

For release in afternoon newspapers,
Friday, December 8, 1950.

THE "FLUID" DEFENSE AGAINST INFLATION

An Address by Oliver S. Powell, Member,
Board of Governors of the Federal Reserve System,
Before the Pacific Northwest Banking Conference,
Olympic Hotel, Seattle, Washington,
December 8, 1950.

THE "FLUID" DEFENSE AGAINST INFLATION

The title for this address uses a common military term. At times it is not expedient to form a solid defense in depth all along a battle-front, and it is necessary for troops to be sent in to the lines wherever the danger seems greatest. There is a continual reappraisal of the aggressor's moves and a shifting of defense to meet new situations. The Defense against inflation is somewhat similar. There is no such thing as an over-all defense move to prevent higher prices short of complete freezing of prices, wages and profits. In a peacetime economy, or one of a growing national defense short of war, we have rejected these complete controls and we are using a battery of voluntary and regulated restraints.

It is my purpose this afternoon to give you a progress report on the use of these restraints; but first let me give you a brief account of the inflation problem and its sources. Early in 1950 the recovery of business from the minor recession of 1949 had brought the level of production, consumption and employment to a high plateau. Production was almost at capacity, a point beyond which it is difficult to expand except by the slow processes of population growth, more factories and improved industrial techniques. Then came the Korean invasion and it set off a rush of panicky buying. Remembering the shortages that developed during World War II, we rushed to the stores and bought abnormal quantities of merchandise--everything from sheets and coffee to television and autos. There was also an unprecedented increase in residential building, which will probably bring the 1950 total to a new high record of one and one half million units. This buying rush caused retailers and manufacturers to step up their purchases

and production rates, and there was a sharp increase in employment. The inevitable result of all this was a sharp rise in prices, and another round of wage increases.

It is important to analyze the sources of buying power which made possible this abnormal buying movement which was superimposed on a high level of peacetime trade. There were three principal sources of buying power:

First, current income. The sum total of wages, rents and income from invested capital which normally just about equals the production of goods and services.

Second, the use of savings by drawing down savings accounts, cashing savings bonds and spending funds which had remained idle in checking accounts awaiting a suitable time for use.

Third, borrowing against future income. Consumers' borrowings to buy automobiles, household appliances and houses; business firms borrowings to increase inventories or to pay higher prices for inventories or to extend credit to consumers.

The combination of these three sources of buying power, coupled with the greater activity of deposit accounts, when used to purchase a quantity of goods and services that could not expand with equal rapidity has caused a price rise of three to four per cent in consumers' goods and a much larger price increase in raw materials and wholesale prices.

This situation would probably have called for restraining action of some sort even in peace time. It became much more essential to invoke restraints under today's conditions of growing plans for national defense. The

gap between available goods for civilian consumption and the supply of purchasing power promises to be even larger as the months go on. Within a year we are likely to see a million fewer employees engaged in making civilian goods. The amount of raw materials available for civilian goods production will probably be less next year than today because of defense requirements. Already allocations and restrictions in many strategic materials have been announced. Yet with full employment, counting as employees those producing civilian goods, the workers in defense industries and people in military service, the national income might be as much as twenty-five billion dollars above current levels. This guess is on the assumption that no further price increases occur. The probable gap between income and available civilian goods would cause tremendous pressure for higher prices, even with no expansion in bank credit and various forms of consumer borrowing against future income. It should be borne in mind that higher prices not only add to our cost of living and subtract purchasing power from our savings, but they also add to the cost of defense and to the problem of financing the defense effort.

This is the problem with which we are faced. Now, what of the "fluid" defense? Again, in military terms, let us list the attacking forces and consider the defenses that have already been set up or are in prospect.

1. The rapid spending of income and savings. Here the defense must primarily be in the form of taxes and still more taxes. Through our elected representatives, the Federal Government has already increased income taxes to channel a portion of our national income into the purchase of defense materials and services. At the same time, they are eliminating to

that extent our ability to use the same funds for the purchase of civilian goods.

A secondary line of defense is for the American people voluntarily to restrict our purchases of goods and to substitute increased savings in the form of purchases of Federal savings bonds and insurance, increasing savings deposits, etc.

2. Borrowing for the purchase of consumer goods--automobiles, household appliances, home modernization, furniture, etc. Credit in this field has increased four billion dollars in the past year and it now totals nineteen billion dollars, which must be paid out of future income. This is ten per cent of a whole year's disposable income of the nation.

The defense set up against this pressure toward higher prices is Regulation W, with whose terms this audience is fully familiar. We have all been curious as to the effects of the Regulation and the monthly estimate as of the end of October was awaited with considerable suspense. When the mass of statistics was assembled, it was found that the increase in consumer credit had been checked although not entirely eliminated. In place of a monthly increase ranging from 464 million dollars to 644 million dollars as had occurred during the third quarter of the year, the October increase was only 51 million dollars. It is still too early to say whether this development was caused principally by the tighter terms of Regulation W imposed on October 16 or whether it was a complex of other factors, such as the slowing down of automobile sales due to preparation for new models, a slowing down in consumer buying due to the heavy buying of last summer or other factors. We shall need to observe the course of consumer credit in future months for a

better interpretation of the causes. One development in October which was not caused by Regulation W was the decrease of 38 million dollars in charge account credit.

3. Borrowing for the construction of housing. Real estate credit has expanded between four and five billion dollars in the past year and it is now estimated that the American public owes 41 billion dollars for housing. This tremendous growth of credit which made possible the new high record in residential construction in 1950 has also made possible a tremendous consumption of materials and a use of manpower at a level which if continued might slow down the defense effort. The defense set up against this type of credit pressure toward higher prices is Regulation X, authorized by the Defense Production Act of 1950 and inaugurated with the concurrence of the Federal Housing and Loan Administrator. Here again this audience is familiar with the terms of the Regulation, which at present is limited to terms for the purchase of new homes and for loans on existing homes when insured by the Federal Housing Administration. I cannot report any measurement of the effectiveness of Regulation X which went into effect on October 12, 1950. Something like four hundred thousand housing units were in the commitment stage on October 12, not counting houses already under construction. Thus, the building industries will continue to be active for many months to come before the effects of Regulation X become apparent. Furthermore, there is not as yet any regulation in the rental housing field although this area may be regulated under the Defense Production Act.

4. Bank loan expansion. This is listed as one of the forces working toward higher prices in view of the fact that bank loan expansion since

mid-year has totalled the amazing sum of six billion dollars, much the largest autumn expansion in history. It is a simple fact that each dollar of bank credit perforce increases bank deposits and thus adds a dollar to the money supply. I might add that bank loan dollars are very active dollars because businessmen and individuals do not borrow unless they have the immediate intention of spending the proceeds.

The picture of bank credit expansion is somewhat modified by the fact that one half of the effect on the money supply of the bank loan expansion this fall was offset by sales of Government securities out of bank portfolios. A portion of these securities was sold to the Federal Reserve Banks through the money market to obtain more reserves required by the increase in deposits at member banks. A portion of the securities was bought by Government trust funds like the unemployment insurance trust fund, whose assets have been growing during this period of near full employment. Another part of the Government securities was bought by corporations whose liquid asset position has been improving under today's conditions of full production and profits.

Nevertheless, in spite of the offsetting sales of Government securities, some of which have drawn down bank deposits, the net bank credit expansion since mid-year was three billion dollars, representing a two per cent rise in the money supply of the country.

I do not need to tell this audience that bank credit is a very complex affair. It ranges all the way from consumer finance on the one hand to loans for defense production on the other. In between are the normal loans to finance crop moving and loans to business to provide normal

inventories, plant expansion and the growth of receivables which occurs every fall.

In the week before Thanksgiving the Federal Reserve authorities made a spot check to see what had been causing the increase in loans at some of the largest banks in the United States. Information was requested from seventy-one banks whose combined loan increase since June 30 was two billion sixty-five million dollars or approximately one third of the increase at all banks in the country. At these banks about sixty per cent of the total increase was in loans to commodity dealers and processors of agricultural commodities as follows:

Cotton	487 million
Other commodities	203 million
Food and liquor manufacturing	206 million
Tobacco manufacturing	142 million
Textiles, apparel and leather	130 million
Grain and milling	65 million

Sales finance loans increased 324 million dollars. Loans to retail and wholesale trade increased 272 million dollars. There were minor increases in other lines, including construction and public utilities. The increase in loans for defense purposes was notably small--only ten million dollars--and loans to manufacturers of metal products actually decreased by seventeen million dollars.

I cite these figures to indicate that the loan increase at these banks was almost entirely related to peacetime activities, crop moving,

agricultural commodity processing, retail and wholesale trade and consumer credit. While the breakdown of figures for smaller banks in the country would probably be somewhat different, the general pattern would doubtless be the same--a tremendous increase in bank credit to finance peacetime business at rising price levels.

The inflation defense in the bank loan field has been largely one of urging voluntary restraint on the bankers of the country. The problem is difficult due to the large number of banks. The individual banker cannot be expected to see the national situation or the impact of his loans on the national money supply. I am sure that every bank loan is sound in the banker's eyes from the standpoint of collectability on the day when the loan is made, and yet there remains the hard fact that in the aggregate bank credit expansion has added to the money supply at a time when the effect on prices is particularly important. Specifically, what have the banking supervisory authorities done in the field of bank credit restraint?

Here are the moves:

(a) Letters have been sent to every bank in the United States enlisting their aid in screening their loans and explaining to would-be borrowers why loans should be kept at a minimum. One such letter was sent out in August by all of the Federal agencies and the State Bank Supervisors jointly. In November separate messages were sent by the Chairman of the Board of Governors, by the Federal Deposit Insurance Corporation and by the Comptroller of the Currency to banks under their supervision. The general tenor of these letters is indicated by the following sentence from the November Federal Reserve Board letter:

"Commercial banks can also do their part in bringing about restraint of credit by advising borrowers to avoid overstocking of inventories and to postpone unnecessary business expansion, and by discouraging various types of loans that do not make a definite contribution to the defense effort."

I was pleased to note that the Washington Bankers Association has taken the same stand. Here is a quotation from a letter issued on September 22 by that Association:

"The demands on our economy in the coming months will be extremely inflationary. Unless proper protective measures are adopted, both voluntarily and/or imposed by statute or regulation, the value of the dollar could be so reduced that our country would be a fertile field for foreign 'isms' and ideologies which we are aggressively battling."

Next week in Chicago the American Bankers Association is holding a National Credit Conference at which this problem of bank credit expansion and its restraints will be discussed in detail by national leaders.

(b) At the risk of repetition, I should point out that Regulations W and X strike at further increases in some of the most profitable types of loans made by banks. The banks have responded admirably to these regulations and are enforcing them without complaint. Indeed, they are whole-heartedly behind the purpose of the regulations. Listen to this quotation from a letter to Chairman McCabe from a Mid-Western banker who operates a large consumer loan department:

" * * * we have a sizable Installment Loan and Finance Department so that your new regulations are going to affect us adversely as to outstandings and also as to income. However, in spite of this, we feel the new regulations are good for the country and we are writing you today to encourage you to maintain your stand * * * To stop continuing inflation some of us are going to have to get hurt a little along the way, but unless we are farsighted enough to look beyond that small immediate hurt, we are not going to stop inflation, * * *"

(c) Discount rates have been raised from 1-1/2 per cent to 1-3/4 per cent by all Federal Reserve Banks. While borrowing from the Federal Reserve Banks is not large under today's conditions, the increase in discount rates nevertheless served notice that the Federal Reserve Banks advised caution in further bank credit expansion.

(d) Short-term interest rates as reflected in the prices of short-term Government securities have been allowed to rise by a fraction of one per cent. This move has exerted steady pressure to discourage the sale of Government securities by present holders for the purpose of using the funds in other ways. It has also made these short-term Government securities somewhat more attractive as investments and to that extent has encouraged the diversion of funds out of the spending stream.

The Board of Governors of the Federal Reserve System has not as yet used its remaining powers to increase the reserve requirements of member banks. Under the law, reserves against net demand deposits at country banks and Reserve City banks can be raised two per cent. (From 12 to 14 per cent

and from 18 to 20 per cent, respectively.) The central Reserve City bank reserves against demand deposits can be raised from 22 to 26 per cent. A one per cent increase (from 5 to 6 per cent) can be ordered against time deposits at all classes of banks. The full use of these powers would probably cause member banks to sell upwards of two billion dollars of Government securities through the open market to the Federal Reserve Banks in order to obtain the additional required reserves. Aside from decreasing the earnings of member banks, this move would decrease their liquidity to some extent since they would probably dispose of their shortest term, lowest rate securities. The move would be an automatic way of exerting some further restraint on loan expansion at member banks. Each bank, of course, would continue to make the decisions as to what loans it would make and what loans it would refuse.

I have discussed with you the pattern of the "fluid" defense against inflation, the weapons which have been used or may be used and the ways in which they have been used up to this time. For the present the rapid advance in consumer credit has been merely halted. It is too early to say whether real estate credit restraints will stop the increase in that field. In bank credit expansion, the increase has continued right up through the latest week's figures although bankers expect that the peak for this movement is about at hand. They also expect a heavy liquidation during the winter months that will release credit for defense purposes. In other words, the emphasis should soon shift from the screening of new loans to concern for the prompt repayment of loans already made.

Thus the "fluid" defense is operating. The campaign is continuing and the battle is far from won. The objective, a strong currency with well maintained buying power is well worth the most earnest efforts of the entire banking industry.