Remarks before
Advertising Council of America
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THE CREDIT SITUATION

On behalf of the Board of Governors let me express my appreciation of this opportunity to give you a resume of what the Federal Reserve System has sought to do and will try to do in performing its function of influencing the volume of bank reserves and the supply of money. That is the fundamental responsibility of a central bank--and the Reserve System is a central banking organization. If it were done away with some other mechanism of regulating the country's supply of money would have to be set up in its place. A modern nation has to have some such machinery, most of all a nation that occupies a dominant role in the world today. It follows that this mechanism should be equipped and adapted to perform its primary function under changing economic conditions.

Our System has not been and is not now adequately equipped. True it has very great power. It could force a contraction of credit and bring about a severe, indeed a catastrophic, deflation. It could do that by using its open market powers, that is, by withdrawing from the Government bond market, selling off System holdings of Government securities and contracting the credit base and raising the discount rate, thus forcing interest rates to rise. That would be the meat axe way of dealing with an inflation. The Board and the Open Market Committee is of one mind in rejecting such a course. It has been argued by some that small doses of this strong medicine might have effected a cure for inflation. I shall not burden you with the pros and cons of the argument which has been widely aired until recently. The Board has strongly believed that some other means--other than a credit contraction forced through a breaking of the Government securities market--should be found to influence the money supply. If no other devices were available, it might be argued that this deterrent should be used as a last resort. But whether in small doses or not, the forced credit contraction and high interest rate remedy, if it is to be effective, almost inevitably precipitates deflation. The first objective of Government policy, as declared in the Employment Act of 1946, is to steer a middle course between inflation and deflation. We are not prepared to admit that we must founder on one or the other rock.

That is why, in search of alternative means of checking continued growth of the money supply, the Board, in its annual reports to Congress from 1945 on, has suggested various other ways of meeting the situation. That is why the Board is united in support of the recommendations on the credit front which are contained in the President's economic report to this Congress.

There are two proposals on this front: First, that Congress give the Reserve System continuing authority to require all insured banks--not just members of the System--to hold a supplemental reserve requirement in addition to whatever other reserves they may be obliged to hold under State or Federal laws. Second, that Congress give the Board continuing authority to regulate credit terms in the consumer instalment credit field.

Concerning the first proposal, it may be recalled that the late Senator Glass, an author and unfailing defender of the Reserve Act, insisted in the Banking Act of 1935 that all insured banks, having deposits of a million dollars or more, should qualify for membership in the Reserve System. The 1935 Act so provided. Had the date for entry into the System not been first postponed, then dropped, insured banks would have been subjected to the cash reserve requirements which all member banks are now required to have on deposit with their respective Federal Reserve Banks. That would have been a much more drastic step than is proposed in the President's economic report. This proposal does not require membership in the System and does not subject insured banks to the cash reserve requirements required of member banks. It simply proposes that if further--or supplementary--requirements are imposed, the burden shall be borne by all insured banks, not merely by member banks. Member banks are today put at a very serious disadvantage as compared with non-members because of the relatively large percentage of their deposits which they are obliged to keep on deposit with Reserve Banks. It is an unfair and inequitable state of affairs.

It is unfortunate, I think, that some other word than "reserves" was not invented to describe these cash requirements. They are not reserves in the sense in which a banker or businessman thinks of reserves. They are, rather, a required fund immobilized so far as feeding further monetary expansion is concerned. They are, in effect, a protective fund for the purpose of preventing continuing monetary inflation. Since preventing inflation protects the whole community, it is wholly inequitable to put the community load on some banks and to exempt others. That is why it is proposed that all insured banks, sharing as they do this governmental advantage, should share some of the burden of having their funds immobilized against over-expansion of the money supply.

Authority to change member bank reserve requirements was first made an instrument of credit control in 1933. The Board was authorized, under the so-called Thomas Amendment, to raise reserve requirements in order to prevent an injurious expansion of credit provided the President declared the existence of an emergency and with approval of the Secretary of the Treasury. Under the Banking Act of 1935, the emergency provision was removed, but the authority was limited in that the reserve requirements could not be more than double the ratios stated in the law.

Excess reserves of member banks rose considerably in 1934 and 1935 as a result of a substantial gold inflow. The Board decided in the summer of 1936 that it would be in accordance with the spirit of the law to raise reserve requirements, which could be done without putting banks in debt, and thus prevent the large volume of excess reserves from becoming the basis for a possible injurious credit expansion. Requirements were raised 50 per cent effective in August 1936.

In early 1937 economic activity was increasing rapidly. Inventories were accumulating, a wave of buying was in progress and prices of certain raw materials were rising sharply. Capital expenditures of manufacturers were growing rapidly and prices of securities were at the highest levels since the early part of the depression. In the light of these developments, and in view of the large volume of excess reserves held by banks, the Board decided to raise reserve requirements in two steps to the limit

permitted by law, that is, to double the basic amount stated in the law.

This action was not a reversal of the policy of monetary ease pursued since the beginning of the depression. After meeting the requirements, banks still held large amounts of excess reserves. Interest rates remained very low. The Board's action was precautionary in character and placed the System in a position to control an injurious credit expansion by open market operations and discount policy, should such an expansion occur.

In the spring of 1938, as a part of a general move by the Government to combat a rapid decline in business activity, the Board reduced somewhat the reserve requirements for member banks. Gold inflow in the late 'thirties was very large, however, and excess reserves increased rapidly. In the fall of 1941 reserve requirements were raised again to the legal limits, a step which still left excess reserves at about 3.5 billion dollars.

In order to facilitate financing of the war, reserve requirements at banks in central reserve cities (New York City and Chicago) were lowered in three steps over the late summer and early fall of 1942 to the same levels prevailing for banks in reserve cities.

As a part of the System's general program to place under restraint the inflationary credit expansion of the postwar period, the Board in February 1948 and again in June 1948 increased by 2 percentage points the reserve requirements of member banks in New York City and Chicago. Reserve requirements of other member banks could not be increased since these were already at the highest levels permitted by law. In August 1948 Congress granted the Reserve Board temporary authority to increase reserve requirements of member banks only and the authority was limited to 4 per cent on demand deposits and 1 1/2 per cent on time deposits. So far, the Board has not used 2 per cent of this authority affecting demand deposits. Presumably the Board would have no occasion for applying the additional reserve requirement authority when bank credit is not expanding, as has been the case in the past two months.

Increases in reserve requirements in 1948 absorbed about 3 billion dollars into required reserves of member banks. This was somewhat more than the total amount of new reserve funds banks obtained from gold inflow and return flow of currency from circulation during the year.

It is not suggested that the supplemental reserve now proposed--which would amount, if fully used, to ten per cent of demand deposits and four per cent of time deposits--is the last word, and the perfect solution for the problem of arming the monetary authorities with adequate means of performing their primary function. It is to be hoped that possibly through another monetary study Congress will arrive at a still better long-range means of dealing with the question of bank reserves. The pending proposal, however, is a necessary step in the right direction. Together with other powers now available, it would equip the central banking mechanism with authority to cope with overexpansion of the money supply in case that danger again threatens us. It is a workable substitute for the now unusable discount rate and open-market operation weapons

Perhaps I should digress here long enough to point out that in speaking of open-market operations I am referring to their effects in increasing long-term interest rates. As you are aware, it has been possible to have some dampening effect on the creation of bank reserves by permitting discount rates and short-term Government interest rates to rise somewhat and thereby encourage the banks and other investors to hold short-term Governments and to increase their holdings. Purchases of additional holdings in this way can help to offset the credit expansion effects of additional reserves supplied by Federal Reserve purchases of Government bonds, by gold imports, or by inflows of currency from circulation.

I should like to quote the President's words, in this connection, because they state, briefly, the fundamental principle that the country's monetary authorities should be equipped at all times to deal with inflationary pressures on the one hand or deflationary forces on the other. Monetary policy is not a one-way street. It must be flexible, and suited to the changing economic situation.

> "On previous occasions", -- the President said, "I have recommended that adequate means be provided in order that monetary authorities may at all times be in a position to carry out their traditional function of exerting effective restraint upon excessive credit expansion in an inflationary period and conversely of easing credit conditions in a time of deflationary pressures."

So far as the recommendation relating to consumer instalment credit regulation is concerned, this type of selective credit control, like the statutory margin requirements on listed stocks, is always a fruitful source of debate. It can be said fairly, I think, that the Regulation is exerting some effective pressure on instalment credit expansion. With more than 8 billion dollars in instalment credit outstanding, it seems to us desirable to have some concern over the soundness of this credit and over any further excessive growth of it. It is in the public interest, too, to have competition in consumer markets take place in prices and in quality of product rather than in credit terms. Recently, with the reimposition of consumer instalment credit regulation under authority granted last summer, the inflationary credit and monetary expansion based on such loans has slackened considerably. The volume of consumer instalment credit, which had been increasing at the rate of from 180 to 200 million dollars a month through September 1948, showed a much more moderate growth (150 millions a month) over the last three months of the year.

Available evidence suggests that in the major sector of instalment credit--new passenger car financing, Regulation W has had the direct effect of increasing average downpayments from 47 to 49 per cent and decreasing average maturities from 20 to 16 months. Average monthly payments have apparently increased from 73 to 89 dollars. Differences in these effects appear, of course, among the various car-price classes.

Another impact in the automobile field, attributable in some part to Regulation W, has been a sharp decline in the prices of used cars, particularly prices of recent models. Premium prices are still obtainable on many "used" new cars, especially in lower price brackets.

Retail sales of consumer durables, particularly of household appliances and used cars, exhibited a marked weakening in the fourth quarter of 1948, and total retail sales showed distinct signs of leveling off. Levels of dollar sales, however, are substantially above prewar years. With respect to all categories of durable goods, dealers appear to face a problem of maintaining sales volume at prevailing prices for the first time since the war.

Factory production of most consumer durable goods has continued at high levels, but with recent flagging sales, there has probably been some inventory accumulation at wholesale and retail levels. In 1948 output of a few household lines was moderately below 1947.

Employment in consumer durable goods industries has also continued at high levels, but there are currently more frequent reports of temporary lay-offs, actual or prospective. Generalization of recent tendencies is difficult because of varying seasonal and other production conditions in the several industries.

Equity positions in the sales finance business were under strain prior to Regulation W and subsequent developments have brought only slight, if any, improvement in financial positions. Partly under pressure of limited funds, some sales finance companies have apparently been placing greater emphasis on automobile financing, causing dealers in appliance lines to rely more heavily upon their own resources and on bank financing. Furniture dealers continue to rely on their resources supplemented by bank financing. Reports indicate that sales finance companies are especially concerned about the volume of funds they have tied up in dealer stocks, and are tending to limit the volume of "wholesale" paper they are willing to handle for individual dealers. Such policy "rationing" of dealer financing has an immediate impact on factory sales, output, and employment.

The Board's use of its authorities over listed stock margins has also been a helpful means for checking inflationary credit and monetary expansion. Loans for purchasing and carrying stock have not risen during the postwar period. We have not, as in some past boom periods, weakened our economic position by allowing a speculative boom to develop in the stock market on the basis of an expansion of security loans.

In the Securities Exchange Act of 1934 the Congress directed the Board to issue margin-requirement regulations "for the purpose of preventing the excessive use of credit for the purchase or carrying of securities." The Act does not define what use of this credit shall be deemed "excessive," but leaves this to be determined by the Board. The context and legislative background indicate, however, that decisions to change margin requirements should give consideration to the general economic and credit situation, as well as to the extent of speculative activity and credit inflation in the securities markets themselves.

In general, it may be said that the purpose of security margin requirements is to help prevent economic instability. The Securities Exchange Act of 1934 was a result of the general public recognition that stock speculation had been a very important factor in the serious instability of the economy in the late twenties and early thirties.

According to the broad principles which ordinarily underlie the Board's credit policy, margin requirements would presumably be raised or lowered only when such action appears to be called for both by developments in the general business situation, actual or impending, and by developments in the stock market itself. The pertinent criteria which indicate developments in the stock market itself relate primarily to the degree of speculative activity in the markets. For this reason, the level of the various market indices usually is given less consideration in decisions to change margin requirements than is the rate of change of these indices. Rapid changes, particularly in stock prices, may provide a basis for a change in margin requirements that would not be justified if the same amount of change were spread over a longer period.

Specific stock market criteria usually considered in connection with a change in margin requirements include the following: (1) The level and rate of change of common stock prices; (2) The amount of credit borrowed by customers from brokers in margin accounts; (3) The number of shares traded, and the extent of public or professional participation in the market; (4) The volume and ease of flotation of new security issues.

Two points should be mentioned in connection with the term "excessive use of credit" in the statutory mandate. This has been generally interpretated in the past by the Board as applying not only to the amount of credit in use but also to its turnover, that is, the extent to which a given amount is being used. For instance, an active and sharply rising market may in itself indicate an excessive use of credit even though customers' debit balances remain relatively stable. Furthermore, studies by the Board's staff and others have indicated that most of the credit used in the stock market is not absorbed by the market but flows into the general stream of spending for capital goods and consumer goods throughout the economy. Consequently, the major question in determining whether or not a particular amount of stock market credit is excessive is whether economic stability would be promoted by an increase or by a decrease in the quantity of credit money being spent generally in the markets for goods and services.

Stock prices have been comparatively stable since 1946. For conditions of inflationary prosperity, however, they have maintained stability at severely deflated levels in terms of current earnings and dividends and in relation to prices of fixed income securities and of real estate. While the common stock price factor in itself does not suggest an urgent need for a change in margin requirements at this time, the current high ratios of earnings and dividends to prices expose the requirements to continuing criticism as "unduly strict." However, a lowering of margin requirements could not be expected in itself to change public appraisal of stock price earnings or dividend relationship.

There have been a few short periods in the past year when considerable public participation in the market was evident. In May 1948, there was heavy activity when volume averaged nearly 2-1/2 million shares in a week of sharply rising prices. Again in November 1948, activity in the market suggested considerable public liquidation as stock prices fell 10 per cent in a week after the election. On the whole, however, the market has been relatively inactive in the past two years, with little indication of any sustained bullish or bearish speculative participation at any stage.

There has been a relatively small volume of new stock issues in the past year in relation to the general business level and corporate financing in general but the present 75 per cent margin requirement has been only one factor in this situation. In 1946, when margin requirements were 100 per cent, there was a relatively large volume of new stock issues, compared with past years. The large supply of equity money obtained through undistributed profits, and the sharply lower cost of debt as compared with equity funds, were probably more important factors than the level of margin requirements in influencing the low volume of new stock issues in 1948.

In view of the present huge supply of money and other liquid assets, rising Government expenditures, and the threat of resumed inflationary tendencies, the desirability of substantial lowering of margin requirements at this time, in order to expand the amount of stock market credit and credit money generally flowing into commerce and industry, may be questioned. Inflationary tendencies have shown recent signs of abatement. Should further slackening of inflationary pressures materialize, an economic case for a relaxing of margin requirements would develop.

These two credit regulations that I have just discussed--instalment credit and margin requirements--are flexible. Terms that are appropriate for a time of inflation, scarce goods, and an over-supply of money are not appropriate for a time of deflation, when goods are in abundance and effective purchasing power is not adequate.

I want to stress the point again that monetary measures must be adapted to the times. Credit restraints must be eased in slack times, just as they should be tightened in boom times. The President's economic message broadly states the basic principle which should guide monetary and credit policy. It does not operate in a vacuum. It needs to be closely coordinated with other major economic policy, including notably fiscal measures.

This point is especially important with respect to housing. As to the need of housing and the importance of a housing program, it seems to me there can be no difference of opinion. Yet it is obvious that we have to deal with two things here that are in direct conflict. We can not, that is, expand credit for a housing program with one hand and restrict credit to combat inflation with the other. The time to stimulate economic activity is not when it is over-stimulated already. Housing, unless it is carefully timed, entails a demand for materials that will drive prices up and intensify the inflationary condition that we are trying to cure. It is necessary, therefore, that Federal programs for encouraging housing construction and re-development be so conducted as to minimize inflationary pressures during periods of substantially full employment and production. We must not frustrate policy by attempting to do things simultaneously that are bound to interfere with each other. Whatever we do must be timed not only to be effective itself but to avoid rendering other measures ineffective.

What the present situation still calls for, in my opinion, is the sort of corrective the President emphasized in his Economic Report. He said:

"It is essential to sound fiscal policy to have a budget surplus now. This is our most effective weapon against inflation. It will enable us to reduce our debt now; it would be much more difficult to do so in less prosperous times......

"Increased taxation is only one of the means by which we can accumulate a budget surplus. The other is a careful limitation of Federal expenditures. It is essential that our fiscal policy under present circumstances contemplate not only a surplus of revenues over expenditures, but also a surplus achieved at the lowest level of expenditures which is consistent with our needs."

Finally, let me say a word about the downside of the cycle. The Reserve System today is far better equipped than ever before to help offset deflationary dangers. Apart from relaxing instalment credit and margin requirement regulations, it has virtually unlimited means of supplying the market with additional reserves through purchases of Government securities. Under existing legislation with respect to gold reserve requirements--25 per cent of note and deposit liabilities--the System is not now hampered by any crippling limitations on its ability to supply funds to the market, should the need arise. The Federal Reserve Banks have $23 billions of gold certificate reserves, only half of which is required by the law. Accordingly, their note and deposit liabilities could be more than double what they now are. The System is also in a position to make advances freely--that is, to lend on any assets of member banks acceptable to the Reserve Banks as security. This greatly liberalized lending authority was provided by the Banking Act of 1935. In addition the Reserve Banks are empowered to make direct loans for working capital purposes to business and industry, in case other lenders are not available.

If the System is now armed by the new Congress with sufficient means to deal with over-expansion of credit--just as it has been armed since the mid-thirties with important powers to offset deflationary credit forces--it will be equipped once more to play the role that central banking has to play in a modern economy. The adequate equipping of this mechanism should not be left for another emergency. The time to prepare for stormy economic weather is before the storm breaks. The President's recommendations are adequate for the period ahead, and they are moderate.