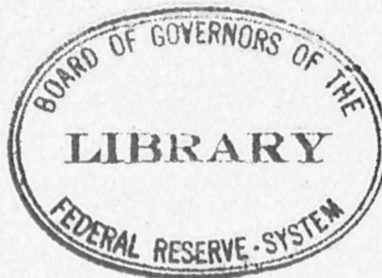

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RESTRAINTS UPON CREDIT

An Address by Oliver S. Powell, Member,

Board of Governors of the Federal Reserve System,

Before Luncheon Session of Annual Meeting,

Chamber of Commerce of the United States,

South American Room, Statler Hotel, Washington, D. C.

May 1, 1951.

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RESTRAINTS UPON CREDIT

It is a pleasure to appear on the platform with two such distinguished leaders to discuss the "Restraint of Credit" as a phase of "Finances and Defense". I take it that this session is largely focussed on Inflation Control. The discussion of taxation and Governmental economy by the other speakers brings these important aspects of inflation control into focus in this period of growing Defense expenditure. Probably taxation is the most important tool of inflation control, for if purchasing power is taken from the individual or business firm for common ends, the same funds cannot be used to compete with Government for goods and services.

That would seem to be the final corrective for inflation except for two forces, the use of savings and the availability of credit. I shall refer to savings at another point in my address, for the use of various kinds of savings for current expenditures may affect either the turnover of money or the volume of bank credit.

As a beginning, I want to take you back to some elementary economics. Since we are dealing with the mechanics of inflation, we should recall that an increase in prices occurs (1) when the money supply increases more rapidly than the volume of business or (2) when the rate of turnover of money increases to a point where the monetary work done by the money supply is greater than needed for the Nation's business.

This story really starts back in 1934 with the devaluation of the dollar That event immediately created an enormous increase in gold reserves which are the base of the bank credit pyramid. In the next few years after devaluation, world events caused a tremendous inflow of gold into the United States, adding further to the basic gold reserves. From that time on, the problem of monetary authorities has centered largely around the management of these large gold reserves in such a

way as to prevent undue manufacture of credit and an inflation in commodity prices. This holds true today in spite of the gold exports in the last year and a half.

There was a respite from the gold reserve problem during World War II. In fact we were very thankful to have such large gold reserves, for these reserves made it possible for the banks of the United States to purchase Government securities in huge quantities to provide for money for war, over and above the amount provided out of national savings and taxes. However, at the close of the war the Nation found itself with bank investments and bank deposits greatly increased. As these bank deposits went to work for the purchase of civilian goods, price advances occurred as soon as controls were removed.

These price advances would have been much greater except for a little-understood development in the behavior of bank deposits. This was the fact that the turnover of bank deposits had declined steadily from the 1920's until 1945. In the 1920's an annual turnover of demand deposits from 31 to 37 times was considered normal for leading cities. By 1945 this turnover had been reduced to 16 so that a dollar of deposits was doing only half of the monetary work that it did in the 1920's. There was some increase in deposit turnover during the post-war years, and a sharp increase since the Korean War to a turnover rate above 23 turns a year. However, if the owners of bank deposits were to use these deposits with the efficiency shown in the 1920's, prices could increase substantially from present levels without any further increase in bank loans, investments or deposits.

Thus, we have two difficult factors in the money supply to deal with: first, large basic reserves which make it possible to increase the amount of bank credit and bank deposits, and second, a rate of turnover of deposits which, as has been demonstrated in former years, can grow substantially above today's levels.

Both bank credit and the turnover of bank deposits increased sharply in 1950 and in the early months of 1951.

I have already mentioned the use of savings for current expenditure. Savings are in many forms. I shall mention only two and indicate the relation of "dis-saving" in those fields to the turnover of money and the volume of bank credit.

The simplest illustration is the idle bank account. A phenomenon of the last ten years is the extent to which personal and corporate savings have been allowed to remain idle in commercial bank accounts. Reposing there, with no checks drawn, the monetary work done by those deposits is zero. If suddenly people and firms decide to spend those funds, the money supply begins to work more actively, exerting a pressure toward higher prices, and mind you, without any increase in the amount of bank credit. This chain of events has played a large part in the rise of prices in the last ten months.

Another kind of dis-saving is the conversion of Government bonds into cash, or more usually into bank deposits for current spending. I do not refer to tax notes and other short-term Government obligations, used for temporary employment of funds that have been earmarked for later use. I refer to long-term securities bought by individuals as a means of employing their savings; e.g., savings bonds. I also refer to Government securities bought with the savings of others by insurance companies, savings banks, pension funds and trust companies.

In the case of savings bonds, the Government redeems the obligation and sells a new security to obtain the redemption funds. If banks buy the new securities, bank deposits are created. If other Government securities are sold before the redemption date to obtain funds for current spending or for other employment of savings, someone must buy the bonds. If a bank buys them, it creates deposits; if

the Federal Open Market Committee buys them, it creates bank reserves. Thus, when we try to tighten the money supply as a restraint on credit we find that the rope has considerable slack--a potential increase in the turnover of money, gold reserves that permit further credit expansion and a high level of liquid savings just one stage removed from cash.

The monetary authorities have made important moves in their field of action to counteract the inflationary effects of these factors.

(1) Last August, the discount rates of the Federal Reserve Banks were raised somewhat and short term money rates were allowed to rise.

(2) The consumer credit regulation was reestablished. While the reestablishment of this regulation has not brought about any marked reduction in the total of consumer credit outstanding, it has served the purpose of preventing any further expansion in instalment credit since last October.

(3) A new regulation dealing with real estate credit was imposed. It is commonly understood that it is too early to appraise the restraining effect of Regulation X since builders are still working on the backlog of orders received before Regulation X was announced.

(4) In January 1951 reserve requirements of member banks were raised to substantially their upper legal limits.

One of the most important tools of inflation restraint was practically unusable for several months. This was the employment of open market operations, which were devoted almost solely to maintaining a pegged price for long-term Government securities. The pegging of the Government bond market had deep-seated and pernicious effects. Holders of long-term bonds instead of treating those securities as true investments came to consider them equal to cash in liquidity.

In fact they were the equivalent of cash so long as they could be sold to the market at a fixed rate and the market could be sure that it could sell them to the Federal Reserve Banks at the same price. This caused the Federal Reserve Banks to manufacture bank reserves at the whim of the holders of Government securities.

Recently, it became possible for the Federal Reserve authorities to cease their operations in a pegged bond market and to change to support of an orderly Government security market. The recent reduction in prices of long-term Government bonds has had far-reaching effects in the control of inflation. Holders of those securities have been reluctant to dump them on the market and as a result supplies of funds for mortgage loans and for many other types of credit have been reduced. Skeptics of this change in the administration of the Federal Open Market account have overlooked two aspects of the money market: First, low rates had been in force for so many years that they have been built into the financial structure. Any change to a higher level of long-term money rates forces far-reaching adjustment in financial commitments. Second, the direction of movement in the money market is an important factor entirely aside from the level of money rates. Whenever rates are rising, until the money market reaches reasonably firm ground at a higher level, it is natural that many financing plans are postponed.

To complete the picture of moves toward inflation control in the monetary and credit field, there is the Voluntary Credit Restraint Program. This program is in essence nothing but enlistment of the collective horse sense of all kinds of lenders to sort out the kinds of credit which should have priority under today's conditions and in that way to avoid Governmental regimentation of credit which, at best, must be a clumsy affair. The Board of Governors of the Federal Reserve System and the managements of all of the Federal Reserve Banks are eager to have the voluntary plan succeed and are lending all possible assistance.

As one banker who is taking a leading part in the Voluntary Program expressed it, "This is the greatest adventure in American finance." At the same time it is a prodigious undertaking. Recall that there are 14,000 banks, more than 400 life insurance companies, about 3,000 investment bankers and dealers and many thousands of other types of lenders. All of these lenders must be educated in the fundamentals of the Program to a point where they not only give their complete cooperation but so that they do not unwittingly extend credit of an undesirable character. It is only by this complete understanding that we can overcome what one United States Senator called the "competitive drive" for business, which though desirable from the earnings standpoint of the lender, is nevertheless needlessly inflationary under today's conditions.

This Program has been inaugurated under the provisions of Section 708 of the Defense Production Act. The authority to set up the Program was delegated to the Federal Reserve Board, which body consulted with the Federal Trade Commission and obtained the approval of the Attorney General of the United States for the Program on March 9, 1951.

The first step was for the Federal Reserve Board to request all lenders in the United States to take part in the Voluntary Program. For this purpose a letter was sent to some 90,000 lenders, the broadest list available to the Federal Reserve Banks. The next step was the appointment of a national Committee by the Federal Reserve Board.

The national Committee has set up regional committees to deal with problems in three major lending fields: commercial banking, life insurance and investment banking.

Considerable progress has been made in other directions. The national Committee has issued two bulletins on credit problems in relation to the Voluntary Credit Restraint Program. The first bulletin dealt with the subject of inventory loans. In view of the rapid increase in inventories, particularly at the retail and wholesale level, the Committee decided that this was its number one problem. Bulletin No. 2 dealt with credit for plant expansion. According to Government estimates, business firms were planning to spend about $24 billion on plant expansion in 1951. While part of this money would come out of corporate savings, a large part would need to be financed by borrowing. Furthermore, regardless of the sources of funds, it seemed very doubtful to the Voluntary Credit Restraint Committee that expenditures of this magnitude, aside from those directly related to defense, could be carried through without exerting undesirable inflationary pressures.

Progress has also been made in collecting better statistics to measure the developments in the credit field. The largest banks in the United States have already begun reporting weekly to the Federal Reserve Banks a detailed breakdown of their loans so that the national Committee can ascertain periodically the cross currents due to the rising volume of defense lending and the desired decrease in other types of loans.

You are all wondering what success the Voluntary Credit Restraint Program is achieving. I must confess that the national Committee and the Federal Reserve Board share in this curiosity. The Program has not been in operation very long and much of its work has been organizational and educational. Furthermore, two other important restraining influences came to bear at the same time. The top-heavy retail inventory situation began to be apparent with the drop-off in retail sales before Easter and the March and April declines in the Government and corporate bond

markets exerted a chilling influence on credit expansion. However, I deem it something more than a coincidence that the sharp and counter-seasonal weekly increase in commercial and industrial loans at reporting member banks ceased with the week of March 21. The request by the Federal Reserve Board to all lending institutions to cooperate in the Voluntary Credit Restraint Program was issued on March 9. The national Committee's first bulletin dealing with inventory loans was issued on March 20.

From my vantage point as Chairman of the national Committee, I can attest to the tremendous release of energy in the field of credit restraint made possible by the Federal Reserve Board's request. I can also bear witness to the spirit of unified effort and the desire to be "on the team" which is evident in all parts of the country and among all groups of lenders. Perhaps it is significant of the growing effectiveness of the Program that commercial loans at weekly reporting banks during each of the last two weeks in April experienced the largest decreases for any week since April 1926 - 1950. The more detailed figures now available reveal that defense loans are rising, and loans to carry raw commodities are falling. However, loans to carry retail inventories continue to climb.

In this Program of Voluntary Credit Restraint, the national Committee earnestly bespeaks the active assistance and cooperation of the United States Chamber of Commerce. Your organization can aid tremendously in explaining the Program and its vital role to the businessmen of the United States. These same businessmen are also the largest borrowers and their understanding and cooperation with financing institutions will ease the burden on the banks and go a long way toward assuring the success of the Program.