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CURRENT CREDIT PROBLEMS

Three years ago at this time we were all looking forward eagerly to the end of the war, which in the European theater was only a month away. It then seemed that if only the fighting would come to a stop, our troubles would be over. But three years have passed and difficulties, economic and political, are thick all around us. No matter what the field of interest, uncertainties as to the future are weighing down heavily and problems face us demanding solution and at the same time defying it. These problems are both domestic and international.

The Board of Governors of the Federal Reserve System, of which I am a member, is no better off in this respect than anybody else. Difficulties are normal, of course; we always have them, and if it isn't one thing it's another. But just now, both in the field of bank supervision and in the field of central banking, varied problems seem to be pressing on each other and crowding for attention to a degree I have seldom if ever observed before. I should like to take this occasion to review some of the things that are of immediate interest to the Board--not merely because they are of personal interest to me but because they are of interest to you. They concern banking and banking in turn concerns all of us. These matters all involve legislation, either pending or prospective, and relate either to the supervisory or central banking responsibilities of the Board.

The first of these is a measure proposed by the Board, and now pending in Congress, to provide more effective supervision and control of bank holding companies. Bank holding companies, as you know, are organizations engaged in owning or controlling banks. There are a number of such companies in various parts of the country which control substantial groups of banks and, in some instances, have major nonbanking interests. In the Banking Act of 1933, Congress attempted to deal with the problems presented by this development but experience has demonstrated that the existing law is inadequate. In substance, it merely forbids a holding company to vote any stock it owns in a member bank unless it first obtains a voting permit. As a practical matter, submission to regulation is to a large degree voluntary and the regulatory powers which can be exercised by the Board are very limited.

It is inherently dangerous to permit companies which are not subject to regulation to dominate major portions of the banking facilities in particular sections of the country and, particularly, to combine with that activity the control or operation of businesses unrelated to banking. To deal with this situation, the Board has recommended legislation which would regulate <u>all</u> bank holding companies, treating them in much the same manner as banks themselves and including provisions controlling their expansion and requiring them to divorce nonbanking activities. The proposed bill provides that bank holding companies meeting the prescribed definition shall register with the Board and, having registered, shall be automatically subject to all of the regulatory provisions of the statute.

In controlling expansion and requiring the separation of banking and nonbanking activities, the proposed legislation would be applying to bank holding companies accepted principles of bank regulation. Existing law does not permit banks to establish additional offices without the approval of supervisory authorities or permit them to engage in any business other than banking; and there is no justification for permitting bank holding companies to do so. The abuses resulting from unregulated group banking and the potential dangers thereof continue and the need for legislation is urgent.

In the field of central banking the Board has several proposals. One of these is a recommendation to Congress that the Federal Reserve Banks be authorized to grant partial guarantees of loans made by chartered banks to business. The purpose of the guarantees would be to insure that financial assistance is made promptly available to small business firms that might find financing otherwise difficult. The small individually-owned business has a basic need for long-term funds, but it has not recourse to the machinery for raising such funds through the flotation of securities in the money markets that large scale business has. Federal Reserve Bank guarantees would be subject to a charge proportionate to the percentage of the loan guaranteed. A part of this proposal is that the existing provisions of law authorizing direct loans by the Federal Reserve Banks under terms of Section 13b of the Federal Reserve Act be repealed.

These proposals of the Board are aimed at making existing provisions of the law simpler and more effective by providing that the Federal Reserve Banks should not make direct loans to business but should guarantee loans made by private banks to business. The changes proposed would remove the Federal Reserve Banks from any appearance of competition with the private banking system. They would tend rather to enlarge the scope of the private bank's operations. They would provide a stand-by arrangement to fall back on when the need for such credit arises at times in the future. At the moment the provisions for guaranteed loans would not have much if any occasion to be utilized, for our present problem is not at all one of inadequate credit. When present conditions have passed, however, means should be ready to check recession by a ready extension of bank credit to qualified borrowers.

Another measure in the central banking field is the regulation of consumer credit, which was established as a war measure by executive order and should have been continued, in the Board's opinion, as a means of restraining postwar inflation. Actually, Congress did not approve the Board's recommendation but instead terminated the regulation last fall. Inflation, however, was not terminated. The prices of goods are still high, and the purchasing power of the dollar continues to shrink. In the judgment of the Board, it is to the interest of consumers to be discouraged from borrowing in order to pay high prices. In order to avoid alternating booms and busts, it is also in the general interest that the consuming capacity or buying power of the public be maintained as evenly as possible. Otherwise it tends to exhaust itself in competitive buying as prices rise and to be suffocated beneath a mass of debt and unemployment when they fall.

Since the end of the war three years ago, the Board has been preoccupied with the dangerous surplus of money that the war left on our hands in the form of greatly expanded bank deposits. This is an inevitable result of war because in wartime resources are diverted from supplying consumers' and producers' goods to supplying military materials, and people are paid large amounts for producing goods and providing services which they can not purchase with their incomes. In consequence, the supply of money is everywhere excessive in comparison with the supply of things to buy with it. This condition might be corrected from either side or, better still, from both. On the one hand, we need to produce more goods but on the other we also need to restrain further expansion of the money supply.

On the side of production, however, there is little prospect of immediate relief. We are producing at close to maximum volume. Industrial production and employment remain far above all prior peacetime levels, and employment is currently above the wartime peaks. But offsetting this is a level of demand greatly in excess of prewar years. Our people need new cars, new houses, new equipment. And on top of that there is the need of Europe for the materials to restore her economic life. This is not Europe's need alone. It is to our own direct self-interest that the economies of Europe be restored to the point where they can be useful and self-dependent members of the world community, buying our products and contributing their share to world production. Her disorganization and lack of productive power, which we are endeavoring to help her correct, is a prime cause of the pressure we are under. But help to that end can not be given without sacrifice for the time being on our part; if we furnish Europe the things she can not yet supply herself, we must to that extent forego having them ourselves.

Moreover, it is now apparent that we must also renew and expand our military strength. This too will divert money, manpower, materials, and equipment which might have been used for the production of consumer and producer goods. If we turned our backs on the international situation and produced exclusively for our domestic requirements, we should for a short time lighten the pressure of inflation and enjoy the comforts of increased consumption. But our interval of ease would be short and the termination of it painful. No such course can be considered, and we have already turned definitely from it.

In the face of these needs--economic and military--there is little prospect, as I have just said, that production can expand enough to meet the demands for domestic consumption and for export. The problem is largely a physical one--a problem of enough machines, enough material, enough men to produce what the world now needs.

Aggravating this deficiency on the side of production, we have an inflationary excess on the side of purchasing power. Unless this excess is reduced or at least not permitted to increase, it will result in higher prices and increased living costs. The one most effective way to reduce this excess purchasing power is by reducing the Federal Reserve Banks' holdings of Government debt.

Liquidation of the public debt held by the Federal Reserve Banks is an effective curb on inflation because it involves not only a reduction of bank deposits but also of bank reserves. For when the taxpayers' money is used to pay a Government obligation held by a Federal Reserve

Bank, the payment reduces commercial bank deposits and also bank reserves. Thus it extinguishes existing purchasing power in the form of bank deposits and at the same time reduces the possibilities of renewed expansion of those deposits. But though it is important accordingly that Federal Reserve Bank holdings of Government debt be reduced, the difficulty is that so long as the Reserve Banks stand by to purchase Government obligations in support of their market value, it is hard if not impossible for reduction of their holdings to be accomplished.

But as taxes are reduced instead of public debt the problem is made more difficult. For in the first place, to stop retiring the public debt means abandoning the most effective means we have today of restraining inflation. Reduction of taxes means still more: it means that we stimulate inflation, because if the Government takes less money in taxes, then we all have so much more money to spend, and the volume of purchasing power forcing prices upward will be so much the greater. Every dollar not paid to the Government will be available to bid for scarce goods. To each of us individually the reduction of taxes is welcome, of course; but when we think of the response of prices to the increased demand, it is evident that we stand too good a chance of being worse off with the money than without it. For a dollar with prices at present levels may well be worth more than a larger sum with prices at still higher levels.

The tax reduction passed by Congress is $5 billions. In addition to that we are now facing enlarged expenditures not only for European recovery but for military purposes. It is said that approximately $4 billion will be needed for such items as universal military training, a greater air force, and an increase in the authorized strength of the standing army. So if we reduce taxes by $5 billion and increase expenditures by $4 billion, we shall have about $9 billion less with which to reduce the public debt or combat inflation through fiscal policy. The chances are rather that the $9 billion will feed inflation still further.

If fiscal policy can not be relied on, the need of credit controls seems to me all the greater. And if inflated purchasing power can not otherwise be reduced to a reasonable par with the supply of goods, it may at least be pinned down temporarily by a measure which the Board has already recommended to Congress. This is that banks be allowed to count Treasury short-term obligations (bills, certificates, and notes), and cash, cash items, inter-bank balances, and excess reserve balances with the Federal Reserve Banks as special reserves required to be held in addition to legal reserves. This is in substance an increased requirement, the additional reserves to be held at the bank's option, however, either in the form of balances with the Reserve Bank or in Treasury obligations, cash, etc.. Its effect would be to reduce the basis of credit expansion.

These special reserves might reach a maximum of 25 per cent of demand deposits and 10 per cent of time deposits; the requirements would be imposed gradually at the discretion of the Board; and they would apply to all commercial banks, whether members of the Federal Reserve System or not. The arrangement would not oblige banks to reduce the volume of their earnings assets, but it would restrain the further expansion of bank credit. It would also give a fresh effectiveness to the traditional instruments of credit control, namely, discount rates and open market operations. The banks would still be able to meet the credit needs of borrowers, and yet the responsible authorities would be in a position to act for protection of the economy from the inflationary evils of further credit expansion.

This is viewed as a temporary measure limited to a period of three years. It would be helpful in stemming the tide and giving us time to study the new conditions that have sprung up around us. Our present difficulties are not only real but essentially unfamiliar. I think we can not assume that they will quiet down of their own accord. Indeed, wherever one looks conditions that tend to continue to intensify inflationary threats are evident, nowhere can one see any automatic tendency to mitigation or any material forces operating to bring it about. Nor can we assume that the instruments and procedures we have been accustomed to in the past will meet the needs of the future. But neither can we postpone action till we have everything figured out. Something needs to be done now. We have a basic problem which at best must be the subject of long range planning; and we have in addition a mounting emergency. Present proposals may not be perfect but they do go far to meet the immediate need.

Our present reserve requirements have come to be what they are by a process of legislative changes that have never caught up with the facts. For a long time this condition made little difference, but we are now getting to the point where an arrangement originating in Civil War times is altogether too far out of line for present day needs. The arrangement I mean is that which determines the required reserves of banks on the basis of their location. As a matter of fact a bank's location is under modern conditions a pretty poor criterion for determining the reserves it should maintain. The important thing is the kind of deposits, no matter where the bank is, and I think that exploration for a more sensible basis for reserve requirements should be in that direction without regard to location. The further objective should be a requirement administratively feasible, equitable, and adapted to the American system of banking.

So far in considering this problem it has been argued, at one extreme, that deposits should not be classified at all or that requirements should be uniform against all classes of deposits. This was the situation under the National Bank Act and is still the situation under the banking laws of half of the States. At the other extreme, it has been argued that a detailed classification should be made based on such characteristics as turnover, volatility, size, and economic activity of depositor--whether an individual or a business, whether local or national. Some classification is necessary, I believe, but it should not be too elaborate. Furthermore, the requirements should be subject to administrative change, as at present, and they should take account of vault cash and inter-bank balances.

But this search for a new basic system of requirements is a long range affair which the immediate emergency can not wait for; and I think it would be wrong for me to leave you with the thought that we are concentrating on the future and comfortably leaving the present to take care of itself. On the contrary, we feel the need of covering both fronts at once. We feel the need of giving greater effectiveness to the permanent instruments of credit control, but we also feel the need of powers to correct the maladjustments that the war we thought we had won is still vexing us with and that the cold war we now have on our hands is aggravating.

I am glad to have had this opportunity to discuss with you these measures which the Board believes its responsibilities call upon it to recommend. The public has a right to hear from the Board on the problems that engage its attention and the Board feels very keenly the responsibility resting upon it to keep the public informed, not only in the annual reports which it submits to Congress but in special reports from time to time. The measures I have been describing need to be weighed in the light of present difficulties, economic and political, domestic and international. Though they involve technicalities and factors that seem remote from the day-to-day problems of business, they have in reality a close bearing on the future demand for your goods and services as business and professional men, on the supply of goods and services you require, and on the future value of your dollar. I hope that my account of them has been helpful in clarifying their relationship to your individual interests.

This much we all know, we are living in most unusual and uncertain times. We therefore must be informed and prepared to meet any eventuality.