For release upon delivery.

CREDIT RESTRAINT, TAXATION AND OTHER MATTERS

An Address by Oliver S. Powell, Member,

Board of Governors of the Federal Reserve System,

Before the 62nd Annual Convention of the
Tennessee Bankers Association,

The Read House, Chattanooga, Tennessee.

Wednesday morning, May 7, 1952.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

CREDIT RESTRAINT, TAXATION AND OTHER MATTERS

When your program chairman invited me to speak at this Convention I accepted with much pleasure both because of the opportunity to become better acquainted with the bankers of Tennessee and because of the opportunity to explain the Voluntary Credit Restraint Program and to urge members of this audience to continue the good work in supporting the Program. Events of the past few days have developed so rapidly that I now find myself before you not to exhort but to commend for a job that at least temporarily has been completed in the truly American patriotic spirit of private enterprise. Last Monday the Federal Reserve Board withdrew its request for further adherence to the Voluntary Credit Restraint Program and the operations of this great public service will be suspended indefinitely beginning May 12. Thus, I stand before you today to say to all of you "well done" on behalf of your associates in the Voluntary Credit Restraint Program and also on behalf of the Federal Reserve Board.

For nearly two years we have been 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. Suddenly we found 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 resolved 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

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

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.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

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 year. 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, 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 reduces the demand for market supplies and, hence, reduces inflationary pressures.

The increase in taxes 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 find 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 also find with the higher tax rates that there

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

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 have been a lack of an urge to buy on the part of consumers. This was 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.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

(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 were reduced.

The credit policies of the Federal Reserve System were reinforced by a Program of Voluntary Credit Restraint among private lenders. The general credit policy of the System was 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 were designed to restrain the extension of credit in a few lines where standard lending practices prevail. Reliance was 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.

The economic picture has been clearing up very rapidly in recent weeks, so fast, in fact, that it has outrun the statistics. Most statistical measurements are 30 to 60 days old by the time they become available and field

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

reports from competent observers for some time have been indicating a lessening need for the Voluntary Credit Restraint Program. Finally, last week, as a result of these field reports and the latest statistics on the business situation, the Federal Reserve Board called the National Voluntary Credit Restraint Committee in for consultation. The members of the National Committee all expressed their views. These statements were reinforced by a brief round up of opinions of regional committee chairmen. There was near unanimity of opinion that the Voluntary Credit Restraint Program should be suspended at this time. The Federal Reserve Board unanimously approved this recommendation, and last Monday the Board announced the suspension of the Program. The formal suspension becomes effective May 12 to give time for all lenders to be informed and to avoid competitive misunderstandings.

Looking back on the evidence as to business trends which has been accumulating in recent weeks, one is impressed by the balance of great natural forces which are working against inflation as well as toward it at the present time. Industrial plant capacity has been greatly increased since the end of the War and particularly in the last two years. It is estimated that capacity for the production of machinery and chemicals has doubled since the end of World War II. Plant capacity for certain kinds of chemicals, such as synthetic resins, has increased four times. Electric generating capacity is up 75 per cent, petroleum output has increased 50 per cent and steel ingot capacity is up 30 per cent. These are the effects of the huge flow of savings into fixed capital investments which is estimated at more than $100 billion in the last seven years.

The increase in plant capacity means more goods available in the lines where materials have been in short supply. The result is seen in the recent rapid decontrol of the flow of major raw materials.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

The second great natural force is the large and persistent accumulation of savings by the American public. Savings today are not quite as large a percentage of personal income as in 1951 but they are still 7 per cent of income which is an abornally large fraction. These savings show up in impressive increases in funds available for investment by the great savings institutions. Insurance funds have increased during 1951 by $9 billion ($5 billion in private companies and $4 billion in Government insurance), savings deposits have increased $2 billion, and the trend is continuing. For example, mutual savings banks experienced an increase of over $400 million in deposits in the first quarter of 1952 as compared with a $60 million increase in the first quarter a year ago. Savings and loan institutions experienced an increase of $2 billion in their savings accounts in 1951 and pension funds have also shown large increases. This large flow of funds into savings has facilitated plant expansion and has provided large sums of money for residential mortgage financing. At the same time, it has reduced the purchase of consumer goods and thus has served as an important equalizing factor.

A third natural force is apparently beginning to operate. Business inventories which increased sharply immediately after the Korean incident in 1950 levelled off in the past fall and winter. Since February 1 it appears that business inventories have begun to decline although not to a marked degree. To the extent that industry is levelling off its inventories it has reduced its demand for raw materials whereas a year ago there was a two-fold demand for current consumption and for inventory accumulation.

In contrast it should not be overlooked that there continue to be forces favoring further inflation. We are still in the midst of a great defense build up and the actual output of defense items will probably increase

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

for many months to come. We are still constructing new plants for defense purposes and this increase in plant and machinery provides a large market for industrial products. Furthermore, one should not overlook the possibility of wage increases large enough to force increases in certain commodity prices.

Thus, we have two sets of forces at work, one providing a cushion against inflation and the other working towards higher prices. On balance this Nation appears to have reached a temporary state of equilibrium. Personal incomes are the highest in history and rising. Unemployment is very low. Prices seem to have stabilized at a level about 10 to 12 per cent above pre-Korea. Bank credit this spring has been declining seasonally. There was some decrease in over-all production in March and April. On the other hand, building is booming and defense spending is rising.

After marshalling these facts it was the joint view of the National Voluntary Credit Restraint Committee and the Federal Reserve Board that banks and other lending institutions need not adhere to special measurements as to the essentiality of credit at the present time, but that lenders should use their own good judgment as to the desirability of business credit.

Now I should like to turn for a few minutes from inflation and allied subjects to the study of bank taxation which the Federal Reserve Board has been carrying on for the American Bankers Association. This study and its implications have not been fully worked out, but as requested by your program chairman, I am glad to give you a few preliminary sidelights on the study.

Bank Capital in Relation to Bank Assets

It is of great significance to banks and the public that bank assets have grown relative to capital funds quite steadily from the decade of the '30s to the last decade. Back in the 1920s and early 1930s the ratio of member

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

bank capital funds to total assets ranged from 11.6 in 1920 to 15.3 in 1932. From 1932 on there was a steady decline until 1945 and 1946 when the ratio was under 6 per cent. During the last three years the ratio has been around 7 per cent.

What this trend means is that the buffer of stockholders' invested capital has been declining. This was not very significant as long as banks were increasing their holdings of Federal Government securities but it becomes a matter of moment in a period of rising bank loans, such as has developed since the end of World War II and particularly since the beginning of the Korean conflict.

Bank managements have been conscious of the low level of their capital investment relative to deposits. They have followed a conservative dividend policy for many years, paying out less than half of their net earnings to stockholders in the form of dividends and retaining the remainder of their net earnings in additions to capital funds. If bank deposits had not continued to rise in recent years, this retention of earnings would have gone further than it did toward improving the capital-asset ratios. Furthermore, banks with the lowest capital ratios have had the largest percentage of earnings to capital funds. The retention of a major part of these earnings built up their capital funds at a relatively rapid pace, so that the natural tendency was for a leveling up process among banks in capital-asset ratios.

The increase in bank deposits during the war years and since has hidden the constructive activities of bank managements in retaining earnings and has made many bankers consider the necessity of selling more capital stock to the public in an effort to improve their capital position. Indeed some banks have found themselves in a dilemma. They have felt that they needed

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

more capital but the retention of earnings has kept the payment of dividends at a low level. This low level of dividends makes the stock of the bank unattractive to prospective purchasers.

There has been some discussion of the effect of the excess profits taxes on the ability of banks to show net earnings after taxes which would be attractive to the purchasers of bank stocks. In order to obtain fundamental facts for appraising the effects of excess profits taxes, the Federal Reserve Board has been collecting figures from a broad sample of banks in the United States. While the study has not been completed, some significant facts have been released. For example, only 21 per cent of the banks paid excess profits taxes on 1951 income. The total amount of excess profits taxes paid by all banks on 1951 income is estimated at $24 million, whereas other Federal income taxes paid by banks are estimated to have been $542 million. It is readily seen that the excess profits taxes paid were only a small fraction of Federal income taxes paid.

The year 1951 was not entirely a normal year for the purpose of this study inasmuch as many banks took substantial losses in their securities accounts and made other adjustments which reduced their taxable income. Without such reductions in income the excess profits tax payments by the banks of the country would have been around $44 million. Even this substantial amount is not large in relation to bank capital or bank assets. This may be seen from the fact that, if there had been no excess profits taxes against bank income and the $44 million had all been added to the capital accounts of banks, the ratio of capital funds to assets at the end of 1951 would have been increased only from about 6.81 per cent to about 6.84 per cent. Thus the problem of increasing capital funds to a level deemed by bank managements to be appropriate for the present level of bank deposits would still be with us.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

By these remarks about the extent of the excess profits tax burden I do not mean to suggest that I am not fully aware of the broad effect on the operations and policies of banks, as well as other corporate taxpayers, of the implications of taxes aggregating 82 per cent when a corporation reaches the excess profits tax bracket.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis