

Inflation + deflation

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TWO YEARS OF FIGHTING INFLATION

An Address by Oliver S. Powell, President
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TWO YEARS OF FIGHTING INFLATION

As we move farther and farther away from the exciting days of the fall and winter of 1950-51, the contrast between conditions at that time and conditions today becomes sharper. It is hard to realize that only two years ago prices were skyrocketing and we were all wondering where they would stop. These days there is no talk of higher prices, but rather an occasional conjecture about the business recession which some people are sure is just around the corner, and the danger of lower prices. It occurred to me in choosing a topic for tonight's talk that I could best serve this audience by a review of the monetary moves of the past two years, drawing from those events some lessons for the future.

Before analyzing the cure of the 1950 inflation, we should first examine the elements that contributed to the flare-up in prices. We are apt to forget the strong recovery that occurred in the spring of 1950 from the recession of 1949. Consumers had started buying again, using their credit resources to add to current income. Inventories at stores and factories were rising. By mid-year industrial production was at a high point and there was little unemployment. Thus the economy was not ready for a sudden growth in retail demand.

You will recall the panicky buying that followed the Korean invasion. We rushed to the stores and bought abnormal quantities of merchandise-- everything from sheets and coffee to television sets and autos. There was also an unprecedented increase in residential building. This buying rush caused retailers and manufacturers to step up their inventory 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. These forces had spent their power, or were checked, in March 1951 and in the year and a half since that time there has been no significant advance in prices. In fact, wholesale prices have declined 3%.

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 will normally just about buy the full 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' borrowing 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.

Now having analyzed the sources of funds which contributed to the price rise, let us enumerate the events that brought the price rise to a halt. Some of these developments were governmental, but the most powerful ones were entirely outside of government. An important governmental move was the increase in taxation. Taxes modify the public's use of its money in two ways: first, they take away from the public money which might otherwise be spent in competition with the government for needed items, and second,

they furnish the government with funds to purchase the things that the community needs. In short, taxation is a curb on the spending of current income and an anti-inflationary tool of great importance.

To stop, or at least reduce, the spending of savings, it was necessary to do two things: first, to create a belief on the part of the public that there was going to be no scarcity of goods, and second, to create public confidence in the soundness of the dollar. The first of these objectives was, of course, accomplished by the tremendous increase in plant capacity. The second--the creation of confidence in the dollar--was accomplished by a wide variety of moves. Wage and price controls, allocation of scarce materials, and courageous moves by the Federal Reserve Board all tended to stop the price increase and to improve confidence in the dollar.

Lastly, it was necessary to restrain borrowing. Here the Federal Reserve authorities were at home in their own field. Congress gave them emergency powers over consumer credit, and jointly with the Federal Housing Administrator over real estate credit. In the same act, Congress provided for the set-up of a voluntary credit restraint program, and that program was also given to the Federal Reserve Board to supervise. The consumer credit controls were immediately effective in stopping the growth of consumer credit. The real estate credit controls were not effective for several months, owing to the backlog of housing starts which had rushed in ahead of the effective date of the regulation. Later, these controls had some effect, and members of this audience probably know better than I to what extent. The voluntary credit restraint program provided a powerful tool of public education and set up new yardsticks as to priorities in a broad range of credit, running the gamut from business loans to municipal bonds.

At the same time that Congress was raising taxes and these emergency controls were being established, Federal Reserve authorities began to move to tighten credit, and to make its expansion less automatic, by those indirect means which are traditional in central banking. The Federal Reserve actions were far from drastic, really little more than a frown on certain practices or a nudge in the right direction. The rate of discount at which member banks may borrow at their Federal Reserve bank was raised in August 1950. The increase was only a quarter of one percent, but the fact of its occurring served notice that the Federal Reserve System was concerned about inflation and was going to use its powers. In January 1951 reserve requirements of member banks were raised to the maximum legal limit, with the exception of two percentage points for demand deposits at New York and Chicago banks.

Then, in March 1951 the peg was removed which had kept government securities at par or above. This peg was a wartime device. The Federal Open Market Committee purchased all offerings of government securities that were large enough to threaten price declines. The effect of this pegging operation was to afford a ready market for government securities held by lenders who might wish to use their funds for other types of loans. It had the further effect of adding reserves to member bank accounts, thus enabling them to expand their loans and investments by five or six times the amount of the new reserves. When this peg was removed, government bond prices settled down to a few points below par. Holders became reluctant to sell them, and as a result loanable funds dried up. The expansion of bank credit began to behave according to the seasonal pattern. Many lenders were forced to wait for the accumulation of savings funds with which to make advances. Fortunately, as I shall outline, the public began to save at a phenomenal rate, and it was not long before the insurance companies, savings banks, and savings and loan

associations were again in the market for mortgages and bond issues.

Not all of these moves were accepted by the public with equanimity. Manufacturers who had produced television sets in excess of any reasonable demand were importunate in calling for easier retail credit terms. Builders protested that they were ruined. Pressure groups of all sorts converged on Washington. Of more importance was the feeling on the part of the average man that big government was regimenting him. Here is part of a letter which we received after Chairman McCabe of the Federal Reserve Board had sent a letter to all banks in the United States in November 1950, asking them to screen their loans for essentiality:

"We have never needed any assistance in controlling credit. * * * * After 50-odd years of banking, crap shooting, poker playing, trading jackasses, turkey hunting, etc., if I discover I need help in operating my little briar patch business, I will know it is time to fold up, join the Baptist Church and go to hell on my own ticket."

I assure you that the Federal Reserve Board was fully conscious of this sentiment and was anxious to relax the controls as soon as the economy could stand on its own feet.

Just about this time the public took over the control of inflation. I can almost fix the week when it first became evident that something of this sort had taken place. Prices stopped rising in the last week of March 1951. Looking back on the period since then, three important developments seem to have been responsible.

First, plant capacity has increased to a level where we can support the demands of national defense and also supply most civilian demands. I wonder if it is fully recognized how much our industrial plant has grown since the war. Here are some rough figures: we have poured into investment in plant and machinery about \$100 billion since the war, most of it in the last two years;

the capacity for producing machinery and chemicals has doubled; electric generating capacity has increased 75%; petroleum output is up 50%, and steel ingot capacity will soon be 30% higher than seven years ago.

2. Business firms have acquired a level of inventories which seems satisfactory to them. Retail inventories increased until the middle of 1951 and have since declined sharply. Manufacturing inventories grew for a somewhat longer period, but the growth has leveled out in 1952. When firms stop buying for inventory accumulation, it amounts to a decrease in the demand for raw materials and finished goods.

3. The public suddenly began to save. Their withdrawals from savings accounts stopped and increases began. No one knows quite why this occurred. Perhaps the public had bought so much merchandise in the feverish months before that their wants were satisfied. I prefer to think that the public began to realize that we could control prices and that there would be plenty of goods available. At any rate, the accumulation of savings had been tremendous. In 1951, funds in the hands of insurance companies increased by \$9 billion - \$5 billion for private companies and \$4 billion in the government's insurance operations. Savings deposits grew \$2 billion, savings and loan funds increased by a like amount, and it is estimated that pension funds also increased by \$2 billion.

The flow of income into savings is not quite as great in 1952 as in 1951, but it is still impressive. This flow has done two things. First, properly channeled by the insurance companies and others, it has financed plant expansion without the resort to bank credit. Second, it has reduced purchases of consumer goods and thus provided the public's solution to inflation.

I cannot emphasize too much the importance of savings in the control of inflation. I have already referred to the role that it played in 1951-52 in turning the price level downward. To the extent that the public restrains itself, government regulation and monetary controls become unnecessary. Thus an informed public can do the things which make regulation unnecessary.

It is right at this point that bankers have a very important job to do. They are the ones who must mold the public's thought with regard to their savings and investment policies. Advertising and other forms of public relations can be directed by banks to encourage the savings habit and to explain why savings are important.

Savings take many forms and I should like to discuss a few with you. One of the most common forms of savings in the last twenty years-- and I should add a very troublesome one based on its performance--is savings in the form of idle demand deposits. Since demand deposits do not bear interest, it can only be assumed that the deposit is kept in the firm's or individual's checking account, awaiting some rather immediate expenditure. I recall deposits of this sort in the agricultural banks throughout the northwest, especially in the range, wheat, and potato areas. Farmers accumulated rather fabulous demand deposits, and it was a matter of some concern as to how long those deposits would remain unspent. These demand deposits, or temporary savings, influenced bank policies as to cash resources and investment maturities. While I have not had an opportunity to talk with these bankers about those unnatural demand deposits since my return to the northwest, I assume that a large part of the deposits was spent in the 1950-51 buying spree.

How much better it would be if deposits of that sort were placed in the time deposit category or invested in government bonds. The fact that the funds were earning a return would make their owner much less anxious to spend

money. Furthermore, the campaign by bankers to encourage savings would be a healthy contribution to anti-inflation education.

Perhaps some bankers will not welcome expansion in their interest-bearing deposits. To these bankers I would make the recommendation that they encourage purchases of government savings bonds. In fact, it is my judgment that all bankers should get behind the savings bond program as a matter of public service. The government needs the money, and the act of buying savings bonds reduces the danger of the funds being spent for consumer goods.

I have heard that some bankers are reluctant to sell savings bonds because of the resulting reduction in their deposits. I cannot believe that this is true. The story is always that someone else believes that, and not the man that I am talking to. As a matter of fact, I do not believe that over the long run bankers will suffer a net loss in deposits if they sell savings bonds. The money supply in a growing economy must increase with the needs of business. Normally every bank shares in this gradual growth of deposits. If there is no danger of shrinking deposits from the sale of savings bonds, then the advantages to the government and to the individual and the anti-inflation influence of savings bond purchases should make the bankers of the country enthusiastic salesmen.

Now where do we stand today in the operation of monetary policy? The voluntary credit restraint program and consumer credit control were discontinued by the Federal Reserve Board and Congress has since abolished them. Real estate credit regulation was first eased and then completely lifted. The government security market is orderly, but not pegged. The Treasury has conducted huge financing operations, both for new money and for refunding, and the Federal Reserve has contributed support to these financing operations. In the case of refundings, there are always some holders of maturing securities

who do not wish to accept the new securities offered. The Federal Reserve has stepped in and absorbed this attrition and later has reduced its portfolio to a point where no new reserves were added to the banking system. Excess reserves of member banks have been held at a level which seems to fluctuate around \$500 million. Member bank borrowings are around the billion dollar mark, and this is today the principal restraint against unwise credit expansion.

In the words of Dr. Riefler, Secretary of the Federal Open Market Committee: "Member banks have shown themselves quite responsive to changes in the magnitude of their borrowing; they have tended to be conservative with respect to new commitments when their borrowing at the Reserve banks was high, and interest rates in the money markets have reflected this conservatism. In operating terms, experience so far indicates that the Reserve banks can again look to the volume of member bank discounting as a guide in judging the timing and size of open market operations. It means also that discount and open market operations can be regarded as interrelated and integrated instruments of credit policy."

In summary, as I look back on the history of the past two years, I can sum the experience up as a rebirth of confidence. The Federal Reserve Board has new confidence in the tools of its trade. Again quoting Dr. Riefler: "The emergence of a Federal deficit, even of a deficit that is financed in the first instance by securities which appeal to banks, does not necessarily mean that there will be an expansion of the money supply in excess of the needs of the community for cash balances."

Foreign central banks have gained a new sense of leadership from the actions of the monetary authorities in this country. I have this first-hand from presidents of central banks who called at the Federal Reserve Board office

in Washington, and also from the writings of financial journals in the larger countries of Europe. Finally, the impressive savings totals point to the fact that the public has regained its confidence in the value of the dollar.