FEDERAL RESERVE POLICY

An Address by Oliver S. Powell, Member,
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At a Study Conference such as this, the topic assigned to me for discussion could be treated in an abstract or textbook manner. However, I have chosen to speak of Federal Reserve policy in action as applied to today's conditions.

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.

The restraints against inflationary price advances must cover a broad front. First of all is an adequate tax program. Second, 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 restraint, that administered by the Federal Reserve Board and the related Voluntary Credit Restraint Program.
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 smaller allocations and greater 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.

In addition to the inflation gap in current income versus the supply of civilian goods there has also been much use of savings for current expenditure. Savings are in many forms. I shall mention only two.
The simplest illustration is the idle bank account. A phenomenon of the last ten years is the extent to which personal and corporate savings have been allowed to remain idle in commercial bank accounts. Reposing there, with no checks drawn, the monetary work done by those deposits is zero. If suddenly people and firms decide to spend those funds, the money supply begins to work more actively, exerting a pressure toward higher prices, and mind you, without any increase in the amount of bank credit. This chain of events has played a large part in the rise of prices in the last year.

Another kind of dis-saving is the conversion of Government bonds into cash, or more usually into bank deposits for current spending. I do not refer to tax notes and other short-term Government obligations, used for temporary employment of funds that have been earmarked for later use. I refer to long-term securities bought by individuals as a means of employing their savings; e.g., savings bonds. I also refer to Government securities bought with the savings of others by insurance companies, savings banks, pension funds and trust companies.

In the case of savings bonds, the Government redeems the obligation and sells a new security to obtain the redemption funds. If banks buy the new securities, bank deposits are created. If other Government securities are sold before the redemption date to obtain funds for current spending or for other employment of savings, someone must buy the bonds. If a bank buys them, it creates deposits; if the Federal Open Market Committee buys them, it creates bank reserves.

Now, let us turn to the third source of buying power -- borrowing against future income. The use of credit increased sharply after the Korean incident. Loans at all banks in the United States increased
$11 billion between June 30, 1950 and March 28, 1951. Consumer credit increased $2-1/2 billion in the last half of 1950. Residential mortgage lending increased by $2 billion, using annual rates, between the Spring of 1950 and the Spring of 1951. Security issues by municipalities and corporations to obtain new capital have been floated at an annual rate of $8 billion. Of course there is overlapping in these figures, and some mortgages and securities are bought with savings, but the figures serve to point out that borrowing for the purpose of spending today has been an important factor in the rise in commodity prices.

As a backdrop for the problem of credit restraint, I want to take you back to some elementary economics. Since we are dealing with the mechanics of inflation, we should recall that an increase in prices occurs (1) when the money supply increases more rapidly than the volume of business or (2) 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. The recent 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 from the gold reserve 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. 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 development 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 was some increase in deposit turnover during the post-war years, and a sharp increase since the Korean War to a turnover rate above 23 turns a year. However, 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, investments or deposits.

Thus, when we try to restrain credit we find that the rope has considerable slack—a potential increase in the turnover of money, gold reserves that permit further credit expansion and in the background a high level of liquid savings just one stage removed from cash.

Furthermore, bankers are well aware of the time lag that is involved in slowing down the machinery of credit. However, the general public does not understand the extent to which firm and practically irrevocable commitments are made by credit institutions for the future financing of business. Let me give you a few examples. The merchant who orders a supply of goods must be assured before he orders that his bank will lend the necessary money to pay for the goods when they arrive. Cotton, tobacco, and grain buyers must arrange for lines of credit at the beginning of the crop-moving season in order to plan their buying operations. Insurance companies make commitments to mortgage bankers to purchase stated amounts of mortgages, which assurance enables the mortgage bankers to lay out programs of soliciting and purchasing mortgages. Investment bankers underwrite stock and bond issues, a function which is vitally important in the provision of new capital to business. In fact few kinds of business could operate without such assurances of funds to complete transactions.

At times lines of credit granted by banks are little used; but lines of credit are there, firmly promised by the banks and available to the customer at his discretion. Last Fall the great expansion in bank
credit was to a large extent merely the fuller use of lines of credit which had been promised to businessmen long before Korea. As an example, one bank had outstanding normal lines of credit for its customers amounting to $120,000,000 at the time of the Korean incident. However, at that time only $30,000,000 of those lines had actually been borrowed. During the succeeding year, the loans of this bank doubled whereas its commitments for lines of credit increased only 10 per cent.

The monetary authorities have made important moves in their field of action to counteract the inflationary effects of the many factors which I have described.

(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 drastic reduction in the total of consumer credit outstanding, the total has declined by $900 million since last December.

(3) A new regulation dealing with real estate credit was imposed. It is still too early to appraise the restraining effect of Regulation X since builders are working on the backlog of orders received before Regulation X was announced, as well as on more recent orders.

(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 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. Skeptics of this change in the administration of the Federal Open Market account have overlooked two aspects of the money market: First, low rates had been in force for so many years that they have been built into the financial structure. Any change to a higher level of long-term money rates forces far-reaching adjustment in financial commitments. Second, the direction of movement in the money market is an important factor entirely aside from the level of money rates. Whenever rates are rising, until the money market reaches reasonably firm ground at a higher level, it is natural that many financing plans are postponed.

To complete the picture of moves toward inflation control 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 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 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. 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 five major lending fields: commercial banking, life insurance, investment banking, savings and loan, and mutual savings banks.

Considerable progress has been made in other directions. The national Committee has issued six 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 $2 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, the fourth with real estate credit and the other bulletins dealt with international finance and security loans.

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. Excellent figures are being received from life insurance companies, and other data are being refined and coordinated.

It is much too early to make a worthwhile appraisal of the effectiveness of the governmental and voluntary inflation restraints. We still have ahead of us the major portion of the scheduled governmental expenditures for defense. At the same time, the industrial plant of the United States is expanding and at some future time will probably be adequate to take care of any peacetime Government defense expenditures and in addition to supply sufficient civilian goods so that the danger of inflation
will be reduced or removed. At the present time, indications are that with existing restraints the inflationary and deflationary forces are fairly well in balance. Wholesale commodity prices have leveled off at a point about 3 per cent below the peak of last March. Consumer prices are moving sideways. The volume of industrial production continues high although apparently the July rate will be slightly under that of June. Retail trade has also been running at a level rate for the last few months. In the field of credit, business loans at the larger banks have declined moderately (by $240 million) during the past four months. This represents a net change with the rising volume of defense loans somewhat more than offset by seasonal decreases in loans to trade and to commodity dealers.

The banking and other statistics of the next few weeks will have unusual significance. During that period we shall learn the extent of credit needed to move this year's crops and to finance the Autumn increase in general business. At the same time, Government defense expenditures are scheduled to continue their increase. Heavier cutbacks in allocations of raw materials for civilian production will be in force. The construction industry will depend less on its backlog accumulated before Regulation X was invoked, and the real effects of that regulation will become more apparent. As insurance companies and savings banks work out from under their volume of commitments to purchase mortgages and other securities, the relation between current accumulations of savings and the needs of the capital markets will become much clearer. From the standpoint of the group constituting this audience, I strongly recommend that you study the current information coming out weekly in the banking periodicals so that you and your institutions may keep abreast of trends as they develop.