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BANKS, INFLATION AND DEFENSE

An Address by Oliver S. Powell, Member,
Board of Governors of the Federal Reserve System,
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BANKS, INFLATION AND DEFENSE

It is a great privilege to discuss with this banking group some of the urgent current problems which affect banking and the nation today. For many years I have heard of these important Midwinter meetings, but it has not been my good fortune to attend one heretofore. Neither have I had the pleasure of visiting with you gentlemen on your home grounds. However, for thirty years I have lived among the bankers of the Ninth Federal Reserve District and many times a year I have sat down with individual bankers in their own offices to discuss banking problems and methods. Many of those bankers are among my most valued advisers. Thus, in talking with you about banking under today's conditions, I believe that I do so with a sympathetic understanding of some of your problems, especially in the smaller banks.

This country is just beginning to learn an ugly lesson: how to live as a garrison state. Throughout most of our existence as a Nation, we have been able to put aside most of the trappings of War except when armed conflict was forced upon us, and at such times we had powerful allies to carry the burden of war until our armies were recruited and equipped. In peacetime we had the comfortable knowledge that we were protected by two great oceans, the British navy and powerful land forces in Europe, which were either mobilized or in a state of partial mobilization. Now we find ourselves forced to engage in military preparations similar to those with which the countries of Western Europe have lived for generations, but of course on a much vaster scale due to our size and the problems of modern warfare. How to convert to a state of satisfactory preparation for defense without wrecking our economy through the inflation process is the nut which we are trying to crack.

With this background, let me sketch briefly what has been happening in the economic situation of our country with just enough figures to serve as a background for our discussion. Industrial employment is at a record level of more than 45 million employees, and unemployment is at a very low level. Industrial production has been bumping along at an apparent ceiling level of 215 - 217 per cent of the prewar base period. Apparently it is going to be difficult to increase production beyond this level, except very slowly as plants expand, labor-saving processes are developed, workers put in longer hours and more people are brought into the employee group. In spite of this record production, consumer prices have risen 7 to 8 per cent since last March. Paralleling this increase, weekly earnings of employees in manufacturing have risen about the same since June.

Inflation is nothing but an undesirable and excessive increase in the over-all price level. Inflationary pressures have been accumulating for a number of months. The correctives for inflation lie in many fields. The most important corrective is more taxation. This will have the twin results of taking money from all of us on an equitable basis to be spent in the common effort and of eliminating the possibility of our spending the same money for peacetime goods which would certainly bid up their prices at a time of growing scarcity of these goods. The second corrective for inflation is to encourage people to postpone spending through the purchase of Government bonds and the other forms of savings. I should like to elaborate on this matter of the sale of Savings Bonds. There is in many quarters a defeatist attitude, the gist of which is that people should not put their money into fixed income and fixed maturity value securities because

prices are rising and the part of the future buying power of the funds will thus be lost. Of course the same argument would apply to putting money into savings accounts, insurance and pension funds. We, as bankers, should take exactly the opposite stand. Next to taxation the accumulation of savings which will postpone the use of funds for consumer buying is the strongest possible weapon to use against inflation. We, as bankers, should assume that aggressive point of view toward the sale of savings bonds and accept the duty of explaining the necessity for the sale in our community. A third and very important restraint against inflation is to reduce the extent to which consumers borrow against future income to spend today and businesses borrow to build excessive inventories.

There are many other fields in which correctives for inflation lie. Just to name a few, they include restraints in requesting or offering higher wages, acceptance of moderate profit margins by industry, avoidance of commodity hoarding or speculation, postponement of non-essential construction and other spending, and economy in non-defense spending both by national and local governments. Then, as a second line of defense, there are the Government controls, such as allocation of materials, rationing, priorities, and wage and price fixing.

However, this talk is to bankers about banking and I must trust this audience to recognize that I have not lost sight of the importance of the whole list of restraints which I have just mentioned when I proceed to elaborate on banking problems and the restraints, voluntary and otherwise, which have been used or might be used in the inflation battle.

In a large measure your success in explaining the inflationary problem to your borrowing customers and your judgment as to whether loans

should or should not be made and in what amounts will have an influence which it is hard to over-emphasize on the final relationship between bank credit and the price level. This is as it should be, for I do not believe that any Government body in Washington can lay down rules to fit every relationship between banker and borrower or to tell banks exactly what loans should or should not be made.

There is one basic difference between commercial banks and the central bank in the approach to loans. You necessarily look at each loan application first in the light of the situation of the individual borrower, whereas the Board of Governors of the Federal Reserve System must look at bank credit from the over-all national standpoint; namely, that dollars of bank credit are dollars added to the money supply which under certain conditions will permit increases in commodity prices. There are other important factors in your individual loan decisions. Your institutions are subject to competitive pressures. Also you have long-standing commitments for lines of credit which are a fundamental part of the banking system. With these forces brought to bear on your lending operations, it requires a high degree of judgment and self-restraint to conduct your lending operations under today's conditions in the best interests of your borrowers, your banks and in the general welfare.

The money supply of the United States rose during 1950 by the huge peacetime total of over 6 billion dollars. This meant that the public had that many more dollars to spend, and they did spend them. Since the volume of production could not increase rapidly enough the main result has been the price increases which I have mentioned. Now we have in prospect a complication due to the growing level of defense production which will inevitably

reduce the volume of goods for civilian purchase although the money supply in civilian hands will not be reduced and in fact probably will increase.

The entire increase in the money supply was due to an expansion in bank loans which amounted to an all-time record of 9.7 billion dollars at all commercial banks in 1950. Business loans expanded 5 billion dollars and real estate and consumer loans at banks expanded about 2-1/2 billion dollars each.

Now it is important that we, as merchants of credit, understand how our product operates. Let us look at the relationship between price increases and the rise in the money supply. Prices rose from 7 to 8 per cent in consumer goods at retail to 50 per cent for basic commodities. The composite of all prices may have risen 10 per cent; but the money supply rose only 4 per cent. The remainder of the increase in prices was made possible by a more active use of existing bank deposits. In other words, the turnover of deposits rose sharply during the past few months.

Here again the explanation goes back to the lending operations of the banks. Dollars created by bank loans are very active dollars. This is easily explained, for the interest cost to the borrower causes him to use his bank balance as efficiently as possible, to borrow as little as possible and to pay off his loan as soon as possible. Thus, not only his borrowed funds but his entire deposit account is used actively during his period of indebtedness. Increases in bank loans in the past several months have acted in two ways on the price level: first, they increased the money supply, and second, since the deposit dollars must have been urgently needed to cause the great loan expansion, they turned out to be very active dollars, thus contributing to further increases in prices.

Recognizing the effect that credit expansion was having on prices, the commercial banking system and the central banking authorities have been gravely concerned and have strenuously attempted to hold bank loan expansion and consumer credit in check. The problem has been forcefully brought to the attention of banks and the public through letters and statements from supervisory authorities, and from the American Bankers Association and most State bankers associations. Under the leadership of the American Bankers Association, a National Credit Conference was held last month in Chicago, at which meeting the entire bank credit expansion problem was carefully explored.

The Federal Reserve System has taken direct action in a number of ways. The discount rates at Federal Reserve Banks have been increased by $1/4$ of 1 per cent and this was followed by a moderate, but general, increase in lending rates at commercial banks. Short-term money rates in the Government security market have been allowed to rise somewhat. A consumer credit regulation has been issued. (Partly as a result of this regulation, consumer credit expansion almost ceased in October and November, the latest months for which estimates are available.) With the concurrence of the Federal Housing and Home Finance Agency a real estate credit regulation has been imposed. Starting in January, member banks are called upon to carry somewhat higher reserves at the Federal Reserve Banks.

While many of you are associated with non-member banks, I am sure you will be interested in some of the Reserve Board thinking in the matter of the recent increase in reserve requirements. It is a common statement that a move of that sort is futile, for member banks merely sell Government

securities in the market and the Federal Reserve Banks buy an equal amount of Government securities to maintain an orderly Government bond market. Thus, member banks lose a certain amount of their earning assets in order to build up reserve balances at the Federal Reserve Banks, but without any real effect in tightening credit.

This line of reasoning deserves closer examination. An increase in reserve requirements is a double-barreled weapon. First, it requires member banks to maintain larger balances with the Federal Reserve Banks. Second, the credit multiplier is reduced. In other words, the amount of bank deposits which can be built on the basis of a dollar of reserves is lessened as the reserve requirements rise. Thus, if bank credit expansion creates more bank deposits, a larger share of the new deposits is immobilized in the form of Federal Reserve balances.

So much for theory. There are also practical elements to be considered. If the hunters among you will excuse the pun, both barrels of this weapon are partly choked but not entirely closed. Even with 53 billion dollars of Government securities in member banks which theoretically could be sold to the market to obtain reserves, it is probable that these Government securities are not evenly distributed; some member banks might find it necessary to use other means of obtaining the additional reserves required. Other banks may not wish to disturb their investment portfolios and may prefer to let some of their loans run off instead. Still others may be faced with the sale of Government securities at prices slightly lower than the price at which the banks purchased them. It is almost a certainty

that the latter condition will be found in many banks in view of the moderate rise in short-term money rates which occurred last Fall. That the increased reserve requirements have some effect was evidenced by the prompt increase of $1/4$ of 1 per cent in the prime commercial loan interest rate at New York banks.

In a broader way, the announcement of an increase in reserve requirements tells the public that in the judgment of the Board of Governors of the Federal Reserve System, over-all credit restraint is in the public interest.

Now, a word as to the timing of the increase in reserve requirements. Last Fall it was recognized that if the tool was to be used a logical time would be in January. After Christmas there is a tremendous return flow of currency from stores into bank deposits and from banks into their reserve accounts at the Federal Reserve Banks. In the first two weeks of 1951 this return flow of currency totalled 500 million dollars and the movement will probably continue for another five or six weeks. Secondly, deposits ordinarily shrink in the January-March period as loans are paid off due to the completion of Autumn and Winter business. In 1950 the deposit decrease at member banks was about 5 billion dollars and in the preceding three years it was that much or more in every year. The decrease in deposits reduces the requirements for reserves. With reserve requirements being reduced and available reserves being increased by the return flow of currency, member banks would have a large amount of funds available for either investment or loan expansion. The increase in reserve requirements will immobilize these funds. There should be a minimum of sale of investments by member banks and security purchases by the Federal Reserve Banks.

I cannot leave the subject of reserve requirements without a word of appreciation to the New York State Banking Department for their splendid cooperation with the Federal Reserve System. For several years now your State Banking Department has cooperated to the fullest extent with the Board in its efforts to fit changes in reserve requirements to changes in the underlying economic situation.

So much for the history of the recent past. We find ourselves today with bank loans at a peak. During the past week total loans had their first sizable decrease in many months. Perhaps this is the beginning of the seasonal decrease which is certainly about due. However, I do not believe that we, as partners in the banking system, can breathe a sigh of relief and say, "Well, it is over now and we can forget the episode." The total of loans is still very high, and we must look forward to the next phase of our problem; namely, to collect the loans on schedule and not let the borrowed funds be used for other purposes. In this connection I am thinking of the case of a country banker who recently told me that a hardware merchant in his town failed to repay the money which he had borrowed to purchase refrigerators, but used the money instead to buy a carload of furniture. I wonder to what extent bankers may, without their sanction, be entering such a partnership with their borrowers?

A careful check of the loan expansion at a number of the largest banks in the country just before Thanksgiving indicated that the lion's share of the loan expansion was due to the financing of raw farm products, grain, tobacco, cotton, etc., either directly or through the purchase of those products by industry. Since these crops come on the market only once

a year, it should follow that loan liquidation should accompany the disposal and consumption of these crops. In other words, we should be able to eat, smoke and wear our way out of that part of the loan bulge which occurred last Fall.

In addition to an alert collection policy, bankers and other lenders should and will continue to screen their loans. In this connection I am sure that you have all heard of the program of voluntary agreements to restrain credit which was authorized by the Defense Production Act of 1950. A competent committee of commercial bankers and representatives of life insurance companies and investment banking houses has been meeting in New York to try to work out a plan which will meet the requirements of the Attorney General and the Federal Trade Commission and will afford a means whereby lending institutions of all kinds can work jointly in the public interest. It is too early to say what form the voluntary agreements may take, but it is hoped that as a very minimum the committee may produce a statement as to the kinds of loans which are more desirable and those which are less desirable during the present period of the defense effort. A sort of ladder of priorities might be devised. As one banker put it, loans might be classified as black, white, or gray. Those in the black classification should not be made under present conditions even though credit-wise they are sound. Those in the white category have to do with defense and should obviously be made. The gray area should be reduced to a minimum by careful definition. May I suggest that an important part of the program of making the voluntary credit restraint agreement work is to review your unused lines of credit in the light of the principles of the

agreement. I know that these credit commitments come up for review periodically and at the time of these reviews it would seem a strategic time to discuss with your customers the changing policy forced by the growing defense effort.

Such a national pronouncement by representatives of the leading types of financing institutions must obviously be interpreted in the light of local conditions. You will be interested to know, if you do not already, that representatives of New York City banks have been working in close collaboration with the committee. You are fortunate to have near at hand correspondent bankers who can advise you not only as to the broad intent of this program of voluntary cooperation to restrain bank credit but who will be glad to sit down and discuss specific standards in the light of individual bank and customer requirements.

I cannot close this address without referring again to the broader aspects of inflation control during the protracted period of defense preparation with which we are faced. Every citizen has a responsibility in this matter, both personally and through his influence on his associates. Bankers, as community leaders, have a particular privilege and responsibility. This is not alone in the field of loans and collections, but to work for sound anti-inflationary policies in other governmental and commercial fields. It is important to reduce inflationary pressures both to keep the cost of defense at the lowest possible level and to insure the future purchasing power of our savings, our insurance and our bonds. Finally, the preservation of the buying power of the dollar will permit it to stand before the world as a bulwark of stability and as an important heritage for those who come after us in our own country.