BANKING'S FIGHT AGAINST INFLATION

An Address by Oliver S. Powell, Member,
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Having been a long-run supporter of the American Institute of Banking, it is a genuine pleasure to come up to Boston to address this audience under the auspices of the A.I.B. The topic which I have chosen is "Banking's Fight Against Inflation". It is a real conflict against tremendous forces. In addition to the traditional general credit restraints invoked by the Federal Reserve System and the somewhat newer selective credit controls, banking is voluntarily screening credits as to essentiality under today's conditions. In this fight banking has powerful allies in the form of all of the other branches of finance: investment banking, insurance, savings banking, savings and loan associations, and other financial institutions. It is the story of this solid front of finance in combat with inflation that I wish to tell you tonight.

I shall assume that you know the inflationary setting in which Banking's Fight Against Inflation is operating. The origin of the inflationary threat in Korea, the growing defense effort, the effect of credit expansion in the fall and winter of 1950-51 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.

The monetary authorities have made important moves in their field of action to counteract the inflationary effects of the factors which I have mentioned.
(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 re-establishment 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 September 30, 1951, was still $19 billion. It has risen $171 million in August and $94 million in September 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 reduction last spring 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 best judgment 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.

The principles guiding this Program have been drawn in very general terms. In fact, when the principles were first announced some financiers were skeptical. One said that you could drive a truck through the holes in the Program. Others questioned whether the essentiality of loans could be determined. Those sceptical comments might have proved valid except for one all important factor--the patriotism of the leaders of finance. The sacrifice of short-run self-interest to the broader aims of the public welfare is the amalgam which has closed the loopholes and the touchstone which has made the definition of essentiality a simple matter to decide.

I am sure you know about this statement of principles drafted at the request of the Federal Reserve Board by a group of leading financiers to guide the Program. Your chairman has also mentioned the national Committee which oversees its operation. 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 payrolls 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 could point to the fact that wholesale prices are down 4 per cent since March and that the cost of living has risen only
1-1/4 per cent since February after increasing 13 per cent from the beginning of the Korean trouble up to last February. However, the answer is not that simple. Several other important restraining influences also came to bear during the past eight months. The drop off in retail buying after the panicky buying waves which I have mentioned left retailers with top-heavy inventories. The March and April declines in the Government and corporate bond markets exerted a chilling influence on credit expansion. Increased taxes and credit regulations have come into the picture.

Then how do we know that the Voluntary Credit Restraint Program is working? We cannot tabulate the loans that have not been asked for because businessmen in consultation with their financing institutions have decided that such credits would add to inflation. Nevertheless, we in the lending business know the force and effectiveness of the Voluntary Program. Ask the 400 men who are giving devoted service as national and regional committee men. Ask the businessmen throughout the country who have discussed their borrowing needs with bankers and other financiers in the light of the Voluntary Credit Restraint Program. Ask the bankers, underwriters and insurance executives who keep the printed statement of principles of the Voluntary Program on their desks for ready reference and who are using the recommended purpose tests and loan limits in their lending operations. Ask the thousand state and municipal officials who have voluntarily presented borrowing plans to the regional committees for advice.

It is an impressive fact that 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 in June a year ago. Between June 28, 1950 and November 1, 1950, business loans at weekly reporting
member banks increased by $2,887,000,000. In the corresponding weeks this year the business loan expansion at these banks has been only $1,300 million, less than half of last year's increase in the same weeks. Putting the matter another way, it is expected on a seasonal basis that bank loans in the four months July-October should grow by 9 per cent; this year, the increase has been only 7 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 four months are a number of cross currents. Credit for essential industry has been fully available. Loans to manufacturers of metals and metal products, petroleum, coal, chemicals and rubber and public utilities have increased more than $900 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 these groups together, the borrowings of which carry the crops until they are consumed, the seasonal expansion since June was about $600 million. The net change in other business loans has been a decrease of about $200 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.

Credit for essential purposes is readily available. Cold statistics do not tell the whole story. There are heart-warming cases such as that of the City of Hominy, Oklahoma, a community which was dying because the oil wells are drying up. The enterprising citizens of Hominy searched for some industry essential to the defense effort which could be imported to their city to use their surplus labor and their adequate housing, schools, public utilities, and power supply. To attract this industry the community wished to bond itself for the construction of a factory and the training of a staff of factory employees. This prospective bond issue was screened by the Southwestern Investment Banking Committee of the Voluntary Credit Restraint organization and the green light was flashed.

The Voluntary Credit Restraint Program has won the respect, support and hearty cooperation of the Government lending agencies. The Reconstruction Finance Corporation has publicly announced that its lending operations will conform to the principles of the Voluntary Program. The Federal Home
Loan Board and the Presidents of the Federal Home Loan Banks are using their influence in the savings and loan field to support the Program.

The Farm Credit Administration is taking an active interest in the Voluntary Program and has instructed its far-flung field agencies in the voluntary principles. I wish that time permitted me to tell you of the methods by which the Production Credit Corporation is checking with its local associations to test their conformance with this Program.

But to return to banking aspects, 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.

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-peace time 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.

There have been many important by-products of lasting value. 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.

So much for an appraisal of the Voluntary Credit Restraint Program. Now what of the future? 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 also remains a big unknown in the outlook. Following the two "scare" buying waves 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.

Thus, our job is not finished. 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.

It has been a pleasure to bring you this progress report on the development of this newest weapon in the fight against inflation. When this Program was just starting, your own Walter Bucklin called it "the greatest adventure in American finance." Growing out of the vision and foresight of the Federal Advisory Council, led by Ned Brown of Chicago, the Voluntary Credit Restraint Program has developed into a full-fledged and effective partner with the older anti-inflation controls. While the inflation fight cannot be won solely by finance, we can proudly say that private finance is playing its part in the fight, more effectively than ever before.