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THE VOLUNTARY CREDIT RESTRAINT PROGRAM

An Address by Oliver S. Powell, Member,

Board of Governors of the Federal Reserve System,

Before the District of Columbia Bankers Association Convention,

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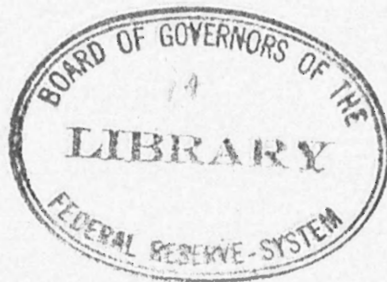

JUL 16 1951

THE VOLUNTARY CREDIT RESTRAINT PROGRAM

(Oliver S. Powell)

This talk might have been labeled "Learning to Live with National Defense". Outside of actual wartime 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.

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.

Many of our monetary problems would probably not have happened without this plethora of gold reserves. The forced feeding of excess reserves into the banks to support the bond market would have been more difficult and doubtless would have ceased much sooner. What now appears to be a titanic struggle against unneeded bank credit expansion would have been greatly reduced. There just would not have been the excess reserves and banks would have automatically limited loans. For most of the history of modern finance this was the traditional situation in banking.

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 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 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, as 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.

It is my purpose today to give you a progress report on the use of inflation restraints. Early in 1950 the recovery of business from the

minor recession of 1949 had brought the level of production, consumption and employment to a high plateau. Production was almost at capacity, a point beyond which it is difficult to expand except by the slow processes of population growth, more factories and improved industrial techniques. Then came the Korean invasion and it set off a rush of panicky buying. 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 sets and autos. There were two waves of buying--autumn and winter. There was also an unprecedented increase in residential building. This buying rush caused retailers and manufacturers to step up their purchases and production rates, and there was a sharp increase in employment. The inevitable result of all this was a sharp rise in prices, and another round of wage increases.

It is important to analyze the sources of buying power which made possible this abnormal buying movement which was superimposed on a high level of peacetime trade. There were three principal sources of buying power:

First, current income. The sum total of wages, rents and income from invested capital which normally just about equals the production of goods and services at stable price levels.

Second, the use of savings by drawing down savings accounts, cashing savings bonds and spending funds which had remained idle in checking accounts awaiting a suitable time for use.

Third, borrowing against future income. Consumers' borrowings to buy automobiles, household appliances and houses; business firms borrowings

to increase inventories or to pay higher prices for inventories or to extend credit to consumers, or to expand plants.

The combination of these three sources of buying power, coupled with the greater activity of deposit accounts, when used to purchase a quantity of goods and services that could not expand with equal rapidity has caused a sharp price rise.

This situation would have called for restraining action at any time. It became much more essential to invoke restraints under today's conditions of growing national defense. The gap between available goods for civilian consumption and the supply of purchasing power promises to be even larger as the months go on. Within a year we are likely to see a million fewer employees engaged in making civilian goods. The amount of raw materials available for civilian goods production will probably be less next year than today because of defense requirements. Already allocations and restrictions in many strategic materials have been announced. Yet with full employment, counting as employees those producing civilian goods, the workers in defense industries and people in military service, the national income might be as much as twenty-five billion dollars above current levels. This guess is on the assumption that no further price increases occur. The probable gap between income and available civilian goods would cause tremendous pressure for higher prices, even with no expansion in bank credit and various forms of consumer borrowing against future income. It should be borne in mind that higher prices not only add to our cost of living and subtract purchasing power from our savings, but they also add to the cost of defense and to the problem of financing the defense effort.

The monetary authorities have made important moves in their field of action to counteract the inflationary effects of these factors.

(1) Last August, the discount rates of the Federal Reserve Banks were raised somewhat and short-term money rates were allowed to rise.

(2) The consumer credit regulation was reestablished. While the reestablishment of this regulation has not brought about any marked reduction in the total of consumer credit outstanding, it has served the purpose of preventing any further expansion in instalment credit since last October, in spite of the high level of retail trade.

(3) A new regulation dealing with real estate credit was imposed. It is commonly understood that it is too early to appraise the restraining effect of Regulation X since builders are still working on the backlog of orders received before Regulation X was announced. However, April building starts did not show a seasonal increase. At 88,000 they were 45,000 less than in April 1950 but just about as many as in April 1949.

(4) In January 1951 reserve requirements of member banks were raised to substantially their upper legal limits.

One of the most important tools of inflation restraint was practically out of use for this purpose for several years. This was the employment of open market operations, which were devoted almost solely to maintaining a pegged price for long-term Government securities. The Federal Reserve Open Market Committee first announced in the depression years that a major objective would be a stable or orderly bond market. This was at a time when the Federal Government was borrowing heavily to provide funds for various kinds of relief. Then came World War II with its huge

expansion of the public debt. The Federal Reserve played an important part in this financing by providing the banks with excess reserves with which to buy Government bonds.

Then came the post-war years. Almost everyone expected a sharp depression as had happened in 1920-21 after World War I. Hindsight proves this to have been an error in judgment but it was a factor in causing the Federal Reserve authorities to continue their easy money, excess reserves, pegged bond market policies. With one or two minor exceptions this policy was maintained until this spring when the pressure of inflation made a change to a more flexible attitude toward the bond market necessary.

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.

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.

Turning from Government controls, and to complete the picture of moves toward inflation restraint in the monetary and credit field, there

is the Voluntary Credit Restraint Program. This program is in essence nothing but enlistment of the collective horse sense of all kinds of lenders to sort out the kinds of credit which should have priority under today's conditions and in that way to avoid Governmental regimentation of credit which, at best, must be a clumsy affair. The Board of Governors of the Federal Reserve System and the managements of all of the Federal Reserve Banks are eager to have the voluntary plan succeed and are lending all possible assistance.

As one banker who is taking a leading part in the Voluntary Program expressed it, "This is the greatest adventure in American finance." At the same time it is a prodigious undertaking. Recall that there are 14,000 banks, more than 400 life insurance companies, about 3,000 investment bankers and dealers and many thousands of savings institutions, building and loan associations and other types of lenders. All of these lenders must be educated in the fundamentals of the Program to a point where they not only give their complete cooperation but so that they do not unwittingly extend credit of an undesirable character. It is only by this complete understanding that we can overcome what one United States Senator called the "competitive drive" for business, which though desirable from the earnings standpoint of the lender, is nevertheless needlessly inflationary under today's conditions.

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 consulted with the Federal Trade Commission and obtained the approval of the Attorney General of the United States for the Program on March 9, 1951.

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. (I repeat, however, that this is not a Government program.) The next step was the appointment of a national Committee by the Federal Reserve Board.

The national Committee has set up regional committees to deal with problems in three major lending fields: commercial banking, life insurance and investment banking.

Considerable progress has been made in other directions. The national Committee has issued three 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. Bulletin No. 2 dealt with credit for plant expansion. According to Government estimates, business firms were planning to spend about $24 billion on plant expansion in 1951. While part of this money would come out of corporate savings, a large part would need to be financed by borrowing. Furthermore, regardless of the sources of funds, it seemed very doubtful to the Voluntary Credit Restraint Committee that expenditures of this magnitude, aside from those directly related to defense, could be carried through without exerting undesirable inflationary pressures. The third bulletin dealt with borrowings by states and municipalities.

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 the cross currents due to the rising volume of defense lending and the desired decrease in other types of loans.

You are all wondering what success the Voluntary Credit Restraint Program is achieving. I must confess that the national Committee and the Federal Reserve Board share in this curiosity. The Program has not been in operation very long and much of its work has been organizational and educational. Furthermore, two other important restraining influences came to bear at the same time. The top-heavy retail inventory situation began to be apparent with the drop-off in retail sales before Easter; and the March and April declines in the Government and corporate bond markets exerted a chilling influence on credit expansion. However, I deem it something more than a coincidence that the sharp and counter-seasonal weekly increase in commercial and industrial loans at reporting member banks ceased with the week of March 21. The request by the Federal Reserve Board to all lending institutions to cooperate in the Voluntary Credit Restraint Program was issued on March 9. The national Committee's first bulletin dealing with inventory loans was issued on March 20. The more detailed figures now available reveal that defense loans are rising, and loans to carry raw commodities are falling. However, loans to carry retail inventories continue to climb.

From my vantage point as Chairman of the national Committee, I can attest to the tremendous release of energy in the field of credit restraint made possible by the Federal Reserve Board's request. I can also bear witness to the spirit of unified effort and the desire to be

"on the team" which is evident in all parts of the country and among all groups of lenders.

Everyone of you in this audience undoubtedly has a dozen lending problems connected with the Voluntary Credit Restraint Program. I urge you to send them to some member of the Fifth District Committee. They will receive prompt attention and on the basis of replies received you will be better able to formulate your opinions as other cases arise. Use the form supplied by the Committee for sending in your problem. This will make sure that the Committee has the necessary information to render an intelligent opinion. Also as the Wall Street Journal shrewdly put it when they first saw this form: "It may be that after you have filled out the form and answered the questions contained in it, you will know the answer to your problem without sending it to the Committee." However, don't send in a case if you expect to turn it down anyway.

In Washington the national Committee is assembling a file of inquiries submitted by lenders to the District Committees and of the opinions rendered by those committees. We are classifying these replies and reporting them back to all of the committees so that the replies given will be as uniform as possible throughout the United States. While your problems may seem unique in your community, I can assure you that many of these problems are showing up all over the United States. It is the collective judgment of lenders and committees that gives the Voluntary Program its special validity and strength.

Your task in restraining loans will be easier to the extent that businessmen understand the program and its purpose. The national Committee

has been helping in this campaign. The newspapers have been generous in carrying stories about the bulletins issued by the national Committee. Probably the most publicity was given to the bulletin suggesting the postponement of State and municipal borrowings that are not urgently needed now. Mr. Charles E. Wilson, Director of the Office of Defense Mobilization, gave us an important "assist" by writing to governors of States and other important municipal officers asking their cooperation. All of the news stories and editorials are part of the education of the public in the facts about inflation and the remedies.

Bankers themselves are taking the lead in educating the business community to the facts: essential credit will be available as fully as needed; nonessential credit will not be forthcoming. An amazing flood of advertisements by clearing houses, resolutions by bankers associations, reports of interviews with bankers, public addresses and radio talks is pouring into my office. I congratulate the banking profession on their public stand so fully proclaimed.

In my judgment there is at least one further informational job to be done, that is to talk to your business customers individually. Get their ear before they walk in with their plans all made and ask for a loan. It is much easier for them to fit their plans to the anti-inflation program when their seasonal and other decisions are being discussed in board meetings or among the firm's executives than after the plans are complete and the owner or treasurer starts out to arrange the financing.

I have two suggestions. First, explain this program to your directors and keep them informed as to how it is affecting your own bank

and community. Your directors are the men of affairs in your city and their explanations in their circle of acquaintances will save you much strain and possible loss of customers.

Second, follow the advice of the American Bankers Association and send copies of the Voluntary Credit Restraint Program to your commercial customers. A few days ago President Shelton of the American Bankers Association wrote to all banks asking that this be done. A postcard addressed to the Federal Reserve Board was enclosed to order copies of the Program. The response has been tremendous. In the first five days' mail we have received requests from 527 banks for 57,059 copies of the Program. I have been greatly pleased to note that it is not just the great city banks that are writing in, it is the hundreds and thousands of smaller banks--the country banks which are taking hold of this project.

We are the richest country on earth. Our standard of living is the highest. We are surrounded by comforts and conveniences that will tide us over a long period of self-sacrifice without real hardship. We are the best educated nation in the world. Bankers as merchants of money must be the leaders in this educational effort. If we can not beat the forces of inflation, we are not worthy of the land handed down to us by the sacrifices and heroism of our forefathers.

Fifth District Commercial Banking Voluntary Credit Restraint Committee

Archie K. Davis, Chairman,
Senior Vice President, Wachovia Bank & Trust Company,
Winston-Salem, North Carolina.

Eugene L. Miles,
President, Baltimore National Bank,
Baltimore, Maryland.

Hulbert T. Bisselle,
Senior Vice President, The Riggs National Bank of Washington, D. C.,
Washington, D. C.

J. Phillips Coleman,
Vice President, First and Merchants National Bank of Richmond,
Richmond, Virginia.

Thos. C. Boushall,
Chairman and President, Bank of Virginia,
Richmond, Virginia.

Ernest Patton,
Chairman of the Board, The Peoples National Bank of Greenville,
Greenville, South Carolina.

N. L. Armistead,
Vice President, Federal Reserve Bank of Richmond,
Richmond, Virginia.

Alternate Member: John S. Alfriend,
President, National Bank of Commerce,
Norfolk, Virginia.