NATIONAL DEFENSE AND INFLATION RESTRAINTS

An Address by Oliver S. Powell, Member,
Board of Governors of the Federal Reserve System,
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The opportunity to discuss with this group the broad problem of inflation and its restraint is most welcome. Probably everyone in this audience is affected in some way by the higher prices which have occurred during this past year and most of you are probably affected directly by the inflationary restraints already invoked. You will note that I have used the word "restraints" instead of "controls", for the program up to date has not been one of absolute control. Rather, it has been one of public education, coupled with regulations for the more conservative use of credit in consumer buying and moderately higher interest costs to borrowers.

It seems to me that what we are doing and the best that we must continue to do is to learn how to live during a long drawn out period of greater national defense. We are not in an all out war and yet we are not in a period of peacetime prosperity. A growing section of industry and manpower is producing goods that we cannot eat, wear or enjoy. In other words, guns, tanks, military aircraft, etc. A larger group of men and women are employed in the military services, earning incomes by producing not the products of peacetime but security for the nation. Defense expenditures have already grown from a monthly total of one billion dollars last summer to one billion three hundred million dollars in October, and they may possibly increase to the neighborhood of two and one half billion dollars a month next summer. It is a fair guess to presume that these heavier defense outlays will continue for several years.

This outlook presents new problems. When the Korean incident occurred, we were at first more than a little panicky. Remembering the
shortages that developed during World War II, we rushed to the stores and bought abnormal quantities of merchandise—everything from sheets and coffee to television and autos. You will remember the joke that was common last summer about buying what we need before the hoarders get it. There was an unprecedented increase in residential building, and it is probable that building starts in 1950 will set a new high record of one and one half million units.

With this rush of consumer buying, retailers and manufacturers tried to replace inventories and manufacturers stepped up production. There was a rush to employ more workers. The inevitable result was a sharp rise in prices and another round of wage increases.

How could an increase in prices have been avoided? Production was already at maximum levels in view of available facilities and manpower. Output of industry can only increase by about three per cent a year, limited by the availability of employees, the building of new plants and the development of more efficient methods of production. When the tremendous buying spree came people began to use funds which they had set aside as savings. There was increased cashing of savings bonds and some withdrawal of savings accounts in banks. On top of that, nearly everybody's credit was good. During the prosperous postwar years, down payments for the purchase of consumer durable goods had been reduced and longer and longer periods were permitted for repayment of loans. These trends seemed justified for the loss experience was good and the volume of foreclosures and repossessions stayed low. However, this greatly expanded ability to borrow next year's income for spending today had a tremendous impact on prices since the volume of output could not keep pace with the spending.
Sober second thoughts called for a reappraisal of what was going on. What would happen if these trends continued and how could we fit defense needs into an over-strained peacetime economy? The skeleton of the problem was about like this: a year from now there might be one million fewer employees engaged in making civilian goods. The amount of raw materials available for civilian goods production might also be less because of defense requirements. Yet, with full employment, counting civilian goods, defense goods and military service, the national income might be as much as twenty-five billion dollars above current levels. This in itself would cause tremendous pressure for higher prices without the extra buying pressure due to the increased consumer borrowing against future income. Here is a fact to remember: for every one per cent increase in commodity prices, the cost of living and doing business in the United States increases four and one half billion dollars. I should add that the cost of defense would go up correspondingly and the problem of financing the defense effort would be that much greater.

There are many parts to the solution of this problem. First of all, in a long drawn out defense program it would seem sensible to pay for our defense as we go. This is not something that warrants leaving to posterity an additional heritage of debt. Thus, we must pay more taxes. These taxes are our collective payment for the arms and military services from which we hope to derive security. At the same time, by taxing ourselves, we are preventing ourselves from competing with the defense program for goods, which would only drive prices up and make both our cost of living and the defense effort more expensive.
Second, since we place national security first and our own comforts second, we must postpone or scale down our purchases of less needed goods. The family car can run another year. We can share the television set with the people next door a while longer. The desire for a new home of our own must wait until we have accumulated a larger down payment. In business, additions to stores can wait and non-essential building can be postponed indefinitely.

This discussion leads directly to the moves already made by the Administration to dampen the forces of inflation. Some of these moves have been directive, curtailing the use of scarce raw materials. Another directive was a prohibition against construction of buildings for recreational purposes. Income taxes have been raised and further increases are in prospect. I would like to tell you something about what the Federal Reserve has been doing in this field. Our moves have been in two general areas: first, durable consumer goods, including residential housing, and second, restraints on commercial bank lending. Probably the principal interest of this audience is in the former of these two categories. Regulations W and X have become household words. Regulation W restricts credit for the purchase of automobiles, household appliances, furniture and residential repairs and improvements. Regulation X restricts credit extended for construction of new one and two family housing units.

Under Regulation W the purchaser of an automobile, either new or used, must make a minimum down payment of one third, which may include the trade-in of a used car. The purchaser then has not more than fifteen months to pay for the remainder of the purchase price. I shall not go
into technical details, but those are the essentials of the Regulation as to automobiles. For appliances, there must be a down payment of at least twenty-five per cent and for furniture, fifteen per cent. In both cases, the maximum maturity for paying the remainder is fifteen months. Residential repairs and improvements may be purchased for ten per cent down and the balance paid in thirty months.

These terms and conditions are not just random figures thought up by a Board in Washington isolated from the facts of trade. When I first came to the Board of Governors of the Federal Reserve System on September 1, 1950, I found the Board and its staff engaged in an exhaustive series of conferences with representatives of trade groups, consumers, labor unions, manufacturers and others, discussing the whole problem of trade practices and the effects of varying terms of credit which might be established. Relatively mild restrictions were announced on September 18, the very day that the Defense Production Act of 1950 was passed, authorizing consumer credit controls to be reestablished. On October 16, these controls were stiffened in view of the mounting level of inflationary pressures. Before and since that date the Board of Governors and its staff have been in constant touch with the situation, weighing and measuring the results of the application of these controls.

Regulation X, dealing with residential real estate credit, was announced with the concurrence of the Federal Housing and Home Administrator. This Regulation sets minimum down payments and maximum maturities for the purchase of new homes and for loans on existing homes when insured by the Federal Housing Administration. The down payments and maximum maturities are less restrictive in the lower price brackets. For
example, a home costing less than five thousand dollars can be pur-
chased for ten per cent down and twenty-five years to pay the balance.
A home costing fifteen thousand dollars can be purchased for twenty-
nine per cent down and twenty years to pay the balance. Veterans of
World War II have some preference.

Regulation X was also drafted after thorough consultations
with groups representing many phases of the building industry and resi-
dential purchasers. Since the Regulation does not apply to buildings
for which commitments had been made prior to October 12, it will be many
months before the effect of the Regulation can be measured. Something
like four hundred thousand housing units were in the commitment stage
or beyond on October 12, not counting houses already under construction.
Thus the building industry will continue to be active for many months to
come.

These restrictions on credit purchases of consumer durables
and houses will have effects both on the consumption of scarce materials
and on the manufacture of credit which, as I have explained, adds to the
pressure toward higher prices. The purchaser of these commodities must
use a larger percentage of his available cash for the purchase and will
thus have less money to spend for other purposes. Furthermore, his pay-
ments in future months will take a larger share of his current income
and his purchases of miscellaneous commodities will be reduced.

The use of bank credit for the past six months has been an out-
standing feature of the business developments following the outbreak of
hostilities in Korea. Since that time bank loans have expanded by more
than five billion dollars, which is far greater than the normal seasonal
increase in loans in the second half of the year. Recently the Federal
Reserve people have made inquiry into the purpose of this great expansion in bank credit. The largest single section of the loan increase was in loans to commodity dealers who have purchased this fall's crops of cotton, tobacco, grains, etc., at exceptionally high prices. The next largest borrowing requirement has been by manufacturers using those commodities and who have required more funds to build up seasonal inventories due to high prices. Retail and wholesale trade have borrowed substantially and finance companies were also heavy borrowers.

In other words, the increase in bank loans was almost entirely in the field of peacetime operations and closely related to the higher prices for agricultural commodities. Converting bank loan operations to the defense effort is slowly getting under way. It is a difficult job for there are more than fourteen thousand banks in the country.

Their trade organization, the American Bankers Association, is planning a national credit conference to be held in Chicago on December 14 to 16, 1950, at which time banking leaders from all over the United States will discuss the problem of banks and the defense effort. Meanwhile, the credit policy committees of state bankers associations have been calling to the attention of banks in their states the danger of inflation through unwise bank loans. Listen to this quotation from a letter issued on September 22 by the Washington Bankers Association:

"The demands on our economy in the coming months will be extremely inflationary. Unless proper protective measures are adopted, both voluntarily and/or imposed by statute or regulation, the value of the dollar could be so reduced that our country would be a fertile field for foreign 'isms' and ideologies which we are aggressively battling."
The Federal Reserve and the other banking supervisory agencies have also been in direct touch with the banks of the nation, discussing the inflationary problem and pointing to its urgency in other ways. Here is the timetable of these moves: Early in August the Board of Governors, with the other federal and state banking supervisory agencies, issued a statement requesting the voluntary cooperation of banks and other lenders in restricting their lending and investment activities. Later that month the rates of discount charged by the Federal Reserve Banks for loans to member banks were slightly increased. The yield on short-term Government securities was allowed to rise slightly through operations of the Federal Open Market Committee. Both of these steps were designed to make reserve funds less readily available, thus putting some restraint on further expansion of bank credit. In other words, the objective is a better balanced relationship so that the supply of money bidding for goods and services will not drive prices still higher. That, in the last analysis, is the primary function and responsibility of the Federal Reserve System. On November 17, the Board of Governors of the Federal Reserve System addressed a second letter to all member banks in the United States. Here is a significant sentence from that letter:

"Commercial banks can also do their part in bringing about restraint of credit by advising borrowers to avoid overstocking of inventories and to postpone unnecessary business expansion and by discouraging various types of loans that do not make a definite contribution to the defense effort."

Now what are the results to be expected from this program of inflation restraints? Certainly there will be fewer purchases of articles requiring scarce materials for their manufacture. There will be reduced pressure on prices due to more conservative lending practices under the new regulations and because of greater public understanding of the problem. Looking farther ahead, the volume of consumer debt to be paid out of future income will not be as great. A larger part of our income will be available either for savings, preferably in the form of Government Savings Bonds, or at least we will be better able to pay the higher taxes which are inevitable. Finally, if the rise in commodity prices and cost of services can be checked, at the same time that we complete our program of national defense, we can look forward to more security and peace of mind with no substantial reduction in our cherished American standard of living.