THE RESTRAINT OF INFLATION

An Address by Oliver S. Powell, Member,
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It is a genuine pleasure to appear before this audience with a discussion of the restraint against inflation. I have known a number of men in your group for many years, and I know you to be keen businessmen, devoted to the profession of sound farming, which means that you are accustomed to taking a long-range view of business trends. Like other business groups you must have been alarmed at the price increases following the outbreak of hostilities in Korea, an increase which spread through most areas of prices, including farm land. Certainly you will agree that the upsurge in farm land prices should not be aggravated by speculative loans or the extravagant use of credit in other fields. You were much too intimately associated with the period of agricultural distress following the collapse of the farm land boom in 1920 to wish any part in a recurrence of that development.

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
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, when used to purchase a quantity of goods and services that could not expand with equal rapidity, caused a sharp price rise.

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, which does not increase the money supply, but the figures serve to point out that borrowing for the purpose of spending has been an important factor in the rise in commodity prices.

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

(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 still 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.

(5) 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.

The credit policies of the Federal Reserve System have been reinforced by a Program of Voluntary Credit Restraint among private lenders. The general credit policy of the System operates to reduce the availability of credit in the aggregate and to make it unnecessary for the System to add to bank reserves by the continued purchase of Government securities; the selective credit controls are designed to restrain the extension of credit in a few lines where standard lending practices prevail. Reliance has been placed upon the voluntary credit restraint effort to foster a spirit of caution and restraint in lending policies in general, but especially in credit fields not suited to selective credit controls, and equally to assist in channeling the existing supply of credit into the defense program and essential civilian activities, while at the same time restraining the use of credit for nonessential purposes.

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, which requested a group of financial leaders to draw up a statement of principles and procedures for the voluntary program. Credit men in all branches of finance were asked to screen their
loans not only as to credit-worthiness but as to consistency with our national
efforts to contain the inflationary pressures. Listen to these sentences
from the Statement of Principles:

"It shall be the purpose of financing institutions to extend
credit in such a way as to help maintain and increase the strength
of the domestic economy through the restraint of inflationary ten-
dencies and at the same time to help finance the defense program
and the essential needs of agriculture, industry and commerce."

The Voluntary Program does not attempt to override the Federal
agencies in the field of inflation control. It does not have to do with such
factors as inflationary lending by Federal agencies, which the Statement of
Principles states "should be vigorously dealt with at the proper places."
Neither does the Program "seek to restrict loans guaranteed or insured, or
authorized as to purpose by a Government agency, on the theory that they
should be restricted in accordance with national policy, at the source of
Guaranty or authorization."

The first step in putting the Program into action was for the Fed-
eral 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. 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, to answer the most pressing questions without delay, 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.

Of these bulletins, two are most directly related to farming operations. The bulletin on plant expansion with the recommendation that only essential plant be constructed or purchased, especially if done with borrowed money, was couched in language applying to the manufacturer and tradesman. However, it applies equally to farming which is, after all, one of the nation's leading industries. Trucks, tractors, combines, automobiles, barns, silos and fences, drainage and irrigation projects are all industrial plant expenditures. The men in this audience are accustomed to using borrowed funds to improve the efficiency of farming operations without indulging in "frills" or luxury expenditures. I am sure that if any of you had been sitting on the committees of financiers who have been chosen to express opinions as to the desirability of certain kinds of loans, you would have decided the cases exactly as these committees have done. For example, loans for needed repairs and modernization on a farm, loans to purchase cattle where there is adequate pasture and feed, loans to clear land for pasturage have all been given the green light. On the other hand, a top-heavy loan to enable a farmer to buy an additional piece of land which is already in production
merely to lease it to a tenant was discouraged on the ground that it did not add to production but would add to the inflationary upward pressure on farm land prices.

The second bulletin in which you are interested is the real estate credit bulletin in which the national Committee expressed the view that most farm land loans are industrial in type. The Committee recommended that the purpose of the loans should be carefully scrutinized as to essentiality. However, a loan involved in the sale of a farm was considered adequate evidence of a desirable purpose, provided only a conservative amount of credit was involved. The Committee recommended that a down payment of at least one-third should be made.

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.

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 credit-worthiness 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.

Returning now to the over-all national picture, 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. When these inventories stop rising the effect will be to reduce the spending stream. In other words that development would wipe out one of the most important inflationary factors which has been in the picture since the Korean incident in June 1950. The productive capacity of the country is tremendous and the record levels of plant and equipment spending are augmenting that capacity month by month bringing us closer to an ability to satisfy all demands.
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, may 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 new tax law will be a restraining influence but only to a limited extent. The large inventorries 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 spend-
ing are present in the economy. Even without adverse developments on the
international front, consumer spending is likely to increase; given deteriora-
tion in the foreign situation, the rise in consumer spending might assume
large proportions.

In summary, three types of credit restraints are being used in the
fight against inflation. The first and probably the most important is
Federal Reserve policy in its various forms—discount rates, reserve require-
ments, and open market operations. The second is the series of selective
credit controls, principally on consumer credit and certain kinds of real
estate credit. The third is the voluntary restraint of credit by all types of
lenders with the support and understanding of the borrowing public. These
restraints in conjunction with conservatism in consumer buying, a strong de-
sire to save, growing productive capacity in industries and agriculture, higher
taxes and better news in Korea have made for price equilibrium throughout
most of 1951.