

MONETARY POLICY TODAY

Within the past year and a half we have seen business recession, business recovery, and a business boom. Six months ago we were wondering how long business recovery could continue. Since June 25 the question on most people's minds has been "How serious is the present inflationary threat likely to become?"

To ignore the present inflationary threat would be to misinterpret recent economic developments. True, immediate plans call for a smaller diversion of gross national product to the defense of Korea and rearmament than the maximum diverted for World War II. Unlike the situation in 1941, however, there is much less slack in the economy at the present time. Our productive capacity is now much closer to being fully utilized for the satisfaction of private consumer demands than it was when we entered World War II.

Not only is our productive capacity more fully utilized, but the purchasing power of consumers is substantially greater today than it was in 1941. During the past nine years disposable personal income has doubled, liquid asset holdings of individuals have nearly tripled, and the ability of the financial system to expand credit is very large. Should the supply of consumer goods be reduced without a corresponding reduction in people's capacity to purchase them, competitive bidding for goods and services would inevitably lead to inflation.

Savings bankers, as guardians of individuals' savings deposits, are vitally concerned with preventing further erosion of the purchasing power of these deposits. More than that, they are vitally concerned with the prevention of inflationary booms and unsound credit expansion that pave the way for future economic collapse. That is why I should like to discuss with you the need for monetary and credit action to curb further inflation, and the effects of such action on savings banks.

Recent Economic Developments

Immediately prior to the outbreak of war in Korea, economic activity and employment were at very high levels. Industrial production in May exceeded the record postwar level reached during 1948, unemployment had declined sharply from the February peak, and wholesale prices had edged back to their early 1949 level. New housing units started were 50 per cent greater during the first five months of 1950 than in the corresponding period of 1949, while business investment in new plant and equipment and inventories was expanding rapidly. It was readily apparent by the early part of June that the year 1950 would be one of exceptionally good business, and that renewed inflationary forces were pressing on the economy.

The immediate effect of war in Korea was to intensify existing inflationary forces, and to add new ones. Many consumers and business men, whose memories of wartime shortages and rationing were still vivid, started to buy up goods as fast as possible. Department store sales, which during the first half of 1950 had been running slightly below those of the same period in 1949, jumped 21 per cent in July--an unprecedented increase for one month. While this sudden upsurge in consumer demand, more commonly referred to as "scare buying," has subsided somewhat in recent weeks, department store sales are continuing at a level from 5 to 10 percent above last year's. The reaction of business men can be seen in a sharp rise in orders and in the heavy demand for primary commodities.

Increased demands of individuals, businesses, and the Government resulting from the Korean war and an accelerated rearmament program have also been reflected in higher prices, increased industrial production, and declining unemployment. By mid-September prices of 28 basic commodities had risen 25 per cent, while wholesale prices of all commodities were up 8 per cent, from their end-of-June levels. Industrial production, as measured by the Board's index, had already reached a record postwar level of 199 in June; since then, it has risen to 207 in August and is expected to reach 211 in September. Unemployment has declined sharply since June, and is now about one-third less than this time last year.

Were it not for the fact that commercial bank loans have expanded by 2.5 billion dollars since June and that prices continue to rise, the recent increase in consumer buying and industrial production might be looked upon merely as evidence of increased prosperity. However, in view of these developments, and an increase during July in outstanding consumer instalment credit that was 2-1/2 times the monthly average for the first half of 1950, it seems fairly obvious that what we are facing today is not vigorous and healthy prosperity but the threat of inflation.

Inflation, if uncurbed by monetary, credit, debt management, and fiscal policies, can creep upon us month by month and year by year until suddenly we find ourselves prostrate in its grasp. It's not a particularly pleasant prospect for us who have watched the purchasing power of the dollar dwindle over the past 10 years, and it's not one that we can afford to let pass unchallenged when we have the means of stopping it at our disposal.

Monetary, Credit, and Fiscal Curbs on Inflation

Several possible courses of action for curbing inflation have been widely discussed in recent months. On the one hand, we hear the proponents of direct price, rationing, and wage controls arguing for an immediate return to the regimented economy of the last war. On the other hand, we hear the somewhat calmer, if less audible, proponents of monetary and fiscal policies arguing for curbing inflation by means of credit control, higher taxes, and debt management.

I shall not take the time today to discuss the relative merits and demerits of rationing and direct controls of production, prices, and wages. I shall merely remind you that they are difficult and cumbersome to administer and that they attack the effects, rather than the basic causes, of inflation. Instead, I'd like to spend a few minutes discussing the ways

in which the banking system and the Federal Government can strike at the causes of inflation and the responsibilities of the Federal Reserve System in an inflationary period.

Since ours is primarily a credit rather than a cash economy, one of the surest ways to curb inflationary forces is to diminish the flow of credit. This can be done in any one of a number of ways, or combinations of ways. By raising the rediscount rate the Federal Reserve makes it more expensive for member banks to borrow on eligible paper. This increased cost of borrowing is usually passed on to bank customers in the form of higher interest charges on personal and business loans. Thus, by making Reserve Bank credit more expensive, the System may discourage credit expansion to some extent.

By increasing reserve requirements, the Federal Reserve can reduce the amount of credit which member banks may extend on the basis of deposit balances maintained with Federal Reserve Banks. Through open market sales of Government securities, which reduce the reserve balances of member banks, the Federal Reserve may contract the basis of bank credit expansion. Theoretically, any one of these methods may be used to curb further credit expansion or to contract the total volume of outstanding bank credit, but in practice they need to be employed in some appropriate combination.

In addition to the general credit instruments which I have been discussing--instruments which affect the total volume but not the particular type of credit extended or outstanding--the Federal Reserve now has authority to restrict specific types of credit. At the present time the Federal Reserve may, by establishing certain terms and conditions for stock purchase, consumer instalment, and real estate construction loans, affect the demand of individuals for such credit. These selective credit instruments, unlike the general credit instruments, do not directly affect the volume of credit which may be extended or outstanding, but they do alter the terms on which credit is available, and hence affect the ability and willingness of individuals to utilize such credit.

The Federal Reserve, as the agency of the Government charged with responsibility for contributing, as best it can, to the maintenance of monetary and credit conditions consistent with the needs of economic stability, is obligated to exercise its monetary and credit powers in curbing inflationary forces. There is no question, therefore, as to whether the Federal Reserve should take action to curb inflation; the question is simply when and in what form it should be taken.

In addition to monetary and credit action by the Federal Reserve to curb further expansion of bank credit, there are other financial measures necessary for attacking the basic causes of inflation. In the field of fiscal or budgetary policy it is possible for the Federal Government to finance a large part of its increased defense expenditures on a "pay-as-you-go" basis by means of higher individual and corporate income taxes. In retrospect, the gravest mistake we made in financing World War II, and the mistake which left the deepest mark on the American economy, was failure to tax enough. This failure left us with a huge burden of Government debt and tremendous potentialities for inflation. As a consequence, we experienced great difficulty in maintaining financial stability in the postwar period.

The longer it takes to increase taxes substantially, the smaller the increase in taxes relative to Government expenditures, and the more the Government borrows from banks, as contrasted with the public and nonbanking institutions, the greater the need for monetary and credit action to restrain further credit expansion.

Even if Government expenditures were almost fully covered by taxation, it would be highly desirable under present and prospective conditions for the Government to siphon off as large a volume of excess investment funds as possible by tapping real savings when borrowing additional funds or when refunding securities that mature. Moreover, the Government should take advantage of every opportunity to sell securities to nonbank investors and to retire public debt held by the banking system. Sales of bonds to individuals, corporations, and nonbank financial institutions would absorb money that might otherwise be spent on current consumption or new private investment, and using the proceeds to retire securities held by banks would reduce bank liquidity and help to offset expansion of bank credit to private borrowers.

Recent Monetary and Credit Developments

During the weeks immediately following the Korean invasion, steps were taken to reduce the expansion of certain types of credit and to broaden the powers of the Government for expediting rearmament and curbing inflation. On July 18 the President directed Federal agencies concerned with real estate financing to restrict their lending activities; on July 19 he requested additional control, allocation, and credit restriction authority from Congress; and, on July 25, he asked that individual and corporate income taxes be increased to provide additional revenues to help cover the costs of rearmament.

Reviewing very briefly the major provisions of the Defense Production Act of 1950, we find that it grants authority to the President to (1) establish priorities and allocations covering the use of scarce or critical materials; (2) requisition productive capacity essential to fulfilling rearmament contracts; (3) expedite the expansion of capacity and supply through guaranteeing banks loans to war contractors and subcontractors; (4) establish wage and price controls and rationing under certain conditions; and (5) control the terms and conditions upon which consumer and real estate loans are extended. In all cases the powers conferred in this act are permissive rather than mandatory, and the extent to which they are used will depend largely on the future course taken by rearmament and inflation.

On August 18, in announcing its approval of the New York Bank's increase in rediscount rates from 1-1/2 per cent to 1-3/4 per cent, the Board pointed to the fact that during the preceding six weeks' period loans and holdings of corporate securities at banks in leading cities had expanded by 1.5 billion dollars--an excessive amount, in view of existing conditions. The Board further emphasized the fact that while effective restraint of inflation must ultimately depend on the willingness of the American people to tax themselves adequately to meet the Government's needs on a "pay-as-you-go" basis, taxation alone would not do the job. On the contrary, prompt and parallel curbs in the area of monetary and credit policy are needed if effective restraint is to be achieved.

Throughout the postwar period, low yields on Government securities, together with the large and growing volume of short-term securities outstanding and held by banks and savings institutions, have prompted these institutions to shift their funds to higher yielding investments. In so doing, they have made real estate and other credit readily available to private borrowers. The problem of restricting such credit expansion has been further complicated by the policy of maintaining an orderly market for Government securities at rates which assured low cost refunding and new financing by the Treasury. In order to keep short-term rates from rising, the Federal Reserve had to purchase substantial amounts of short-term securities. These purchases created additional bank reserves.

In an effort to curtail extension of credit to private borrowers, the Board of Governors and the Federal Open Market Committee initiated a new phase of open market operations on August 18. On that date they stated that they were prepared to use all the means at their command to restrain further expansion of bank credit consistent with the policy of maintaining orderly conditions in the Government securities market.

The first test of the new open market policy was provided by the Treasury refunding of bonds and certificates maturing September 15 and October 1 with 1-1/4 per cent notes of 13 months' maturity--a rate which was lower than the rate established in the market as a result of discontinuance by the Federal Reserve of the policy of preventing rates from rising. In order to assure the success of the Treasury refunding, the Federal Reserve bought the maturing issues. At the same time, however, to prevent a growth in bank reserves, the Federal Reserve sold other outstanding issues at somewhat higher yields. As a result, the average yield on short-term Government securities has risen during the past month. Federal Reserve purchases so far have somewhat exceeded sales and bank credit and bank reserve expansion has continued, but it is hoped that with termination of the refunding operation, the effects of the Federal Reserve's policy will be more restrictive.

Futura Monetary and Fiscal Policy

The rise in short-term Government yields, coupled with increases in rates on bankers' acceptances, security loans, and other forms of bank credit in response to Federal Reserve open market and rediscount rate actions, are first steps in the direction of curbing inflation by seeking to reduce the availability of reserves. Should these steps prove to be inadequate, further action might have to be taken.

So far as general credit controls are concerned, the Federal Reserve still has not invoked its authority to increase member bank reserve requirements. Under this authority, as presently constituted, required reserves of central reserve city banks could be increased from 22 to 26 per cent of demand deposits; those of reserve city banks, from 18 to 20 per cent; and those of country banks from 12 to 14 per cent; while reserves against time deposits could be increased from 5 to 6 per cent.

As long as short-term interest rates are rigidly kept down and banks have an abundance of short-term securities, the effectiveness of reserve requirement increases is limited. In the event existing authority over reserve requirements should prove inadequate, Congress may

decide to expand this authority to permit further increases in reserve requirements. It may even be necessary, in my opinion, particularly if large-scale deficit financing would necessitate some Treasury borrowing from banks, to institute some sort of supplementary requirement. Under such a plan commercial banks might be required to hold some percentage of their demand and time deposits, in addition to present reserves, in the form of Treasury bills, certificates and notes, or cash and cash items.

Such supplementary requirements could be limited by law to a certain percentage of demand and time deposits. Banks could retain the same volume of earnings assets as they now hold, or perhaps more, but at the same time the supplementary requirement would restrict the basis of credit expansion currently and in the future.

Selective Credit Instruments

Consumer Credit Regulation

In accordance with the authority granted by Congress in the Defense Production Act of 1950, the Federal Reserve implemented, as of September 18, certain restrictions on consumer credit. In general, these restrictions call for somewhat larger down payments and shorter maturities on consumer instalment loans than prevailed at the time the regulation was issued. Thus, for example, purchases of new automobiles on credit can only be made with a minimum down payment of one-third of the purchase price, the balance to be paid off within 21 months; of stoves, radios, dishwashers, refrigerators, and other household equipment, with a minimum down payment of 15 per cent, the balance to be paid within 18 months.

The purpose of these larger down payment and shorter maturity provisions is to curtail consumer purchases of automobiles, household appliances, and other durable goods, particularly where recent expansion of such purchases has occurred largely in response to progressively more liberal terms.

Control of Real Estate Credit

As I mentioned previously, in discussing current economic developments, the demand of consumers for housing has been one of the major factors contributing to recent high levels of business activity and employment. This demand for housing has in large measure been supported by, and in turn has contributed to, a rapid expansion in real estate mortgage credit.

New Loans made on small residential properties during the first eight months of 1950 totaled slightly more than 9 billion dollars--an annual rate of almost 14 billion, as compared with roughly 11 billion in each of the past three years. Residential mortgage debt outstanding, which on December 31, 1949 totaled 37 billion dollars, increased at a record rate during the first eight months of 1950, reflecting a more rapid increase in new debt than in retirement of previously contracted debt. As of August 31, mortgage loans outstanding on one to four-family houses totaled about 41 billion dollars, an increase of nearly 4 billion since the first of the year, as compared with an increase of less than 4 billion during the entire 12 months of 1949.

To argue, as some responsible individuals have, that real estate mortgage lending based on expansion of bank credit is not inflationary, seems to me in contradiction of the facts. Not only is the volume of money in circulation increased by the expansion of credit, but its turnover is quickened by the chain of transactions involved in building. More than that, private building operations increase competitive bidding for labor and materials needed for the defense effort and thus induce price rises.

During the past 12 months prices of most building materials have been advancing steadily--by the beginning of September they had advanced 16 per cent, on the average, from the lowest level reached in 1949, which was still very high, and were continuing to climb. In the case of some building components, such as millwork, the price increases have been even more pronounced.

Real estate mortgage credit plays a very important and desirable role in our economic system in normal times. Without such credit, widespread home ownership would not be possible. However, in order that such financing may be of greatest value, it is important that it be used most fully when the construction industry as well as all other industries are in a position to meet demands without inflating prices and otherwise damaging the whole economy.

When industry in general is running at capacity and increased needs for national defense require a substantial diversion of labor and materials from civilian use, the expansion of mortgage credit will only add fuel to the fires of inflation. If mortgage credit is appropriately limited now, it will be in a better position to play its essential role when more productive capacity becomes available to meet consumer demands.

The Defense Production Act of 1950 and executive orders pursuant thereto provide for the regulation of private real estate construction credit by the Federal Reserve, with the concurrence of the Housing and Home Finance Administrator. Government guaranteed real estate credit will be regulated by the Housing and Home Finance Administrator, and to the greatest extent possible will be coordinated with the restrictions imposed on private credit. While regulations implementing private real estate credit control have not yet been published, the general intent and form of such control will probably be about as follows.

Restrictions will be imposed on credit (whether or not secured by a mortgage) granted for new construction, including major additions and improvements to existing structures, and may cover industrial and commercial as well as residential properties. Interest rates will not be regulated, but minimum down payment requirements will be established on residential properties. Consideration is also being given to maximum maturity and/or minimum rate of repayment requirements.

Unlike consumer credit regulation, where we have an extensive experience to draw upon, restriction of real estate credit presents many new and knotty problems. In an effort to deal equitably and wisely with these problems, the Federal Reserve has elicited the assistance of recognized experts in the field of real estate credit, and has invited the cooperation and advice of bankers and others who extend real estate credit.

Conclusion

Quite obviously, the measures for curbing inflation which I have been discussing will have their effects, directly or indirectly upon savings banks. To the extent that these measures are employed successfully, they will preserve the purchasing power of savings deposits and will sustain the confidence of those who maintain savings deposits. In an era in which savings banks must compete with other institutions and investment media for the savings of individuals, this in itself is of great importance to the savings banker.

If consumer instalment and real estate credit controls succeed in deferring consumer expenditures, savings deposits may be expected to increase at somewhat higher than present rates, as they did during World War II. At the same time, reduction of real estate credit extension may reduce the supply of such investments available to savings banks. This should strengthen market demand for long-term Government securities.

Whatever the ultimate effects of present monetary, credit, and fiscal policies may be on the earnings and investment prospects of savings banks, I am confident that savings bankers throughout the country will lend their wholehearted support to the prevention of inflation. The more we can accomplish by means of monetary, credit, and fiscal policies within the existing framework and institutions of our free enterprise economy, the less need there will be for the authoritarian harness of rationing and other direct controls.