THE VOLUNTARY CREDIT RESTRAINT PROGRAM

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(Oliver S. Powell)

The title of this talk might have been labeled, "Learning to Live With National Defense." Outside of actual war-time conditions, the United States for generations has found it possible almost to forget defense against outside enemies and to devote its energies completely to developing a higher standard of living at home. Now we find ourselves the most powerful non-communist country in the World, able to depend on other countries for protection only in very limited ways and faced with the problem of rebuilding a strong national defense.

The problem resolves itself into one of increasing the production of defense items while maintaining the supply of civilian goods at as high a level as possible.

If the total demand for goods exceeds the supply, prices go up. This is inflation. It hurts the civilian economy and increases the cost of the defense program. A considerable amount of price increase has already occurred since the Korean war began.

The restraints against inflationary price advances must cover a broad front. First of all is an adequate tax program. Then, people should be encouraged to increase their savings. Abnormal profit margins should be discouraged.

If commodity prices can be held in check, further rounds of wage increases should be avoided. Above all, individuals and businesses should be encouraged not to buy more than their normal requirements.

This address deals with one particular phase of inflation control.

As a beginning, I want to take you back to some elementary economics. Since we are dealing with inflation, we should recall that an increase in prices occurs when the money supply increases more rapidly than the volume of business or when the rate of turnover of money increases to a point where the monetary work done by the money supply is greater than needed for the Nation's business. This story really starts back in 1934 with the devaluation of the dollar. That event immediately created an enormous increase in gold reserves which are the base of the bank credit pyramid. In the next few years after devaluation, world events caused a tremendous inflow of gold into the United States, adding further to the basic gold reserves. From that time on, the problem of monetary authorities has centered largely around the management of these large gold reserves in such a way as to prevent undue manufacture of credit and an inflation in commodity prices. This holds true today in spite of the gold exports in the last year and a half.

There was a respite in the problem during World War II. In fact we were very thankful to have such large gold reserves for these reserves made it possible for the banks of the United States to purchase Government securities in huge quantities to provide for money for war over and above the amount provided out of national savings and taxes. However, at the close of the war the Nation found itself with bank investments and bank deposits greatly increased and as these bank deposits went to work for the purchase of civilian goods, price advances occurred as soon as controls were removed. These price advances would have been much greater except for a little-understood phenomenon in the behavior of bank deposits. This was the fact that the turnover of bank deposits had declined steadily from the 1920's until 1945. In the 1920's an annual turnover of demand deposits from 31 to 37 times was considered normal for leading cities. By 1945 this turnover had been reduced to 16 so that a dollar of deposits was doing only half of the monetary work that it did in the 1920's. There has been some increase in deposit turnover during the post-war years, but even the sharp increase since the Korean War started has not brought the turnover rate above 23 turns a year. If the owners of bank deposits were to use these deposits with the efficiency shown in the 1920's, prices could increase substantially from present levels without any further increase in bank loans or investments.

Thus, we have two difficult factors in the money supply to deal with: first, large basic reserves which make it possible to increase the amount of bank credit and bank deposits, and second, a rate of turnover of deposits which it has been demonstrated in former years can grow substantially above today's levels. Both bank credit and the turnover of bank deposits increased sharply in 1950 and in the early months of 1951.

The monetary authorities have made important moves in their field of action to contract the inflationary effects of these increases. Last August, the discount rates of the Federal Reserve Banks were raised somewhat. The consumer credit regulation was reestablished. A new regulation dealing with real estate credit was imposed. Reserve requirements of member banks were raised to substantially their upper legal limits.

One of the most important tools of inflation restraint was practically unusable for several months. This was the employment of open market operations which were devoted almost solely to maintaining a pegged price for long-term Government securities. The pegging of the Government bond market had deep-seated and pernicious effects. Holders of long-term bonds instead of treating those securities as true investments came to consider them equal to cash in liquidity. In fact they were the equivalent of cash so long as they could be sold to the market at a fixed rate and the market could be sure that it could sell them to the Federal Reserve Banks at the same price. This caused the Federal Reserve Banks to manufacture bank reserves at the whim of the holders of Government securities. Recently, it became possible for the Federal Reserve authorities to cease their operations in a pegged bond market and to change to support of an orderly Government security market. The recent reduction in prices of long-term Government bonds has had far-reaching effects in the control of inflation. Holders of those securities have been reluctant to dump them on the market and as a result supplies of funds for mortgage loans and for many other types of credit have been reduced.

To complete the picture of moves toward inflation control in the monetary and credit field, there is the Voluntary Credit Restraint Program. This Program has been inaugurated under the provisions of Section 708 of the Defense Production Act. The authority to set up the Program was delegated to the Federal Reserve Board, which body must consult with the Federal Trade Commission and the Attorney General of the United States and the Program must have the approval of the latter. A tentative Program was drafted by a group of investment bankers, commercial bankers and insurance company executives at the request of the Federal Reserve Board. This Program, with certain changes, was approved by the Attorney General on March 9, 1951. The organization of the Program has been proceeding rapidly since that date.

The first step was for the Federal Reserve Board to request all lenders in the United States to take part in the Voluntary Program. For this purpose a letter was sent to some 90,000 lenders, the broadest list available to the Federal Reserve Banks. The next step was the appointment of a national Committee by the Federal Reserve Board. In its original form, it consisted of four investment bankers, four commercial bankers and four insurance company representatives, with your speaker as chairman. Further additions to the national Committee can be made if it seems desirable to include spokesmen for other types of lenders on this Committee. No additions to the national Committee have been made up to the present time since many types of lending are already under various Government regulations, and thus are excluded from the Voluntary Program.

The national Committee has set up regional committees to deal with problems in three major lending fields. There are four regional committees for investment banking problems, four for life insurance and twelve for commercial banking. Investment banking regional committees have their headquarters at New York, Chicago, Dallas and San Francisco. The national Committee feels that it has been extremely fortunate to obtain as regional committee members a group of outstanding men representing large, medium and small institutions and widely distributed geographically.

The national Committee has held two meetings and will hold a third on Wednesday and Thursday of next week. On Thursday the chairmen of all of the regional committees will meet with the national Committee for a discussion of the future plans of the Program.

Considerable progress has been made in other directions. The national Committee has issued the first of a series of bulletins on credit problems in relation to the Voluntary Credit Restraint Program. The first bulletin dealt with the subject of inventory loans. In view of the rapid increase in inventories, particularly at the retail and wholesale level, the Committee decided that this was its number one problem. Progress has also been made in collecting better statistics to measure the developments in the credit field. The largest banks in the United States have already begun reporting weekly to the Federal Reserve Banks a detailed breakdown of their loans so that the national Committee can ascertain periodically whether the volume of bank credit is rising or falling and the cross currents due to the rising volume of defense lending and the desired decrease in other types of loans.

Excellent figures are already available from New York City commercial banks. For the three weeks ending April 11, New York City commercial and industrial loans decreased $41 million. This is not a large decrease compared with the $2 billion increase in commercial and industrial loans at these banks during the past year. However, it is a move in the right direction. Furthermore, a detailed analysis of these loans showed that loans to heavy industry presumably for defense in large measure increased $43 million during the three weeks ending April 11, whereas loans to commodity dealers, retail trade and light industry decreased $84 million.

Within the next two or three weeks similar information will be available for the larger banks across the country. The national Committee has also asked the Federal Reserve Board to obtain similar improved statistics on the credit operations of insurance companies and on the issues entering the capital markets. Thus, we will know where the trouble spots are and will be able to measure currently the progress of the Program.

While the development of the Voluntary Credit Restraint Program up to date has revolved principally around the Commercial banking aspects, investment bankers have an important task to do which will grow in relation to other parts of the Program until the peak of the defense effort is passed. The estimates of plant expansion by American industries for the year 1951 total up to the staggering sum of $24 billion. A portion of this capital outlay will come from internal savings of business, but with higher taxes and higher costs of operation, it seems likely that internal savings will be less in 1951 than in 1950. Thus, the capital market will be called on for a large amount of new money if this program goes forward without restraint.

Even assuming that strategic materials were available for this great plant expansion, the inflationary pressures would be tremendous. To quote from a letter which I received yesterday from an eminent banker-economist: "I just don't see how we could add that much pressure to the situation without inflation, and if this program goes forward it would go a long way toward defeating our credit program. One reason is that these long-term undertakings all involve the use of bank credit at one time or another by plumbers, and contractors, and equipment manufacturers, and so forth."

It is at this point that the investment banking committees of the Voluntary Credit Restraint Program will find much work to do. The Statement of Principles of the plan sets forth certain priorities for all types of credits which by definition include equity issues as well as true credit flotations. Since the plan is entirely voluntary, the screening of issues and the postponement of less important issues will depend entirely on the persuasive powers of investment bankers and the understanding of the national problem by would-be borrowers. It is to be hoped that all major prospective issues will be submitted for approval to the regional committees. I would suggest to avoid over-burdening these committees that for the beginning at least some minimum size of issue should be adopted -- say, $1 million.

Judging from the experience of World War I, a great deal of moral pressure can be generated. Under the Capital Issues Plan of 1918, it became practically essential for the flotation of an issue for it to bear the statement that it had been approved by the Capital Issues Committee. It would seem possible that a similar badge of desirability could become an important part of the announcement of future issues under today's conditions.

Borrowing again from the experience of 1918, the Capital Issues Committee carefully refrained from passing on the soundness of a proposed issue. The statement used was this: "Passed by the Capital Issues Committee as not incompatible with the National interest, but without approval of legality, validity, worth or security."

In checking issues for essentiality, the committee relied upon (a) the claims of the applicant supported by such evidence as contracts with war agencies, (b) the opinions of interested Government agencies, (c) the knowledge and investigations of the district committees.

A special problem arises in the case of public issues. It is fully recognized that states and municipalities are autonomous in their handling of their own finances. At the same time, public officials are as much interested in the national welfare as any private citizen. Investment bankers are frequently the financial advisers of public officials. It should be possible in many cases for members of the investment banking profession to advise effectively for the postponement of public projects which use scarce materials or where the projects are not immediately essential to the defense effort.

From the standpoint of the mechanics of inflation, municipal issues are particularly attractive to banks. The purchase of securities by a bank adds to the total of bank credit and bank deposits just as effectively as the granting of a business loan. Thus, the smaller the supply of municipal securities available for bank investment, the less increase there will be in the money supply from this source.

I have necessarily talked this evening in generalities. The Voluntary Credit Restraint Program is just getting under way. The national Committee and the four regional committees set up to deal with investment banking problems will be going into action immediately, and you will hear much more from them in a very short time. I wish to close with two comments. First, the success of the Voluntary Credit Restraint Program depends on the fullest public understanding of the need for credit restraint in this period of expanding national defense. We shall be fostering this understanding by press releases, public addresses and by other means. The members of your Association can play an even more important role by explaining fully and carefully to your clients the inflationary problems of the day and the relation of capital issues to this problem. Second, the Program will need the full cooperation of borrower, underwriter and lender. I can illustrate my point by a little story.

Down South a shiftless colored man proudly informed his minister that he had "got religion."

"Dat's fine, brothah," the parson remarked, "but is you sure that you is going to lay aside sin?"

"Yessuh, Ah'se done it already."

"An' is you gwine to pay up all yo' debts?"

"Jest wait a minute, parson. You ain't talking religion now--you is talking business."

Applying this story to today's problem, we must all recognize that inflation control is not somebody else's business. It is ours.