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CONSUMER CREDIT REGULATION IN A GARRISON ECONOMY

An Address by R. M. Evans,

Member, Board of Governors, Federal Reserve System,

at a meeting of the Tri-State Convention,

Atlantic City, New Jersey, at 10:15 a.m.,

October 13, 1950.

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When one gives a talk before a trade organization, he naturally likes to make some felicitous remarks about the industry represented by his audience.

Frankly, I don't know what I can say about the automobile industry that is not common knowledge. Almost everybody knows that the automobile is the most prized material possession of millions of American families. Everybody knows that the automobile has revolutionized life for millions of city dwellers and farmers.

We all know that the automobile industry has been the backbone of the great expansion of American industry during the past 30 years. It has been an important customer of established industries, such as the steel and glass industries. And it has been a major factor in the development of businesses, such as petroleum, rubber, truck transportation, highway construction, and the tourist trades.

Perhaps the most vivid picture of what the industry means to the United States comes to mind when one tries to think what the country would be like without it. My memory goes back, I must admit, to the day when the automobile was known as the "horseless carriage" -- for, of course, until we invent a name for the new we invariably describe it in terms of the old and familiar. That negative term is as archaic as the early "gasoline buggies," which are now museum pieces. They seem to the present generation as primitive as the spinning wheel.

Functions of Consumer Instalment Credit

The phenomenal development of the automobile industry in the past 30 years has been closely associated with the remarkable development of consumer instalment credit. It is fair to say that the automobile industry could not have risen to its present position without instalment selling. Conversely, it is fair to say that instalment selling would not have developed as it has without the automobile.

To be sure, instalment selling had been known for at least a quarter of a century before the rise of the automobile, and the techniques and institutions of consumer instalment financing were quite developed by the time the automobile came along. But it was the successful instalment financing of millions of motor cars that was largely responsible for making the instalment plan generally respectable and highly popular. Partly because of its successful role in the automobile business, instalment selling has played an important part in the development of other industries, particularly in durable goods, such as vacuum cleaners, radios, washing machines, refrigerators, television, furniture, and still others.

The instalment plan could not have caught on as it did if it had not offered important advantages. For the consumer, probably the chief advantage is that it enables him to obtain the goods he wants immediately and to use them while he is paying for them out of his income. He doesn't have to wait until he has saved up the full cash price before getting the goods. And he might not have the perseverance to hang on to his money until he had saved up the full cash price.

The instalment plan commits the consumer to the discipline of regular payments. If the terms are sufficiently conservative so that the article is paid for more rapidly than it wears out and if the consumer does not buy more than he can pay for, the instalment plan encourages him to accumulate an equity in durable goods. In other words, properly used, the instalment plan is a form of thrift. On the other hand, a person whose eyes are bigger than his pocketbook can get bogged down in a state of intolerable indebtedness via the so-called easy payment plan. It is well to remember there is no such thing as easy credit. The cheapest way to purchase anything is to pay cash.

For you dealers I assume that the principal merit of instalment selling is that it enables you to sell more cars than you otherwise could. And, properly managed, the extension of instalment credit itself can be a lucrative form of investment. On the other hand, as some of your trade publications frequently point out, instalment selling can get a dealer in plenty of trouble if it encourages him to sell terms rather than cars.

Need for Consumer Credit Control

From the standpoint of the individual instalment buyer or seller, the principal consideration is whether the credit is sound. That is, can it be repaid when due?

Whether the individual credit is sound or not is generally best left to the judgment of the individuals or businesses involved. If they become overextended in buying or selling on instalment, they will soon learn better the hard way, or fall by the wayside.

But we must realize that the soundness of individual credit extensions is not the main problem facing us today. It is sometimes said that everything will be all right so long as instalment credit is extended only to reasonably sound risks. This, it is said, is properly left to the discretion of businessmen, free of Government interference. Therefore, the argument runs, there is no justification for Government restrictions on consumer credit.

This reasoning, it seems to me, ignores the overall impact of consumer credit upon the economic system as a whole. Credit extension is more than a transaction between the purchaser and seller, and the soundness of the credit is not the only important aspect of the matter. An extension of credit immediately puts more purchasing power in the hands of the purchaser than he would otherwise have had. Once he has spent this on, say, an automobile, it is passed on to others, and much or all of it remains to swell the demand for goods in general until the credit is paid off. The result must be a more or less general rise in prices or production or both.

Part of the purchasing power put into circulation by consumer credit extensions is provided by savings and part of it comes, directly or indirectly, from bank credit. Extensions of bank credit are of special interest to the Federal Reserve because when total bank credit expands, bank deposits also expand. Bank deposits, at least demand deposits, are money in a very real sense and an excess of money creation by the banking system in relation to the output of commodities and services can spell only one thing -- inflation. The immediate connection between the volume of consumer credit and the economy's total money supply is one very good reason, and probably the major reason, why responsibility for regulating the terms of consumer credit invariably falls to the lot of the Federal Reserve System.

At a time like this, when we must all be enlisted in this home-front battle against inflationary forces, it does no good to tax spendable dollars out of our pockets if we can replace them with borrowed dollars.

In relatively normal times, when production can be expanded to meet increased demand, an expansion of credit may result primarily in an expansion of production rather than prices. Thus, the volume of production in general will depend to a considerable extent on the volume of sales of durable goods which account for most of the credit extended.

From past experience, we have reason to believe that the demand for durable goods is rather unstable. When times are hard, the replacement of old automobiles, refrigerators, and the like, can be put off for a long time, resulting in an abnormally high demand when good times come. This can result in a vicious circle, with the fluctuations in sales of durable goods resulting in fluctuations in instalment credit, which in turn bring about fluctuations in total purchasing power and thus in the demand for goods in general.

The foregoing considerations underlie the argument for regulating consumer credit in normal times in order to moderate ordinary business booms by moderating fluctuations in instalment purchases of durable goods. However, this question is not before us at this time. The Congress provided the present regulatory powers to meet our rearmament emergency only.

The current emergency is a result of national commitments which our country has been obliged to make to maintain security and freedom in the democratic world. This spring, before we were aware of imminent crisis, much of our industry was operating close to capacity to meet record peacetime demand for automobiles and other goods. There were already some indications that purchasing power was outstripping production and that some inflation was coming.

Invasion of Korea settled the question of what this country's international responsibilities are as one of the United Nations in combating communist imperialism. To carry these responsibilities is going to require a garrison economy for the time being. For this to be possible, we will need to make substantial cutbacks in the supplies of many civilian goods, particularly durable goods. The post-Korea demand for goods, however, has not only continued unabated, but in many lines has increased, in anticipation of future shortages or price increases. This has aggravated the situation by leading to current shortages and price increases. From June 20 to September 12, consumer prices rose an average of 2 per cent, wholesale commodities by 8 per cent, and basic commodities by 25 per cent. And wage rates in the automobile industry have already yielded to the inflationary pressures.

Although some of the hysterical buying has subsided, demand, as you well know, continues in excess of supply in many lines. Unless demand is adequately restricted, the situation can become much worse if shortages actually develop. Even if all the slack is taken out of unemployment, there may well be a sharp drop in the labor and materials available for civilian goods as men are taken into the armed forces or diverted to defense production. And, at the same time, the national income will be increased by defense expenditures. Effective action must be taken, and now, if we are to head off a serious inflationary spiral.

Functions of Consumer Credit Regulation

The measures which our Government is instituting at this time are designed to reduce excess purchasing power in an attempt to reduce the gap between demand and supply and thereby dampen upward pressures on prices. The principal measures are tax increases and credit restrictions. Credit is being regulated in two ways. First, it is being tightened at the source, namely, the banking system. Second, it is being tightened at the customer end by the regulation of consumer instalment credit and residential real estage mortgage credit. If possible, it would be desirable to adjust taxes and credit terms so that the demand for goods was on the average about equal to the supply. Then there would be no inflationary pressure on the price level.

How does consumer credit regulation work? In its present form, as you all know, the regulation specifies minimum downpayments and maximum maturities for instalment sales of certain listed articles. The terms are set to be stiffer than those which would ordinarily prevail in the absence of regulation. The object is to make instalment purchases of these goods more difficult than they would otherwise be. The listed articles cover the major durable goods. These goods are chosen for two reasons:

First, they require the types of labor and materials most likely to be diverted to defense production. They are thus the goods most likely to be in short supply.

Second, they account directly or indirectly for the bulk of instalment credit extensions and outstandings. Governmental regulation which is wisely conceived will only affect those elements of a business that are essential to accomplish a public purpose.

We hope that the restrictions imposed on consumer instalment credit will help to achieve two major objectives. As a first aim, we hope that tightening credit on the listed articles will reduce demands for these specific goods to levels more nearly in line with supplies. This will relieve some of the upward pressure on the prices of these goods and on the prices of the labor and material used, which can then be more readily released for defense production.

A second major objective is to curtail in some degree the demand for unlisted articles, as well as for listed articles. For if the output of durable goods is curtailed, there will probably be an increase in demand for other goods and services. Even though these may be relatively abundant, the intensified demand, if unchecked, is likely to drive up prices. Thus, if we are to minimize the inflationary pressure, we need to limit the demand for goods and services in general.

Consumer credit regulation can help to limit total demand by checking the expansion of credit balances, or, if carried far enough, by causing a contraction of such balances. An extension of credit is an extension of purchasing power. Once in circulation, this purchasing power contributes to total demand. Credit restrictions on the listed articles, which account for the bulk of instalment credit, should act to check total credit extensions. This will tend to limit total purchasing power and thus limit the demand for goods and services in general. Thus consumer credit regulation can help in heading off general inflation.

Administration of the Regulation

The administration of consumer credit regulation has been made as flexible as possible, for two reasons. In the first place, we can't predict exactly what conditions we are going to face in the future. That will depend on the outcome of the Korean conflict, among other things. So we need to be able to adjust the regulation to meet changing conditions.

In the second place, we know from past experience that it is hard to predict the precise effects of consumer credit regulation on the demand for particular goods or for goods in general. One difficulty is that the effects of credit restrictions on one article can be shifted to some extent to other articles. Some individuals, for example, may keep up their automobile purchases, in the face of tighter automobile credit, by spending more cash on cars and less on other goods. Thus, restrictions on automobile credit may bring about a reduction in the demand for other goods rather than for automobiles. Another difficulty is that purchases of the other goods may be kept up by using more credit than usual in these lines, particularly in lines with relatively easy terms. If this practice should become widespread, our consumer credit regulation might have to be both broadened in scope and tightened considerably in order to be effective. Another possibility is that consumers may try to maintain their purchase in the face of credit restrictions by drawing on reserves of cash or other liquid assets.

Because of these uncertainties the regulation has been set up so that the terms and the items covered can be adjusted in the light of experience. We are feeling our way along, starting out with what seem to be moderate restrictions. If these restrictions are found to be inadequate, they will be strengthened accordingly. If, later on, they are found to be more restrictive than is necessary, they will be relaxed. Our object is to maintain the flow of available goods at stable prices, if possible, without price fixing or Government rationing.

Effects on Your Business and on Consumers Generally

How will credit control affect you and your business? It is not likely to prevent you from selling all the products you can get. By helping to limit the demand for goods in accordance with supply, thus reducing the inflationary pressure, consumer credit regulation can help to maintain orderly markets and stability of costs and prices.

Most important of all, there will be less likelihood of setting off another inflationary spiral, with wages and prices chasing each other in a futile race like a man chasing his shadow. If we have learned anything at all, we have learned that in such a race almost everybody loses.

How will credit regulation affect consumers? It is not likely to prevent consumers from buying all the goods that are available. And they can't buy more than that, in any case. If they try, the only result will be higher prices. Our object is to cut down on credit, to discourage consumers from trying to buy more goods than are available. Consumers should be encouraged to save up their credit for the day when supplies of goods are again plentiful and buying stimulation is needed. Now is an excellent time to pay debts and accumulate savings.

Concluding Remarks

Consumer credit regulation alone cannot stop inflation. It is only part of a general anti-inflationary program for the present rearmament emergency. This program is intended to help plug the various gaps through which excess purchasing power might otherwise seep into the economy. Some of these gaps can be plugged by heavier taxation. Others can be plugged by other credit measures. All must be plugged if the total program is to be successful.

We are, I think, in general agreement on the objectives of the anti-inflation program. Your industry and others have cooperated generously in helping us to reinstate consumer credit regulation. Your continuing cooperation and advice can be of great help in administering the regulation equitably and effectively. The administration is carried out by the various regional Federal Reserve Banks and is therefore on a grassroots basis. We have twelve

Federal Reserve Banks and twenty-four Branches located in strategic centers of the country so if you have any problem or suggestions it is not necessary for you to come to Washington. You can take them directly to your regional Federal Reserve Bank or Branch -- they are in the best position to advise you and enable the System to benefit by your suggestions. With your help we should be able to weather the present crisis in the best interests of you and of the general public.