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THE VOLUNTARY CREDIT RESTRAINT PROGRAM

An Address by Oliver S. Powell, Member,

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(Oliver S. Powell)

Last January I had the privilege of addressing the Mid-West Conference of Robert Morris Associates in Chicago. At that time, the Voluntary Credit Restraint Program was merely a couple of paragraphs in a Federal statute supplemented by preliminary discussions of program and method among a group of the Nation's leading financiers. It is a pleasure to come before the National Convention of your organization to give you a battlefield report on what has happened in the Voluntary Program between January and October.

I shall assume that you know the inflationary setting in which the Voluntary Credit Restraint Program was established and is operating. The origin of the inflationary threat in Korea, the growing defense effort, the effect of credit expansion last fall and winter are all well known to you. Also I am sure that you are aware that the fight against inflation must be waged on many fronts: taxation, management of savings, temperance in profits and wage demands, avoidance of speculation in inventories, real estate, securities, etc., economy in Government and private affairs, and the postponement of unnecessary projects--Federal, State, municipal and private. Finally, there is the credit sector.

In a very real and tangible way, the credit policies of the Federal Reserve System and the Program of Voluntary Credit Restraint are complementary in character; each supplements and increases the effectiveness of the other. The general credit policy of the System is intended to reduce the availability of credit in the aggregate and to make it unnecessary for the System to add to the credit base by the continued purchase of Government securities; the selective credit controls are designed to restrain the extension of credit in a few areas where the formulation of specific and generally applicable lending standards is feasible. Reliance has been placed upon the voluntary credit restraint effort to engender a spirit of caution and restraint in lending policies in general, but especially in sectors not amenable to selective credit controls, and to assist in channeling the reduced supply of credit so as to meet the needs of the defense program and of essential civilian activities, while at the same time restraining or curbing the use of credit for nonessential purposes.

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) In August 1950, 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 $800 million since last December, the amount of consumer credit outstanding on August 31, 1951, was still $19 billion. It rose $171 million in August (annnal rate of $2 billion) after Congress eased the restraints.

(3) A new regulation dealing with real estate credit was imposed. It is still impossible 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. Moreover, Congress liberalized the terms in August.

(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. However, 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.

This Program was 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. 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 banking, 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.

Summarizing the statement of principles and the bulletins, it can be said that the recommendations are of two sorts: first, as to desirable and undesirable purposes for credit and second as to maximum limits for certain kinds of credit. The Program was inaugurated on the theory that the purpose test should determine whether or not a loan should be made. However, very early in the operation of the Program it became evident that it must be dovetailed with the Regulations of the Federal Reserve Board in some fields of credit and so maximum credit limits were recommended in the fields of real estate and securities loans. In the latter cases, the objective was still to reduce the amount of credit to a point where speculative price increases would be discouraged.

One general observation can be made, based on common sense and the experience during the past few months. No matter how many bulletins or individual pieces of advice are issued, the question as to whether any particular loan should be made rests on the credit judgment of the lender and on the understanding and voluntary cooperation between lender and borrower. Credit is not something which can be pigeonholed or channeled into one particular activity of a borrowing firm. While the necessity for credit may arise from the need for plant expansion or for working capital to meet pay rolls or to carry inventory and receivables, the actual money borrowed may be used for a variety of purposes. Thus, unless the borrower and lender understand the inflationary impact of certain uses of borrowed money and have a patriotic desire to avoid such employment of funds, credit granted ostensibly for one purpose may do mischief in other fields.

Much of the advice and many of the procedures set up under the Voluntary Credit Program depend on this fundamental understanding and cooperation. For example, no detailed recommendations have been made to guide the relationship between finance companies and their sources of funds. Rather the national Committee has placed the responsibility on the finance companies not to ask for funds which will be used for purposes outside of the Voluntary Program and on banks and other lenders to use their intimate knowledge of the business practices of finance companies to determine whether or not lines of credit to those companies should be expanded.

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, several other important restraining influences came to bear at the same time. For example, 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.

Moreover, bank credit has not been as freely used this summer as a year ago. You will recall the startling increase in bank loans that followed the North Korean attack last June. Between June 28, 1950 and September 27, 1950, business loans at weekly reporting member banks increased by $2,123,000,000. In the corresponding weeks this year the business loan expansion at these banks has been only $858 million, less than half of last year's increase in the same quarter. Putting the matter another way, it is expected on a seasonal basis that bank loans in the third quarter of the calendar year should grow by 6 per cent; this year, the third quarter increase has been only 4-1/2 per cent. It would be more reassuring if this increase in bank credit were not being added to a high level reached this spring, but it must be recalled that business is also at a high level and requires a great deal of credit for normal operations.

Buried in these statistics of increasing loans during the third quarter are a number of cross currents. Loans to manufacturers of metals and metal products, petroleum, coal, chemicals and rubber and public utilities have increased more than $700 million. These industries include most of the defense industries, although not all of these loans are defense loans. Many of these loans have been increasing, not because of seasonal requirements, but because of abnormal or defense demands. It remains to be seen whether they will taper off after the first of the year, following a seasonal pattern. Another group of loans has been increasing for purely seasonal reasons. These are the loans to finance the marketing of the crops--loans to commodity dealers and food, liquor and tobacco manufacturers. Loans to textile, apparel and leather manufacturers have declined. Taking all of the groups together, the borrowings of which carry the crops until they are consumed, the seasonal expansion in the third quarter was about $300 million. The net change in other business loans has been a decrease of about $150 million. The over-all picture would seem to indicate expert workmanship in the handling of the nation's bank credit in this period of 15 per cent defense and 85 per cent peace activities.

In interpreting these trends in the credit field, it is important to keep in mind that the purpose of credit policy in general, and of the Voluntary Credit Restraint Program in particular, has not been to prevent the use of private credit. The objectives of credit measures are rather to attempt to stop the use of credit for speculative purposes, to channel credit into defense and defense-supporting activities, to reduce the credit made available for postponable and less essential civilian purposes, and to engender a more cautious and careful lending policy on the part of lending officers. The Voluntary Credit Restraint Program is making an important contribution to the attainment of these objectives.

Another indication of the success of the Voluntary Credit Restraint Program is to be found in the support which it has received from the hundreds of financial leaders in all sections of the country who are directly and immediately concerned with its day-to-day operations. About 375 men have assumed the arduous and unrewarding task of serving on the regional committees; they are all busy individuals and would not continue their association unless they were convinced that the Program was performing a useful function. Almost without exception these individuals are among the senior personnel of their respective institutions, and almost invariably requests to such individuals to serve on the regional committees have met with a favorable response.

In turn, the regional committees have conscientiously and energetically fulfilled their responsibilities under the Program. They have been prompt in considering applications for opinions on proposed financing and in making their conclusions known to the applicant. They have displayed good judgment in interpreting and applying the guideposts to lending policy issued by the National Committee. The committees have tried to comply with the spirit of the Program, yet at the same time they have maintained the flexibility which is required if the lending institutions are to continue to meet the peculiar needs of their localities and if undue hardship is to be avoided.

The Voluntary Credit Restraint Program has provided the financial section of our economy with a vital rallying point. Even though the inflationary possibilities of credit expansion were fully understood, there still was needed some mechanism for joint action. No lending institution likes to be known up and down main street as being out of step with its competitors. News of that sort travels rapidly. As one North Dakota banker stated it, "I can now discourage a borrower whose loan is not essential under present conditions, to postpone his borrowing by referring to the National Voluntary Credit Restraint Program, with the full assurance that my competitor banks are following the same Program."

Perhaps the most significant and abiding contribution of the Voluntary Credit Restraint Program is that it has given lending officers new benchmarks for use in their appraisal of loan applications. It has broadened their horizon beyond the fairly limited objective of appraising the creditworthiness of a prospective borrower. The Program has made them increasingly aware of the importance of credit policy in an economic stabilization program, and it has contributed to prudence in lending. Equally important, these have been achieved without shutting off the supply of credit to borrowers with needs in accord with today's part-defense, part-peacetime economy, and without imposing upon lending operations a burdensome harness of detailed and specific rules and regulations. This has helped keep to a minimum the injustices and inequities which are inescapable under a set of detailed rules and regulations, no matter how carefully drawn, and has preserved the flexibility of movement required by financial institutions if they are to serve the needs of the economy.

We have learned a great deal more about the behavior of our credit system due to the effort to interpret the happenings of the past year and the resulting new statistics which are available. The breakdown of business loan statistics by class of borrower which has been under way from week to week since last March is spelling out the seasonal pattern of loans which we have never known before except in vague generalities. The commitment figures recently obtained in detail from the major life insurance companies and in less detail from a number of commercial banks and from the savings bank field tell us a great deal more about the financial assurances upon which American business conducts its operations. We have even learned something more about the effect of changing interest rates and yields in the securities markets upon the willingness of borrowers to float new securities and the willingness of investors to change the character of their portfolios.

The threat of inflation has not been removed, although it is not possible to predict when the next upsurge in inflationary pressures will occur or what proportions it may assume. Business inventories are at peak levels and the pressure to reduce them still continues. The productive capacity of the country is tremendous and the record levels of plant and equipment spending are augmenting that capacity month by month. Nevertheless, it is not clear that production can be increased sufficiently fast to cover the increased takings for military equipment that are in prospect, without some reduction in supplies available for the civilian market. It is significant that steel output is already 2 per cent above rated capacity and unemployment is the lowest since World War II. Defense spending is rising rapidly and a growing percentage of our defense outlays is going into "hard" goods for which basic materials are short. This rise in defense spending, with unemployment at very low levels, poses the prospect of continuing upward pressures on wage rates and increases in personal income. Business spending for plant and equipment, at record levels, will remain high for some time to come.

The consumer remains a big unknown in the outlook. Following the two "scare" buying wages of mid-1950 and early 1951, consumers reduced their spending and increased their savings substantially in the second and third quarters of this year. Currently, consumers are spending a significantly smaller portion of their income than was customary in the postwar years. But, it is not certain how long it will be before money will again start to burn holes in the pockets of consumers. The large inventories of goods in consumers' hands, resulting from the overbuying during the past year, will gradually disappear. With personal income at record levels, and likely to increase further, and with large holdings of liquid assets widely distributed, the basic ingredients for an upturn in consumer spending are present in the economy. Even without adverse developments on the international front, consumer spending is likely to increase; given deterioration in the foreign situation, the rise in consumer spending might assume large proportions.

Last January I served notice on the Robert Morris Associates that we would be calling on them for leadership in getting the Voluntary Credit Restraint Program under way. You have done a fine piece of work individually and as an organization, but as usually happens, one good job done leads to another. Not only must we continue to screen new credits; we must also see that those who have borrowed the money pay it back when the credit has served the purpose for which it was borrowed. Under present excess profits taxes, much of the borrowed money is practically cost free. Thus one of the incentives for paying back a bank loan is temporarily removed. Idle working capital, even though it is provided by bank or other borrowing, might be used for purposes not directly connected with defense or other essential purposes. Part of your job should be that of encouraging your customers to keep their borrowing at a minimum. In this way, we shall avoid piling up the money supply while yet assuring deserving borrowers of adequate credit resources.

There are those who say "Why should we restrain credit and turn down profitable business when there is a strong possibility that some Government credit agency will step in and make the same loan?" Others say, "Why restrain credit at all, when extravagance is still evident in many places?" The answer to such thoughts should be obvious. The failures of others to do their utmost in the restraint of inflation does not relieve us of the obligation to do our best. If we do our part, we shall have the satisfaction of a job well done. In years to come the finger cannot be pointed at private finance for having failed in their part of the fight against inflation and we shall have set an example to be emulated by all others charged with parts of this important campaign.