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INFLATION CONTROL: BANKING ASPECTS

An Address by Oliver S. Powell, Member,

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It is a genuine pleasure to come before this great convention to discuss a topic somewhat unrelated to the immediate problems of your membership but one which is of great importance to all of us as American citizens. Having worked with members of your organization for many years, I know that your discussions center around accuracy, honesty and efficiency in banking to the end that bank earnings will be well maintained and the reputation of banking will be high. Some of you also have the duty of allocating funds to achieve maximum earnings while serving your communities adequately. However, there is a time to make money and a time to conserve real wealth. Today banks and other lenders are foregoing maximum earnings in the campaign to safeguard the buying power of the dollar. Monetary authorities are also applying mild pressure toward the same goal.

The title of this talk might have been labeled, "Learning to Live with National Defense". Outside of actual war-time conditions, the United States for generations has found it possible almost to forget defense against outside enemies and to devote its energies completely to developing a higher standard of living at home. Now we find ourselves the most powerful non-communist country in the World, able to depend on other countries for protection only in very limited ways and faced with the problem of rebuilding a strong national defense.

The problem resolves itself into one of increasing the production of defense items while maintaining the supply of civilian goods at as high a level as possible. If the total demand for goods exceeds the supply, prices go up. This is inflation. It hurts the civilian economy and increases the cost of the defense program.

The restraints against inflationary price advances must cover a broad front. First of all is an adequate tax program. Second, people should be encouraged to increase their savings. Abnormal profit margins should be discouraged. If commodity prices can be held in check, further rounds of wage increases should be avoided. Above all, individuals and businesses should be encouraged not to buy more than their normal requirements.

This address deals with one particular phase of inflation restraint, --that administered by the Federal Reserve Board and the related Voluntary Credit Restraint Program.

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 sets and autos. There were two waves of buying--autumn and winter. There was also an unprecedented increase in residential building. 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 at stable price levels.

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, or to expand plants.

The combination of these three sources of buying power, when used to purchase a quantity of goods and services that could not expand with equal rapidity, caused a sharp price rise.

This situation would have called for restraining action at any time. It became much more essential to invoke restraints under today's conditions of growing national defense. The gap between available goods for civilian consumption and the supply of purchasing power may continue for many months. Within a year we may see a million fewer employees engaged in making civilian goods. The amount of raw materials available for civilian goods production may be less next year than today because of defense requirements. Already smaller allocations and greater 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 many billions above current levels. 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.

In addition to the inflation gap in current income versus the supply of civilian goods there has also been much use of savings for current expenditure. Savings are in many forms. I shall mention only two.

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 year.

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.

Now, let us turn to the third source of buying power--borrowing against future income. The use of credit increased sharply after the Korean incident. Loans at all banks in the United States increased $11 billion between June 30, 1950 and March 28, 1951. Consumer credit increased $2-1/2 billion in the last half of 1950. Residential mortgage lending increased by $2 billion, using annual rates, between the spring of 1950 and the spring of 1951. Security issues by municipalities and corporations to obtain new capital have been floated at an annual rate of $8 billion. Of course there is overlapping in these figures, and some mortgages and securities are bought with savings, which does not increase the money supply, but the figures serve to point out that borrowing for the purpose of spending has been an important factor in the rise in commodity prices.

So far I have spoken of increasing loans and investments which increase the money supply. However, there is another way in which the money supply can be used to accommodate an increase in the volume of business or higher prices. I refer to an increase in the turnover of deposits. This is a little understood phase in the behavior of bank deposits. However, I am sure that you will recognize the phenomenon when I refer to it in terms of internal bank operations. Your bookkeeping departments and transit departments have been plagued during the last year with a tremendous upsurge in the volume of checks handled. This increase was not due to an increase in the level of deposit balances, but rather to a more active use of existing deposits. Measured in national terms, this is what has been going on. The money supply in private hands, including deposits and currency, increased about 3 per cent from June 1950 to June 1951. Meanwhile, debits to individual accounts at banks rose more than 20 per cent in the first half of 1951 over the first half of 1950.

Such wide swings in deposit activity are inherent in the commercial banking system. They arise from the fact that depositors have complete freedom of action in deciding whether to leave their accounts idle or to draw checks against them when the spirit moves. The turnover of bank deposits 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 postwar years, but a sharp increase occurred after the Korean War broke out, to a turnover rate above 23 turns a year. In the last few months the turnover subsided to about 22 turns a year. However, if the owners of bank deposits were to use their deposits with the efficiency shown in the 1920's, prices would increase substantially from present levels without any further increase in bank loans, investments or deposits.

The monetary authorities have made important moves in their field of action to counteract the inflationary effects of the many factors which I have described.

(1) In August 1950, 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. The re-establishment of this regulation has not brought about any drastic reduction in the total of consumer credit outstanding. Although the total has declined by $300 million since last December, the amount of consumer credit outstanding on August 31, 1951, was still $19 billion. It rose $171 million in August (annual rate of $2 billion) after Congress eased the restraints.

(3) A new regulation dealing with real estate credit was imposed. It is still impossible to appraise the restraining effect of Regulation X since builders are working on the backlog of orders received before Regulation X was announced, and on public housing projects as well as on private construction under the regulation. Moreover, Congress liberalized the terms in August.

(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 out of use for this purpose for several years. This was the employment of open market operations, which were devoted almost solely for several years to maintaining a pegged price for long-term Government securities. The Federal Reserve Open Market Committee first announced in the depression years that a major objective would be a stable or orderly bond market. This was at a time when the Federal Government was borrowing heavily to provide funds for various kinds of relief. Then came World War II with its huge expansion of public debt. The Federal Reserve played an important part in this financing by providing the banks with excess reserves with which to buy Government bonds.

Then came the post-war years. Almost everyone expected a sharp depression as had happened in 1920-21 after World War I. Hindsight proves this to have been an error in judgment but it was a factor in causing the Federal Reserve authorities to continue their easy money, excess reserves, pegged bond market policies. With one or two minor exceptions this policy was maintained until this Spring when the pressure of inflation made a change to a more flexible attitude toward the bond market necessary.

The pegging of the Government bond market had deep-seated 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.

The reduction in prices of long-term Government bonds last spring 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. One of the most fundamental results of this recent action has been to restore in the rest of the world a confidence that we can control our own inflationary problems.

In a very real and tangible way, the credit policies of the Federal Reserve System and the Program of Voluntary Credit Restraint among private lenders are complementary in character; each supplements and increases the effectiveness of the other. The general credit policy of the System is intended to reduce the availability of credit in the aggregate and to make it unnecessary for the System to add to the credit base by the continued purchase of Government securities; the selective credit controls are designed to restrain the extension of credit in a few areas where the formulation of specific and generally applicable lending standards is feasible. Reliance has been placed upon the voluntary credit restraint effort to engender a spirit of caution and restraint in lending policies in general, but especially in sectors not amenable to selective credit controls, and to assist in channeling the reduced supply of credit so as to meet the needs of the defense program and of essential civilian activities, while at the same time restraining or curbing the use of credit for nonessential purposes.

The Voluntary Credit Restraint 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.

This Program was 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. That body requested a group of financial leaders to draw up a statement of principles and procedures for the voluntary program. The Federal Reserve Board then 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. (I repeat, however, that this is not a Government Program.) The next step was the appointment of a national Committee by the Federal Reserve Board. This Committee is composed of men chosen from the principal kinds of lending institutions, with a Federal Reserve Board Member as Chairman.

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

Right from the start the national Committee recognized the need for direct contact with lenders to explain the Program, to answer the most pressing questions without delay, and to insure uniform interpretation throughout the nation. The national Committee has issued six bulletins to all lenders 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.

The third bulletin dealt with borrowings by states and municipalities, the fourth with real estate loans, and the others with loans to foreign borrowers and loans on securities.

Summarizing the statement of principles and the bulletins, it can be said that the recommendations are of two sorts: first, as to desirable and undesirable purposes for credit and second as to maximum limits for certain kinds of credit. The Program was inaugurated on the theory that the purpose test should determine whether or not a loan should be made. However, very early in the operation of the Program it became evident that it must be ..

dovetailed with the Regulations of the Federal Reserve Board in some fields of credit and so maximum credit limits were recommended in the fields of real estate and securities loans. In the latter cases, the objective was still to reduce the amount of credit to a point where speculative price increases would be discouraged.

You are all wondering what success the Voluntary Credit Restraint Program is achieving. The Program has not been in operation very long and much of its work has been organizational and educational. Furthermore, several other important restraining influences came to bear at the same time. For example, 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, the fact is clear that bank credit has not been as freely used this summer as a year ago. You will recall the startling increase in bank loans that followed the North Korean attack in June of last year. Between June 28, 1950 and October 11, 1950, business loans at weekly reporting member banks increased by $2,540,000,000. In the corresponding weeks this year the business loan expansion at these banks has been only $1,094 million, less than half of last year's increase in the same weeks. Putting the matter another way, it is expected on a seasonal basis that bank loans in the third quarter of the calendar year should grow by 6 per cent; this year, the third quarter increase has been only 4-1/2 per cent. It would be more reassuring if this increase in bank credit were not being added to a high level reached this spring, but it must be recalled that business is also at a high level and requires a great deal of credit for normal operations.

Buried in these statistics of increasing loans since mid-year are a number of cross currents. Loans to manufacturers of metals and metal products, petroleum, coal, chemicals and rubber and public utilities have increased by $800 million. These industries include most of the defense industries, although not all of these loans are defense loans. Many of these loans have been increasing, not because of seasonal requirements, but because of abnormal or defense demands. It remains to be seen whether they will taper off after the first of the year, following a seasonal pattern. Another group of loans has been increasing for purely seasonal reasons. These are the loans to finance the marketing of the crops--loans to commodity dealers and food, liquor and tobacco manufacturers which have risen $450 million. Loans to textile, apparel and leather manufacturers have declined. Taking all of the latter groups together, the borrowings of which carry the crops until they are consumed, the seasonal expansion was about $400 million. The net change in other business loans has been a decrease of about $150 million. The over-all picture would seem to indicate expert workmanship in the handling of the nation's bank credit in this period of 15 per cent defense and 85 per cent peace activities.

In interpreting these trends in the credit field, it is important to keep in mind that the purpose of credit policy in general, and of the Voluntary Credit Restraint Program in particular, has not been to prevent the use of private credit. The objectives of credit measures are rather to attempt to stop the use of credit for speculative purposes, to channel credit into defense and defense-supporting activities, to reduce the credit made available for postponable and less essential civilian purposes, and to engender a more cautious and careful lending policy on the part of lending officers. The Voluntary Credit Restraint Program is making an important contribution to the attainment of these objectives.

The Voluntary Credit Restraint Program has provided the financial section of our economy with a vital rallying point. Even though the inflationary possibilities of credit expansion were fully understood, there still was needed some mechanism for joint action. No lending institution likes to be known up and down main street as being out of step with its competitors. News of that sort travels rapidly. As one North Dakota banker stated it, "I can now discourage a borrower whose loan is not essential under present conditions, to postpone his borrowing by referring to the National Voluntary Credit Restraint Program, with the full assurance that my competitor banks are following the same Program."

Perhaps the most significant and abiding contribution of the Voluntary Credit Restraint Program is that it has given lending officers new benchmarks for use in their appraisal of loan applications. It has broadened their horizon beyond the fairly limited objective of appraising the creditworthiness of a prospective borrower. The Program has made them increasingly aware of the importance of credit policy in an economic stabilization program, and it has contributed to prudence in lending. Equally important, these have been achieved without shutting off the supply of credit to borrowers with needs in accord with today's part-defense, part-peacetime economy, and without imposing upon lending operations a burdensome harness of detailed and specific rules and regulations. This has helped keep to a minimum the injustices and inequities which are inescapable under a set of detailed rules and regulations, no matter how carefully drawn, and has preserved the flexibility of movement required by financial institutions if they are to serve the needs of the economy.

Returning now to the over-all national picture, the threat of inflation has not been removed, although it is not possible to predict when the next upsurge in inflationary pressures will occur or what proportions it may assume. Business inventories are at peak levels and the pressure to reduce them still continues. The productive capacity of the country is tremendous and the record levels of plant andequipment spending are augmenting that capacity month by month. Nevertheless, it is not clear that production can be increased sufficiently fast to cover the increased takings for military equipment that are in prospect, without some reduction in supplies available for the civilian market. It is significant that steel output is already 2 per cent above rated capacity and unemployment is the lowest since World War II. Defense spending is rising rapidly and a growing percentage of our defense outlays is going into "hard" goods for which basic materials are short. This rise in defense spending, with unemployment at very low levels, poses the prospect of continuing upward pressures on wage rates and increases in personal income. Business spending for plant and equipment, at record levels, will remain high for some time to come.

The consumer remains a big unknown in the outlook. Following the two "scare" buying waves of mid-1950 and early 1951, consumers reduced their spending and increased their savings substantially in the second and third quarters of this year. Currently, consumers are spending a significantly smaller portion of their income than was customary in the postwar years.

But it is not certain how long it will be before money will again start to burn holes in the pockets of consumers. The large inventories of goods in consumers' hands, resulting from the overbuying during the past year, will gradually disappear. With personal income at record levels, and likely to increase further, and with large holdings of liquid assets widely distributed, the basic ingredients for an upturn in consumer spending are present in the economy. Even without adverse developments on the international front, consumer spending is likely to increase; given deterioration in the foreign situation, the rise in consumer spending might assume large proportions.

May I close with a word to you as representatives of private finance? There are those who say "Why should we restrain credit and turn down profitable business when there is a strong possibility that some Government credit agency will step in and make the same loan?" Others say, "Why restrain credit at all, when extravagance is still evident in many places?" The answer to such thoughts should be obvious. The failures of others to do their utmost in the restraint of inflation does not relieve us of the obligation to do our best. If we do our part, we shall have the satisfaction of a job well done. In years to come the finger cannot be pointed at private finance for having failed in its part of the fight against inflation and we shall have set an example to be emulated by all others charged with parts of this important campaign.