VCR-229

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THE 1952 LOOK

AT THE VOLUNTARY CREDIT RESTRAINT PROGRAM

An Address by Oliver S. Powell, Member,

Board of Governors of the Federal Reserve System,

Before the Cleveland Chapter of the Robert Morris Associates,

Cleveland, Ohio.

Wednesday evening, January 23, 1952.

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THE 1952 LOOK - AT THE VOLUNTARY CREDIT RESTRAINT PROGRAM

It was a genuine pleasure to accept your invitation to address the Cleveland Chapter of Robert Morris Associates on the topic of the Voluntary Credit Restraint Program. You men are on the firing line of finance. Just as in military affairs, you can have a good cause, the best possible general staff, and plenty of ammunition, but without performance on the firing line, the war can be lost. I fully realize that it is much easier to lay out a statement of principles and to make abstract recommendations for meeting the inflationary pressures in the field of finance, than it is actually to turn down or postpone a loan. You men of Robert Morris Associates are the men who make the actual decisions and it is you who must talk to your customers and persuade them that your decision is made in the public interest, so that your institution will not lose the good will of its long-time customers.

Realizing your difficult task, I am sure that you are entitled to the best possible information as to the progress of the Program so that you can accurately gauge the credit requests that you will receive and can explain logically and clearly to your customers the reasons for your decisions. I am glad to bring you the latest information which we have on lending trends and prospects, knit together into what I shall call the 1952 look at the Voluntary Credit Restraint Program.

In outlining today's bank credit picture, I shall use partly the established facts and partly the results of a survey of bank lending prospects just completed by the Federal Reserve Banks. Early in January the Federal Reserve Board requested the Federal Reserve Banks to consult leading bankers in their

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districts to obtain an appraisal of present and prospective loan trends. The replies were very uniform in opinion. Of course, subsequent events may change the premises on which these opinions were based, but they seem to give a sound appraisal as to what to expect in bank loans for the next few months.

First, here are some of the facts which are likely to have an important bearing on the trend of bank loans. You will recall that bank credit to business expanded sharply in the fall and winter of 1950-51 and expanded again by a considerably smaller amount in the fall and winter of 1951-52. Today, the banks of the country in spite of conservative dividend policies and the retention of a majority of their earnings have a ratio of capital funds to earning assets minus Government securities which is the lowest since 1926. For this reason, if no other, banks will be taking a conservative look at new loans.

Government expenditures for defense have been steadily mounting and are expected to continue to grow until they reach a high plateau some time in 1953-54. There doubtless will be changes in the importance of individual items, but the over-all expenditure is following a definite pattern. Bottlenecks are being eliminated and substantial new plant capacity is being added. It only remains to be seen to what extent the increasing military production can be achieved without reducing the output of civilian goods.

The increase in defense spending has created a demand for bank credit both directly and indirectly. Inventories of raw materials and partly completed defense products increased sharply in 1950 and the first half of 1951. In the last few months the rate of increase appears to have declined somewhat. Increasing inventories always require increased bank credit. Plant expansion and requirements

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for additional machine tools in defense industry have also added to bank credit demand. Part of this demand has been temporary with the intent of replacing the bank funds with funds obtained from the sale of securities. Another part of this demand has been for term loans which will be paid off gradually over a period of years out of corporate earnings. A less direct defense demand for bank credit came from such defense-supporting industries as transportation and public utilities. A good deal of the credit extended by banks for public utility expansion has been in the nature of revolving credits which will continue to be used until the expansion programs are complete. It is expected that the demand for loans for direct defense purposes will continue strong through 1952 at least.

Of more basic concern to bankers is the deterioration in the liquid asset position of corporations due to the use of corporate income for plant and machinery, growth of factory inventories and maintenance of high dividend levels. Industrial balance sheets have become less liquid. On September 30, 1951 cash and government securities were only 57 per cent of current liabilities as compared with 73 per cent on June 30, 1950. This means that future plant expansion will be financed more extensively than in the recent past with borrowed money. More immediately it points to the fact that corporations will probably need to borrow some part of the money needed for the payment of federal taxes in March and June of 1952. In addition to higher tax rates, businesses are faced with the requirement to pay a larger proportion of their previous year's tax liabilities in the first two quarters of the year than was formerly the case due to the inauguration of the Mills Plan. These loans to pay taxes are not self-liquidating and may be slow in repayment.

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Another credit problem has crept into the picture as a result of the present excess profits tax law. Borrowed money increases a corporation's tax base to a point where the reduction in taxes more than offsets the interest paid on the borrowed money. Thus, a corporation treasurer with a sharp pencil can figure that he makes money for his firm by borrowing. Of course borrowing solely for this purpose would probably not be allowed as part of the tax base by the Treasury Department but borrowing for other and perfectly legitimate purposes may tend to stay on your books longer than in normal times.

The Federal Reserve Credit Survey developed other significant facts as to bank credit trends. Loans to finance the '51 crops increased by large amounts during the fall and winter but are now tapering off and are expected to decline in the first half of 1952. There appears to be only a limited amount of bank borrowing to finance backed up inventories. Much past borrowing of this kind has been liquidated.

Summarizing the picture, it can be said that defense lending is expected to remain large. Commodity loans will furnish the major seasonal reduction in bank credit during the next six months. This seasonal loan reduction will be partly offset by borrowing to pay taxes. It will require very conservative screening of less essential credit to prevent an increase in the money supply in the first half of 1952 as a result of over-all bank credit expansion.

Now let us return to the facts of the present business situation. It has been a reassuring fact for nearly a year that commodity prices have remained at stable levels, particularly in the raw material and wholesale sectors. Prices at retail have risen slightly but not significantly during this period. It is

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important to explore the restraining influences which have resulted in this sidewise movement 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, except for some desirable items, are not much higher than normal for today's volume of business. An over-hang of inventories always spells caution to the lender and the businessman. Later, when factory inventories of raw materials are being reduced, the use of those materials will reduce the demand for market supplies and, hence, in their turn 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 providing for 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 been, in recent months, any dramatic move against the

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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, and for some goods an over-supply. 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

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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 since last April, except for temporary periods. Member banks needing additional reserves on account of increases in deposit liabilities or requiring currency for their customers have increasingly resorted to borrowing from the Federal Reserve Banks. Also gold imports have provided a sizable volume of reserve funds. When a bank is borrowing to obtain a part of its reserve requirements, such indebtedness 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 for whom the money is not attractive at the increased rate.

The credit policies of the Federal Reserve System have been reinforced by the 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

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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.

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 still remains, 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. Now that these inventories have stopped rising so fast, the effect has been to check the rise of the spending stream. In other words, that development is tending to moderate one of the most important inflationary factors which have been in the picture since the Korean incident in June 1950. The productive capacity of the country is tremendous and the record sums we are spending on plant and equipment are augmenting that capacity further month by month, bringing us closer

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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 in previous postwar years. But it is not certain how long it will be before money will again start to burn holes in their pockets. The new tax law is 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, are disappearing. 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

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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 in this period the pressures on him to keep the funds in use are especially great. 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.

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