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DEVELOPMENTS IN CREDIT CONTROL

An Address by Oliver S. Powell, Member,

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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 members of your Association 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. On May 5 the Federal Reserve Board withdrew its request for further adherence to the Voluntary Credit Restraint Program and the operation of this great public service was suspended indefinitely beginning May 12. A few days later Regulation W was suspended. 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 noncommunist 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 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 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 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.

(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 reports from competent observers for some time have been indicating a lessening need for consumer credit regulation and the Voluntary Credit Restraint Program. Finally, a few days ago, as a result of these field reports and the latest statistics on the business situation, these credit restraints were suspended.

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.

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 abnormally 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 mid-1951 and for the past eight months there has been little change in the overall level. 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 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. Housing starts are now running at about the same as in the spring of 1951, which was one of the largest years in the history of residential building construction. Furthermore, one should not overlook the possibility of wage increases large enough to force increases in certain commodity prices.

Turning to the recent trends in credit, we find bank loans to business declining and consumer credit also slightly lower, but residential real estate loans outstanding continue to increase. Business loans at banks, while higher than a year ago, have been exhibiting their seasonal reduction in farm commodity credit which has more than offset a continuing rise in loans to industries associated with national defense.

Consumer credit is estimated to be only 1 per cent higher than a year ago. The total has declined seasonally since the end of the year. Instalment buying is larger than a year ago. This is a paradox, since total sales of consumer durables are lower than a year ago. However, the rate of repayment recently has exceeded the rate of new credit granted, resulting in a net reduction in instalment credit outstanding.

The record of home mortgage debt reflects six years of active home buying. From about $20 billion of home mortgage debt at the end of 1945 the total has now reached a figure estimated at about $54-1/2 billion. In the first quarter of 1952 it appears that about $1-1/4 billion was added. The increase is occurring largely at savings and loan associations and life insurance companies.

In summary, 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. There was some decrease in over-all production in March and April. On the other hand, building is booming and defense spending is rising.