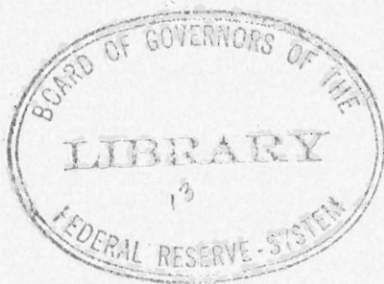


INFLATION INFORMATION FOR STATE BANKERS ASSOCIATIONS

An Address by Oliver S. Powell, Member,
Board of Governors of the Federal Reserve System,
Before a Luncheon Meeting on December 15, 1950,
at the National Credit Conference of the American Bankers Association,
in Chicago, Illinois.



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This luncheon meeting is, I take it, a workshop for the discussion of ways and means of informing the banks in your various state associations as to the nature of the inflationary threat under today's conditions, the means already taken for combatting inflationary trends and the part which the banks which are members of your associations can play in further inflation restraint. Chairman McCabe of the Board of Governors of the Federal Reserve System yesterday gave the Conference a complete picture of today's problem and the reasons why we are working through the field of credit controls and voluntary credit restrictions rather than by all-out regimentation of the economy. This noon I should like to give you certain facts and figures which may be useful to you in later meetings and messages which you may plan in the various states. While there may be some repetition with Chairman McCabe's address, it is perhaps pardonable in view of the objective of this talk.

I know from personal conversation with a great many bankers that they are keenly concerned over the dangers of inflation and that they have screened their loans for many months to check so far as possible the expansion of credit for less essential purposes. These efforts of individual banks have been stimulated by messages and advice from the credit policy committees of many of the state associations. Recently, I had the pleasure of reading the short and direct message sent out by the Credit Policy Committee of the Wisconsin Bankers Association. The Washington State Bankers Association, on September 22, also issued an excellent letter. Here are two sentences from that document:

"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."

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 from which expansion can take place only 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 all kinds of merchandise, in fact, 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, wholesalers 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 rise in prices, and another round of wage increases.

Now let us enumerate the sources of buying power which made possible this abnormal buying movement which was superimposed on a high level of peacetime trade. There are three principal sources of buying power and all three have played their full part in recent price and shortage developments.

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

Second, past savings. Past savings supplement current income as a source of purchasing power when savings accounts are drawn down, when savings bonds are cashed and when funds are spent now which had remained idle in checking accounts awaiting a suitable time for use.

Third, borrowing against future income. Especially important to this group is the use of credit as a source of purchasing power. When consumers borrow to buy automobiles, household appliances and houses, and when business firms borrow to increase inventories or to pay higher prices for inventories or to extend credit to consumers, the main result is, in times like these, a strong upward pressure on prices.

Since Korea all three of these sources of buying power, coupled with the greater activity or turnover of deposit accounts, have been extensively used to bid for a quantity of goods and services that could not expand with equal rapidity. The result, of course, has been a price rise of three to four per cent in consumers' goods which does not, even yet, fully reflect the much larger price increase in raw materials and wholesale prices during the same periods.

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. It is important to explain and to emphasize that the gap between available goods for civilian consumption and the supply of purchasing power promises to widen progressively 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 a number of 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 will exert tremendous additional pressure for higher prices, even with no expansion in bank credit and in various forms of consumer borrowing. It should be borne clearly 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.

Next, let us list the inflationary 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.

One credit 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 fifty-one 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 the result of 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 thirty-eight million dollars in charge account credit.

3. Another credit defense is Regulation X applying to 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 forty-one billion dollars for housing. This tremendous growth of credit which made possible the new high record in residential construction in 1950 has also resulted in a tremendous consumption of materials and a use of manpower at a level which if continued might slow down the defense effort. Regulation X, which is authorized by the Defense Production Act of 1950, was inaugurated with the concurrence of the Federal Housing and Home Finance 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. It is too early to measure 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. We come now to the matter of 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 expansion for a like period in history. It is a simple fact that each dollar of bank credit performance 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 in this period of full production and high 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	437 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."

(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 far-sighted 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 diverted funds from 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 decision 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. In the week ending November 29, weekly reporting member banks experienced a loan increase of 550 million dollars.

Bankers expect that the peak of this loan expansion is near at hand. From estimates of well-informed bankers, a period of liquidation should ensue during the winter months. The amount of this liquidation will measure the extent to which bank credit is released for defense purposes. In your further advices to the banks which are members of your associations it may be that your emphasis will shift from screening new loans to an adequate collection policy for reducing maturing loans.

As a final word, let me offer on behalf of the Board of Governors of the Federal Reserve System any assistance which we can give you

in the way of supplying information and facts for you to use in discussing the inflationary problem with your members. We appreciate the efforts already made by your associations which have added a great deal to the public information on this important subject. We would like to work hand in hand with you as you take whatever further steps may seem desirable to bring the subject to the attention of your members.