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INFLATION AND THE BANKING SYSTEM

An address by Thomas B. McCabe, Chairman of the Board
of Governors of the Federal Reserve System
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My colleague, Oliver Powell, and I are here today because of our friendship for Ken Cravens and our desire to give him our complete support in his chairmanship of your special committee on voluntary action to curb credit expansion. Ken has had several conferences with us in Washington recently and the more we see of him the more we come under the spell of his persuasive and dynamic personality. Ken reminds me of the late Charlie Schwab whose masterful salesmanship is legendary. The story is told that once a prospective customer emerging from Schwab's office exclaimed to a friend that Schwab's charm was irresistible and he thanked God that he was not a woman.

I am here also to pay respects to your new President, Jim Shelton, who honored me with a visit shortly after he took office. We spent considerable time discussing the plans for this Conference as well as many other problems of mutual interest. Although Bob Fleming, another of your former Presidents, could not be here today, he has talked to me several times about this program which you are inaugurating and is giving it his strongest support.

I am grateful to Ken for inviting me here as it gives me an excellent opportunity to renew some old friendships and to meet many of you for the first time. I have a feeling that Jim Shelton and Ken Cravens are blazing another new trail in this Association and that this meeting has more significance than might appear on the surface. I detect a new spirit on the part of the banking fraternity, a desire to rise to the emergency in this hour of crisis, and to close ranks in the face of our most important internal hazard -- namely -- the threat to the purchasing power of the dollar.

Inflation must be curbed. The deterioration of our international position has made the problem more difficult. It is more compelling than ever that we work together to develop an effective program to curb inflation. It should be a program preferably with a minimum of compulsion. This is the more democratic way. It will require the backing and initiative of each of you here, because this battle cannot be won in Washington alone. It must be fought at the grass roots.

As you know, several concrete steps have been taken to stimulate voluntary efforts to curb the credit expansion. You led the way with the joint statements made by your former President and leaders of other financial groups in mid-July cautioning their members against the use of bank credit to stimulate inflationary trends. I remember, too, how quickly your organization appointed its special committee on voluntary action to which I have already referred.

Early in August, as you will recall, the 52 bank supervisory agencies in the United States also issued a joint statement that urged financial institutions to screen their lending operations with great care during this period of intensified defense effort. It was a very strong appeal for the voluntary cooperation of every financial institution in the country to help in restricting unnecessary credit.

A little less than a month ago, on November 17, as Chairman of the Federal Reserve Board, I addressed a letter to all member banks in which I pointed out the unprecedented rise in bank loans since the middle of the year. I emphasized that the continuation of such a trend would not only add to inflationary pressures but would seriously handicap the necessary expansion of military production. I appealed again to all banks to do their part in restricting the credit expansion. Similar appeals have gone out from other supervisory agencies.

Banks today have a more responsible role to play than ever before in their history. They stand in higher repute throughout the country today than ever before. More and more people look to them for confidence and reassurance. People now think of bankers as active participants in both local and national affairs, generous with their time for the welfare of the community.

There is less and less feeling today that bankers are steely-eyed money bags with offices in cold marble halls, interested only in lending money to a privileged few. With the development of new checking facilities, consumer loan departments, and other services for persons with small incomes, bankers are being recognized as providers of essential services to all of the people. Banks are coming more and more to be regarded as genuine community centers for personal financial affairs.

It is particularly because of the increased public trust in the banking community that we must recognize the inflationary potential of overall bank lending and investing in an emergency period such as this. We must realize that under present conditions every lending and investment decision we make has a bearing on the problem of inflation. At a time when there is full employment, full use of plants and machinery, and also when all available raw materials are being sold and used, every dollar of new bank credit adds a dollar to the competition for limited supplies of goods and services. As a result, prices and wages are bid up. No more goods are produced or hours worked as a result of the credit expansion. Instead the available goods are sold at higher prices and the available labor is employed at higher wages.

The first part of 1950 -- that is, before Korea -- was marked by a sustained demand for all kinds of credit, including mortgage, business, personal and governmental credit. Bank loans expanded by about two billion dollars and bank holdings of State and local securities by almost another billion. This general expansion of credit contributed to and also resulted in part from, an accelerated business situation. Financial institutions participated widely in financing the construction and ownership of homes, the expansion of business inventories, and the purchase by consumers of durable goods. As a result business borrowing declined much less in early 1950 than might have been expected on seasonal grounds.

This was the stage in June. After Korea, credit demands ballooned. Since mid-year, in the commercial banking field, loans have increased by almost 7 billion dollars. They are still increasing. This is larger than any expansion in any other period of comparable length. The outstanding volume of such credit is now at a record level of almost 52 billion dollars.

Businesses have been especially heavy borrowers since June. Loans to business borrowers have accounted for more than half of the over-all bank loan expansion in the past four months. This increase has also been substantially greater than in any comparable period.

The recent increase in business loans has been much more than the volume we might have expected on purely seasonal grounds. The lion's share of the increase has been for the purpose of carrying additional inventories. About 60 per cent of the increase can be attributed to borrowings of commodity dealers and processors of agricultural commodities. It has both reflected and accentuated the sharp rise in commodity prices that has taken place.

An additional 30 per cent went to sales finance companies and distributors in about equal amounts. The remaining 10 per cent went to a wide variety of business borrowers. It is notable that thus far an insignificant amount has been required to finance defense contracts.

Of the 7 billion dollar increase in total loans of commercial banks since mid-year, between 40 and 50 per cent probably represents, either directly or indirectly, home mortgage and consumer instalment debt financing. An unprecedented rate of activity in home building has been a large factor in the recent expansion of private credit. New loans on small residential property reached an all-time peak in August and have declined only slightly since then. For the first ten months of the year the total of such loans has exceeded the annual rate of any previous year.

Banks have participated heavily in this type of financing. Real estate loans outstanding at commercial banks have increased since June by a billion dollars. The total expansion this year is about double that amount.

Even before the Korean crisis, banks and other lenders were financing a marked expansion in consumer buying, especially through the extension of instalment credit. After June consumer instalment credit increased very rapidly. The expansion in the third quarter was more than half again as large as in the same period of 1949.

Consumer loans by commercial banks have increased by about a billion dollars in the past five months; and the growth thus far this year has amounted to around two billion. Fortunately, it may be coming to an end following the usual seasonal peak at Christmas. All of the evidence indicates that Regulation W is being effective in curbing the growth of consumer instalment credit.

Bank credit is directly related to the money supply, that is the total of bank deposits and currency. When banks increase their total loans and investments, the volume of deposits is likely to increase by a corresponding amount. When demand is already excessive, this feeds the fires of inflation.

At the end of June, the money supply was close to the highest level ever reached. Since June, it has grown by about four billion dollars to a new peak of nearly 173 billion dollars. It must be stopped if the value of the dollar is to be maintained.

I do not wish to leave the impression that I am singling out the banking system for criticism. I appreciate that you are part of a larger financial community which operates in a highly competitive environment. What I am saying to you is equally applicable to insurance companies, mutual savings banks, savings and loan associations and government credit agencies. But I do want to bring home to you today with great emphasis that this is your problem as well as ours.

Certain fiscal and monetary measures to cope with the inflation situation have already been adopted. More are needed. We must tax heavily to finance the defense effort without inflation. We must siphon off excess purchasing power through taxes. One set of tax increases has been enacted, but others are necessary.

Certain national and State projects will have to be postponed. We all will have to prepare ourselves to do with less so that we may preserve the value of the dollar while we are meeting our full military requirements. In addition individuals and institutions with real savings must be induced to purchase Government securities and to hold them. The limits for purchase of Series F and G savings bonds have been raised. Further campaigns will be inaugurated to promote the sale of Series E bonds, especially through payroll savings plans. Additional sales of savings bonds are essential to absorb funds that might otherwise be spent. Thrift and savings are crucial in the fight to protect the dollar.

Many counter inflationary measures have been initiated by the Federal Reserve System.

On August 18 the Board approved an increase in discount rates from 1-1/2 to 1-3/4 and made a significant announcement. It stated that the expansion of loans even at that early date was clearly excessive; that the Board and Open Market Committee were prepared to use all the means at their command to restrict further bank credit expansion within the framework of an orderly Government securities market; and that Congress would be asked to provide additional authority if necessary. Since that time, open market operations have been directed toward discouraging sales to the Federal Reserve of short-term Government securities including sales by banks to obtain funds for extending other types of credit.

Let me say a word more on the significance of these moves, for they have not been generally understood. There is much more to these actions than a small rise in interest rates. One main objective is to reduce Federal Reserve purchases of Government securities. Such purchases supply bank reserves and provide the basis for a sixfold expansion in bank credit and in the money supply.

Restraint is accomplished by making the market for short-term Government securities more self-supporting. Resulting higher yields on such securities induce nonbank investors to buy these securities and also discourage banks from selling them prior to maturity to get funds for making other loans. When yields rise, banks are unable to sell securities without incurring some penalty.

On September 18 the Board reinstituted regulation of consumer instalment credit through Regulation W. This regulation established minimum down payments and maximum maturities on automobile and other instalment credit. On October 16, after the extent of the inflationary pressures growing out of the defense program had become more evident, the regulation was made substantially more restrictive.

On October 12 the Board of Governors, with the concurrence of the Housing and Home Finance Administrator, placed curbs on private credit for real estate construction. At the same time the Federal Housing Administration and the Veterans Administration issued new regulations designed to produce a similar tightening of credit under Federal programs. These regulations were designed to help reduce the currently high inflationary pressures by restricting the demand for funds in the mortgage market and through the reduction of new home construction activity to assure that materials and labor required for the defense program would be available when needed.

In spite of all of these actions and the appeals by your Association and by the bank supervisory agencies,credit still expands. This is a matter of the gravest concern to the men who initiated this meeting and to us. The blunt truth is that, thus far, appeals and voluntary efforts have not been sufficiently effective to hold the line. That is the reason we are meeting here today. Gentlemen, this is truly a critical situation. There are definite responsibilities for further moves both on you as private bankers and on us as public servants. They are inescapable.

We are here to counsel together on what you can do and what we must do to meet this situation. So far, the approach to credit restraint on a voluntary basis has been through appeals to you and all other lenders on an individual basis. We now know that your competitive situation is such that this approach is not sufficiently effective. The primary question before us today is what further you can do to restrain credit expansion through both individual and collective action on your part.

We have a new facility that may be useful. I refer to that clause in the Defense Production Act which exempts from the anti-trust laws voluntary agreements between financial institutions and the Government in furtherance of the objectives of the Act. The administration of this provision has been assigned to the Federal Reserve Board. It has not yet been used. We have no experience with it. It has the warm support of the Attorney General. He has written us that he feels it desirable, because of the inflationary conditions now existing, to assist and encourage in every way possible the making of voluntary agreements among financing institutions which would aid in checking any expansion of credit that is not essential to the defense effort.

In conjunction with Ken Cravens, a meeting has been arranged in New York shortly after this conference to see whether an effective loan agreement can be reached. It is contemplated that such loan agreements will be used primarily by the larger institutions in screening larger loans. It is your problem today to develop ways and means to discourage further credit extensions at all banks irrespective of size and to take collective action to enlist every officer of every bank in your anti-inflation drive.

We have thousands of banks in this country with an army of officers. With such an array going into action important results can certainly be accomplished. It is the reduction of credit on as many loans as possible that really counts. Reductions of $500 here, $1,000 there, and $25,000 some other place by thousands of banks serving millions of customers can produce substantial results.

We know you must stand ready to meet the legitimate credit needs of your customers. But how many loans have you made during the past six months that were not really essential? In how many cases have your customers' needs required the full amount they have borrowed? In how many cases would their really legitimate needs have been served with 20 per cent less, or at least 10 per cent less? In how many cases have you renewed or extended loans when a part, or a larger part, might have been paid off? The sum total of these marginal amounts has swelled the money supply and added an increment of buying power to the market that is reflected in the rise of prices, wages, and costs in general, and in the scarcities that pervade the market today.

This does not mean that a single dollar of really essential credit should be refused. But we must remember that in inflationary periods all additional credit dollars are inflationary, no matter how important they may be to the original borrower. Even credit dollars obtained by the original borrower for defense purposes, when spent, get into the money stream.

There is no question that many business concerns are receiving or will soon receive new defense orders that will require increased bank borrowing for one purpose of another. Such additional credit needs should be met out of the proceeds of the repayments of existing loans as they fall due. The volume of credit that turns over in our banks each day is huge. The credit currently being used by business should be transferred to defense production as civilian production is cut back. We should restrict the growth in total bank credit to avoid inflation.

One final point. Everyone is conscious of the charge that Government credit has also been expanding. There have been times when this has been true. The facts are that since June the budget has been in approximate balance, and that new extensions of credit by the various Government agencies have been substantially reduced. Measures have already been adopted to bring about an actual curtailment in the amount of this credit outstanding. Undoubtedly still more can be done in the Governmental field but the major credit problem today is in the private field. That is where the great expansion has taken place.

We are all in this boat together. Your responsibilities and those of the Federal Reserve System are inseparable. Neither you nor we can meet our responsibilities successfully without close and understanding teamwork between us. Your role is indispensable because you help to shape the business leadership in this country. I have noted in the past that when you exercise your individual credit judgment you really decide who, among all the applicants for credit, will be financed. In making that decision in the past you have played a vital part in providing this country with the virile, enterprising, economic leadership for which it is famous. In making that decision today, you will do much to determine whether the value of the dollar will be defended and whether the strength of this economy of ours which is the hope and safety of the freedom loving peoples of the world will be maintained.

May you play your role with courage and vision. The world needs your initiative and your contribution as never before.