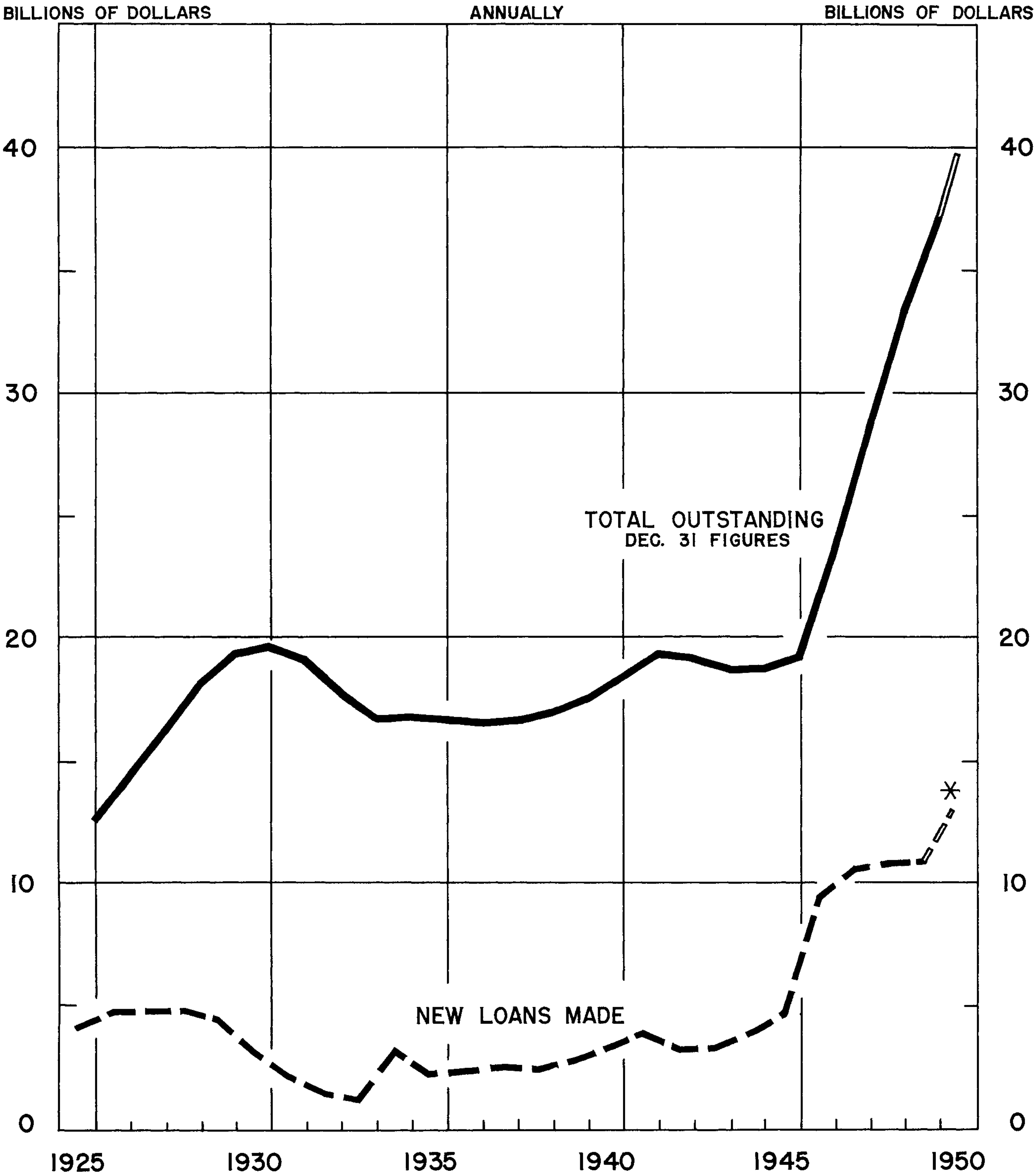
BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

# NONFARM MORTGAGE DEBT

HOME LOAN BANK BOARD ESTIMATES




*ANNUAL RATE FOR JAN – JUNE.