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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. 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 in the year 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. This is as it should be. The bill for national defense is not a proper inheritance to pass on to our descendants. Individually, we want protection, and we should pay the bill out of our current income, no matter how it hurts. 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 private 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.

(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.

(5) 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 early in 1951. 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.

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 available supply of credit into the defense program and essential civilian activities.

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 issued to all lenders when the Program started. 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.

Here in South Dakota where agriculture plays such an important part in banking activities, you will be particularly interested to know that the central organization of the Federal Farm Credit agencies is giving the Voluntary Credit Restraint Program excellent support. Repeatedly, they have sent messages to the various field offices explaining the principles of the Credit Restraint Program. The examiners who inspect the affairs of the field offices review their operations to see whether they are conforming to our Program. I have a standing invitation from Governor Duggan to submit to him any cases of criticism which are sent to me and his promise to review such cases and attempt to obtain correction. I am happy to relay this invitation to you and to offer to act as your intermediary if there are cases which you believe need to be corrected.

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. 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. 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 goals 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.

The application of the Voluntary Credit Restraint Program in the agricultural regions has been puzzling to many bankers. A year ago in New York an up-State banker said that his town was not in a defense area. He wondered whether he should stop making loans altogether to comply with the Program. Of course he had misunderstood the nature of defense and defense-supporting activities. Certainly a well-rounded farm program is essential and should have banking support. On the other hand, there are many things which bankers in the farming regions can do to support the Program. For example, the pyramiding of farm real estate holdings by an owner is of doubtful desirability at any time and certainly should be discouraged today. You can counsel your municipalities to use conservatism in expenditures and to hold their borrowings to a minimum. You can withhold credit for less desirable business construction, such as new store fronts, which will provide useful employment later on and are unnecessary at the present time. You can discourage farmers from over-investing in farm machinery. In fact, with the general principles of the Voluntary Credit Restraint Program in mind, I believe that you will have no difficulty in applying the principles either for or against practically every type of loan which you are offered.

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 have 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.

It looks now that in the second half of 1952 the Treasury may unwillingly add to the problem of inflation control. Federal government spending will in all probability exceed cash income. Either savers or banks must provide these needed funds to bridge this gap. Bank loans add to deposits and are definitely inflationary. It will be wise for the savings institutions and individuals and corporations to buy Treasury securities to provide the extra funds for defense. We in the Voluntary Credit Restraint effort can do our part by urging the postponement of the use of savings for other less essential purposes, so that today's high level of savings will flow to the Treasury.

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 is one job which bankers can do right now. You can 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.

In this way, 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.