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THE VOLUNTARY CREDIT RESTRAINT PROGRAM

An Address by Oliver S. Powell, Member,

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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.

You will recall the panicky buying that followed the Korean invasion. 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 was also an unprecedented increase in residential building. This buying rush caused retailers and manufacturers to step up their inventory 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. These forces had spent their power or were checked in March 1951 and since that time there has been no important advance in prices.

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.

Having analyzed the sources of buying power which caused the upsurge in commodity prices in 1950 and early 1951, it is important to explore the restraining influences which have resulted in a sidewise movement of prices for the past ten months. The principal factors are found in some widely varying fields. Certainly the rapid expansion of inventories caused part of its own cure. Just before Easter in 1951 merchants decided that inventories at retail were too high. They have been scaling their inventories down as occasion permitted ever since until, according to the most recent information, inventories are not much higher than normal for today's volume of business. Manufacturing inventories, on the other hand, have continued to increase steadily, probably as a result of defense production requirements. An over-hang of inventories always spells caution to the lender and the businessman. Later, when inventories of raw materials are being reduced, the use of those materials will reduce the demand for market supplies and, hence, reduce inflationary pressures.

The increase in taxes has undoubtedly had a restraining effect. Business firms faced with higher taxes are finding the remainder of income after payment of taxes and dividends to be shrinking sharply, leaving them with less funds for expansion of plant and business unless they borrow the money for the purpose. Individuals are also finding with the higher tax rates that there is less money left over after paying current living costs for the purchase of items of household equipment or for embarking on programs of instalment purchase. Taxes are doing two important things: They are deterring spending and borrowing, and they are providing the national government with funds so that our national defense is more nearly on a pay-as-we-go basis.

There seems to be a lack of an urge to buy on the part of consumers. This is probably a composite result of a number of factors. Many people overbought in the excitement after the Korean incident, and those goods have not yet worn out. There has not, in recent months, been any dramatic move against the democratic nations which might have touched off another buying wave. Productive capacity in the United States has been steadily increasing so that most kinds of goods are in adequate supply on dealers' shelves. Then, there is the sobering effect of having to meet monthly payments on homes purchased in the last two years. It is well to recognize that some two and one half million housing units were constructed in 1950 and 1951. As families buckle down to the grind of monthly payments over a long period of years for a home, while meeting normal living costs and higher taxes, they are obviously less able or inclined to increase their spending.

Finally, we come to the banking and monetary moves that were made following the start of the Korean trouble to counteract inflationary forces.

(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 reestablishment of this regulation has not brought about any drastic reduction in the total of consumer credit outstanding, but it has apparently checked any substantial expansion.

(3) A new regulation dealing with real estate credit was imposed.

(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. This program was modified last spring. The 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 many types of credit have been reduced.

Freedom from the necessity to maintain Government security prices at any fixed level has had other important effects in counteracting inflationary expansion of credit. It has been unnecessary for the Federal Open

Market Committee to add to its portfolio of Government securities except for temporary periods since last April. Member banks needing additional reserves on account of increases in deposit liabilities or requiring currency for their customers have obtained the needed funds by borrowing from the Federal Reserve Banks except to the extent that gold imports have provided the funds. When a bank is borrowing to obtain a part of its reserve requirements, it is apt to exert restraint on increases in its loans.

With member bank reserves less easily available, bank lending rates and the rates for borrowing in the capital markets have risen. This, in turn, has undoubtedly discouraged some borrowing. There are always those who are able to delay borrowing in the hope of a better rate later on and those for whom the money is not attractive at the increased rate.

The credit policies of the Federal Reserve System have been reinforced by a Program of Voluntary Credit Restraint among private lenders. The general credit policy of the System is intended to put a brake on the expansion of credit in the aggregate and to make it unnecessary for the System to add to bank reserves by the continued purchase of Government securities; the selective credit controls are designed to restrain the extension of credit in a few lines where standard lending practices prevail. Reliance has been placed upon the voluntary credit restraint effort to foster a spirit of caution and restraint in lending policies in general, but especially in credit fields not suited to selective credit controls, and equally to assist in channeling the supply of credit into the defense program and essential civilian activities, while at the same time restraining the use of credit for nonessential purposes.

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, which requested a group of financial leaders to draw up a statement of principles and procedures for the voluntary program.

We have now come to the principal part of my talk--the credit standards appropriate for an inflationary period. The first statement of such standards appeared in the Statement of Principles to which I have referred. Credit men in all branches of finance were asked to screen their loans not only as to credit-worthiness but as to consistency with our national efforts to contain the inflationary pressures. Listen to this sentence from the Statement of Principles:

> "It shall be the purpose of financing institutions to extend credit in such a way as to help maintain and increase the strength of the domestic economy through the restraint of inflationary tendencies and at the same time to help finance the defense program and the essential needs of agriculture, industry and commerce."

The Voluntary Program does not attempt to override the Federal agencies in the field of inflation control. It does not have to do with such factors as inflationary lending by Federal agencies, which the Statement of Principles states "should be vigorously dealt with at the proper places." Neither does the Program seek to restrict loans guaranteed or insured by a Government agency, on the theory that they should be restricted, in accordance with national policy, at the source of guaranty.

At the center of the Voluntary Credit Restraint Program there is a national Committee appointed 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.

There are nineteen regional commercial banking committees, one or more in each Federal Reserve District, composed of leading bankers from institutions of varying sizes. Mr. W. F. Farrell, President of the Providence Union National Bank and Trust Company, is a member of the First District Commercial Banking Committee. Committee headquarters usually are in Federal Reserve cities in order to take advantage of the clerical and other assistance which can be provided by the Federal Reserve Banks. These regional committees are set up to answer your questions if loans are presented to you about whose propriety under today's inflationary pressures you are in doubt. There are inquiry forms which you may obtain and which will enable you to submit full information about the problem case so that a prompt and informed opinion can be rendered by the committee.

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 a series of bulletins to all lenders on credit problems in relation to the Voluntary Credit Restraint Program. These refer to specific credit areas such as inventory loans, credit and securities for plant expansion, municipal credit and conventional real estate credit.

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 credit-worthiness 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.

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. When these inventories stop rising, the effect will be to reduce the spending stream. In other words, that development would wipe out one of the most important inflationary factors which has been in the picture since the Korean incident in June 1950. The productive capacity of the country is tremendous and the record levels of plant and equipment spending are augmenting that capacity month by month bringing us closer to an ability to satisfy all demands.

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. 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.

The consumer also 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 1951. 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 new tax law will be a restraining influence but only to a limited extent. The large inventories of goods in consumers' hands, resulting from the overbuying during the recent past, 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.

I should be failing in my duty if I left this discussion of inflation and the Voluntary Credit Restraint Program hanging in the air. In addition to screening new credits according to the inflation restraint principles, there are two other jobs which bankers can do right now. One of these is to see that the money loaned last fall for seasonal purposes is repaid when it has performed its usual function. The older heads among credit men know that there is sometimes a tendency on the part of the borrower to drag his feet when it comes to repaying a loan. There is always something else which he can do with the money, and that secondary use of the funds may or may not meet with the approval of the banker. Unless the banker is willing to go into partnership with the borrower, he should insist on the repayment of the loan and then negotiate another credit if the borrower needs money for further operations.

The second job for bankers which should be done at this time of year is the careful analysis of the annual reports of business firms and the equally careful fixing of lines of credit for the coming year. From now on through the spring months credit departments in every bank will be receiving reports showing the results of last year's operations of their customers. It is customary at this time to discuss with the financial officers of those firms their needs for funds for the coming year. This is an excellent occasion to explain to the customer the Voluntary Credit Restraint Program and to agree with him on a line of credit which will meet the tests of inflation restraint.

In these ways, the bankers of the nation will be doing their full part to carry on the Program on which you have all been working so conscientiously for nearly a year, to provide essential credit for defense and to avoid over-extension of credit in nonessential lines. This is your part in the effort to protect the future value of the dollar under today's emergency conditions.