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OUR COMMON PROBLEM

An address by Thomas B. McCabe,

Chairman, Board of Governors of the Federal Reserve System,

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Your very cordial invitation to come here today and to join with so many of my good friends was gratefully accepted because I was most anxious to share your thoughts and to enjoy the warmth of your friendship.

During the two and a half years that I have been in my present position you have always accorded me the most courteous and satisfying relationship. I want to pay particular tribute before the entire membership of your Association to the splendid work which has been done by Maury Sparling, and the members of your executive and legislative committees. Many times during the past year they have contacted me and largely through their efforts really cordial relations have been established between the Federal Reserve System and the Supervisors of State Banks.

I think it is fair to say that in our discussions we reached a basis of fine understanding and frankness. We now have a mutual appreciation of each other's problems and a healthy respect for each other's point of view. This is a source of great satisfaction to me. Not only have we found many grounds for common agreement, but I find that we share the same basic philosophy regarding the value of the dual banking system.

All of us represented here today share a responsibility for the maintenance of a sound banking system in the United States. That is our common problem. In the past 50 years there have been tremendous forward strides to make our banking system more efficient. At the turn of the century, State banking departments were relatively undeveloped in sharp contrast to their present-day organizations. There was no Federal Reserve

System to provide flexibility in the provision of credit. There was no Federal Deposit Insurance Corporation to maintain confidence of depositors. The whole philosophy of banking has undergone a substantial overhaul.

When I was a boy, we had just been through the money panic of 1907-1908 and Congressional investigations in the field of money and banking were the order of the day. In Delaware my father was the Banking Commissioner who inaugurated the regular inspection and physical examination of the records and books of State-chartered banks.

It was all too common practice in the early days for banks to be organized for the private benefit of a few business and professional men, and for the officers and directors to be the largest borrowers. All too frequently, there was inadequate recognition of the credit needs of the community or of the people who lived in that vicinity. Today, I am glad to say that the vast majority of our bankers are men of vision. They pride themselves on the fact that they have been able to develop an honored profession. There is less response today to the age-old jokes about the glass-eyed bankers and the Shylocks that evoked hilarity when I was a boy. Our bankers recognize that the basic premise of their operations must be "service to the community". As a result, the banking community today stands in higher respect throughout the body politic than ever before.

Ours is still a country predominantly of independent local banks. We are coming to think of the banker as an active participant in local affairs, generous with his time for the welfare of the community. To fulfill his new role, he is inspiring the confidence of his customers to greater extent than ever before, and they are confiding in him the most intimate details of their financial affairs. More and more he is making credit services available to meet the legitimate needs of all classes and conditions. We have seen a distinct trend in recent years away from the cold marble halls that typified banking accommodations a generation ago. With the inauguration of personal loan departments, sales finance departments, and, more recently, specialized departments to facilitate small business financing, our banks are becoming more and more to be regarded as genuine "community centers" for financial affairs.

Today, the banking system -- indeed the existence of our republic -- is threatened by the international crisis. War and preparations for war inevitably raise credit problems that go to the foundation of our credit structure -- specifically the threat of inflation. I welcome this opportunity to counsel together on how we may mutually prepare ourselves to meet that threat.

For the second time in a decade -- the third time in a generation -- this country faces the grim prospect of adjusting to a program of preparedness. It is clear that the defense programs thus far announced are only a beginning. There is no escaping the need for huge defense expenditures. It is now nearly three months since the North Koreans first set foot on the wrong side of the 38th parallel, and still it is impossible to predict what the ultimate cost in either men or materials will be on the battlefront. It is impossible to foresee what sacrifices will be necessary on the home front to assure peace and security. Of cardinal importance, however, is the fact that our ultimate objective is now firmly fixed -- under the banner of the United Nations we have resolved to resist by force, if necessary, a further corrosion of the foundations we have been trying to build for a free world and a peaceful world for all peoples.

Our leadership in world affairs, our military responsibilities, rest fundamentally on the rightness of our cause and the strength of our economy. We cannot meet these responsibilities without a strong, dynamic economy. It is no overstatement to say that the peace and safety of the world are dependent on a strong American economy.

The American dollar and the securities of our Government have always been symbols of the strength and integrity of our country. Our institutions, the freedoms which we cherish, not for ourselves alone but for all mankind, rest on the foundations of a strong economy. We must above all maintain the soundness of our credit institutions and our financial structure.

History shows that whenever the forces of inflation have been allowed to run rampant in a country, the faith of its citizens has been shaken and the strength of their economy and of their government itself has been put in jeopardy. We saw how a runaway inflation in Germany after World War I ushered in Hitler and how the astronomical Chinese inflation paved the way for communism in China.

We must fight with all the resources at our command in this country to eradicate the cancerous sore of inflation so that it will not eat into the vitals of the greatest economy the world has ever known.

Gentlemen -- this is the most pressing internal problem before our country today, and it is ours in common. It is not around the corner. It is here right now.

It is THE common problem not only of those of us in the financial community, but of every American citizen.

At every turn in the economic road there are alarming symptoms of the forces of inflation which are already at work. Let me go over with you quickly a few facts which highlight the seriousness of the problem we face.

Since Korea the loans of all commercial banks are estimated to have increased 2-1/2 billion dollars. This expansion is phenomenal. It is very much larger than in the same months of 1948 when the postwar inflation was sufficiently grave for Congress to meet in special session to take steps to deal with it.

Consumer indebtedness has been growing at a spectacular rate in the past few months. Credit extended to consumers, exclusive of the money they owe for the purchase of homes, is now estimated at more than 20 billion dollars. This is a record volume, but even more significant is its recent rate of growth. Adding to this amount the 40 billion dollars of home mortgages brings the total debt of consumers at the present time to more than 60 billion dollars -- an increase of roughly 10 billion dollars in the past 12 months.

Prices had begun to move upward even before the outbreak of hostilities in Korea. The pace has quickened measurably since June 25. By mid-September the price index for 28 basic commodities was 25 per cent above the June level and 35 per cent higher than in March. The average levels of all wholesale commodity prices and of consumer prices have risen substantially in this same period.

You are all well aware of the snowballing tendencies of inflationary pressures. Here are a few additional factors to consider in our present situation. For one thing, attitudes of businesses and individuals are less cautious than earlier in the postwar period. Experience of a rapidly rising price level is fresh in the memories of most people. Profits are in record volume and many businesses and individuals are in a highly liquid position and therefore able to carry out extensive buying plans even without borrowing from banks or other lending agencies.

The threat of still higher prices in the months ahead results not only from the existence of a strong demand but in many cases from mounting costs of labor as well as materials. You are all familiar with the current pattern of price and wage increases.

Unless we live up to our responsibilities the outlook for a serious inflationary spiral is foreboding. Inflation would diminish incentives. It would misdirect tremendous amounts of effort into nonproductive areas. Nothing would be more disruptive to mobilization than a merry-go-round in which wages and prices chased each other. Nothing would serve more to increase the total cost of the defense program. Clearly, we must use every possible means to curb inflation. I do not need to emphasize that inflation would cause untold hardship throughout our economy, particularly to people dependent upon fixed incomes and money savings and to our great educational and religious institutions.

It will be no easy task. There is much more to the problem than merely imposing a few direct controls. If we have learned any economic lessons from our experience in World War II and the postwar period, it is the fact that direct controls will not prevent inflation. They serve mainly to retard its impact. Once we have a vigorous and effective program for fiscal, monetary and credit actions the need for direct controls will become less urgent and their use can be limited to specific situations.

A well-rounded program, in my opinion, should have as its keystone a tax system which would put the entire defense effort as far as possible on a pay-as-you-go basis. The President correctly emphasized the necessity for this in his recent broadcast and I think it imperative that there be strong public support for higher taxes all along the line. That means we must cut down the spending power of all but the lowest income group. "During World War II", the President said, "we borrowed too much and did not tax ourselves enough. We must not run our present defense effort on that kind of financial basis."

I sincerely hope we will have the political courage to levy adequate taxes across the board and to economize on non-military expenditures of government and to postpone deferrable projects at every level -- Federal, State, and local. Of course, it will take time for a tax program to be effective. In the meanwhile our main reliance must be on allocations, control of inventories and measures to curb the expansion of private credit. Without that we cannot hold the line.

Certain concrete anti-inflationary steps have already been taken. By themselves they are inadequate, although they are a beginning, and a good one. In mid-July, the American Bankers Association and other organizations of financial institutions cautioned their memberships against the use of bank credit to stimulate inflationary tendencies. On August 4, the 52 supervisory authorities in the United States issued a joint statement outlining a basic policy for the lending operations of financial institutions during this period of intensified defense efforts. You will recall that this was a strong appeal for the voluntary cooperation of every financial institution in the country in restricting unnecessary credit.

This was a forthright recognition by all of us that our common problem throughout the coming months would be the maintenance of a strong and healthy economy backed up by a sound banking system. It was a clear-cut warning that bank credit for nonessential purposes would have to be curtailed if we were going to avoid a spiraling inflation and to bring our maximum productive potential into the defense effort.

Recently the Federal Reserve System has taken several specific actions designed to restrict the use of credit. Open market operations have been directed toward making bank reserves less readily available and discount rates have been raised from 1-1/2 to 1-3/4 per cent throughout the country. The System has stated that it is prepared to use all the means at its command to restrain further expansion of bank credit consistent with the policy of maintaining orderly conditions in the Government securities market.

When the Defense Production Act became law on September 8, the Board moved within the hour to reinstate consumer instalment credit controls. Starting Monday of this week credit terms on automobiles, refrigerators, television sets and other consumer household goods were again brought under regulation. The initial terms might be considered moderate, but we have the assurance of the most responsible elements in the trade, who should know the most about it, that they are adequate to curtail instalment credit expansion. We have already instituted spot checks to observe operations and we will not hesitate to tighten the regulation promptly, almost any day, if the facts require.

The Defense Production Act also gave the President authority to regulate credit on new real estate construction and, by Executive Order, joint responsibility for this control was delegated to the Board and to the Administrator of the Housing and Home Finance Agency. Probably in no other area has credit expansion had a more inflationary effect recently than the real estate credit that has been generated by our unprecedented housing boom. This situation will soon be brought under control. Mr. Foley, the Housing Administrator, is giving us his full and active cooperation in carrying out the President's Executive Order which applies both to conventional loans and to Government mortgage programs.

The top-notch leaders in the private mortgage financing field are working patriotically and conscientiously to help us formulate an effective control that our people can live with and that we hope will be reasonably simple to operate. I know it will be full of headaches, yet I am convinced it is vital to the over-all control of credit in this emergency. We are setting up a temporary organization which can be disbanded as soon as the need passes.

The regulation of consumer credit and real estate credit are both selective types of controls in that they apply to specific credit areas. They are needed in these areas, but by themselves they cannot be expected to work miracles. They must be backed by effective general monetary and fiscal policies and by a general attitude of caution and restraint on the part of lending institutions. To make them effective, we will have to lean heavily on the support which the other Federal agencies and State supervisory authorities can give us.

We will need your aid in helping to administer these selective controls, but above all we need your initiative in helping to curb the expansion of general bank credit outside of these specific areas.

A few moments ago I referred to the joint statement issued six weeks ago in which we appealed to financial institutions to curtail unnecessary credit extension. Because we live in a democracy, you and we would like to accomplish our objectives by reliance on voluntary methods. In this case, however, I feel we must do something more. We must recognize that in a competitive system it is not always possible for an individual institution to respond to an appeal.

Let me illustrate. I recall one banker who told me recently of a case where an important customer wanted to borrow a substantial sum for the accumulation of an inventory that was about five times his normal supply. The banker talked him out of most of the loan, but nevertheless did advance enough to enable him to double his normal inventory. In this particular case, it took some courage to refuse any part of the loan because the customer maintained a substantial deposit balance and was actually in a position to transfer his account to a competing bank. At the same time, we must recognize that the action of the banker in extending the credit added to the current inflationary picture. I cite this instance because it dramatizes vividly the complexities of the competitive problem the banker faces.

The area of general credit expansion outside of consumer, real estate and stock market credit does not lend itself to organized selective controls. Yet the expansion that is going on in this area today is equally dangerous. Perhaps during this conference you can organize yourselves to explore further this problem and then to discuss with us your suggestions of how best to deal with it.

During such discussions I would welcome the opportunity to establish a common understanding on the subject of bank reserves. It has long been one of my cherished hopes that the laws of the several States would be broadened to give you sufficient authority to cope with this question. There is no doubt in my mind that if you were empowered to take adequate action concurrently with the Federal Reserve this source of difference would be largely eliminated. I am confident that in facing up to this and other problems which we share in common we can achieve a meeting of minds and find equitable and effective solutions which will assure the preservation of the dual banking system.

I would not want to leave the impression with you that the common problem which is on my mind today is primarily a matter of bank reserves. We are faced with general credit expansion and we are the responsible authorities who must find ways to deal with it.

As indicated to you earlier, I think the moves that have been made so far, and are now planned, are good and are in the right direction. I feel, however, that taken alone they are inadequate to meet the problem. What I want to do again, most sincerely, is to ask you what more is there that we should do -- and that you can do -- to meet our common problem.

I cannot impress upon you deeply enough the genuine humility with which I seek your aid, your counsel, and the best of your judgment. I am fully aware that credit restrictions alone will not prevent inflation. I am equally convinced that we will not control inflation without them.

This is a time when we — all of us — as supervisory officials have grave responsibilities to take the initiative and to make the critical decisions to preserve and protect our economy.

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