THE VOLUNTARY CREDIT RESTRAINT PROGRAM

An Address by Oliver S. Powell, Member,
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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 particularly 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, 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 may continue for many months. 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 may 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 $25 billion above current levels. This guess is on the assumption that no further price or wage 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. 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.

At least temporarily the tide of saving has turned for the better. We as bankers should encourage this movement. One way is to promote vigorously the Treasury’s Defense Bond Drive which starts next month.

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 mort-
gages 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. Also mark this important fact: Our
gold reserves are large enough to permit a large further increase in bank
credit.

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 me-
chanics 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 Na-
tion's business.

Price changes cannot be fully accounted for without observing the
behavior of bank deposits. The turnover of bank deposits declined steadily
from the 1920's until 1945. In the 1920's an annual turnover of demand de-
posits 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 in-
crease since the Korean War to a turnover rate above 23 turns a year. How-
ever, if the owners of bank deposits were to use these deposits with the ef-
ficiency 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 commitments are made by credit institutions for the future financing of business. 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, often 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 million at the time of the Korean incident. However, at that time
only $30 million 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. The reestablishment of this regulation has not brought about any drastic reduction in the total of consumer credit outstanding. Although the total has declined by $900 million since last December, the amount of consumer credit outstanding on June 30, 1951 was still $19 billion.

(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, and on public housing projects as well as on private construction under the regulation.

(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 for several years to maintaining a pegged price for long-term Government securities.
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. One of the most fundamental results of this recent action has been to restore in the rest of the world a confidence that we can control our own inflationary problems.

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 703 of the Defense Production Act. The authority to set up the Program was delegated to the Federal Reserve Board. That body requested a group of financial leaders to draw up a statement of principles and procedures for
the voluntary program. The Federal Reserve Board then 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. This Committee is composed of men chosen from the principal kinds of lending institutions, with a Federal Reserve Board Member as Chairman.

The national Committee has set up regional committees to deal with problems in five major lending fields: commercial banking, life insurance, investment banking, savings banks, and the savings and loan system.

Right from the start the national Committee recognized the need for direct contact with lenders to explain the Program and to insure uniform interpretation throughout the Nation. The national Committee has issued six bulletins to all lenders 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, the fourth with real estate loans, and the others with loans to foreign borrowers and loans on securities.

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 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, the seasonal movements of essential loans, and the desired decrease in other types of loans. Insurance companies and others are also contributing new and important data for use in the Program.

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 more detailed figures now available reveal that defense loans are rising. Loans to carry raw commodities declined sharply during the Spring and early Summer, but are now increasing again seasonally. Loans to carry retail inventories continued to climb for a number of weeks after the Program was announced, but have been receding recently.

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 your 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. Some time 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 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 cooperated; it was 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 cannot beat the forces of inflation, we are not worthy of the land handed down to us by the sacrifices and heroism of our forefathers.