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Statement by William McChesney Martin, Jr.,
Chairman of the Board of Governors
of the Federal Reserve System
before the
House Banking and Currency Committee

May 10, 1951

Mr. Chairman and Members of this Committee -

I appreciate this opportunity to present to you the views of the Board of Governors of the Federal Reserve System with respect to the responsibilities placed upon or delegated to the Federal Reserve System under the Defense Production Act of 1950. The Board is strongly of the opinion that these provisions of the Act should be continued.

As has been repeatedly emphasized before this and other committees of the Congress primary reliance must be placed on fiscal, credit, and monetary measures in combating inflationary forces inevitably generated by the expanding defense effort. It is hardly necessary to emphasize that the forces creating upward pressures on prices are likely to continue dominant in the economy even though these pressures may appear temporarily to have been moderated. Nor is it necessary to recount again the many circumstances and factors which have combined to produce grave inflationary dangers, or the preventive and precautionary steps already taken to safeguard the economy. On behalf of the Board I therefore shall address myself particularly to those provisions of the Act with which we have been directly concerned. These provisions deal with certain supplementary rather than primary credit restrictions as well as with the so-called V-loan program to aid the defense effort.

It is important to emphasize that the marked advances in prices and the exceptionally large increase in bank and other credit that have taken place up to the present time reflect mainly expansion in private expenditures. The full effects of expansion of defense activities are still to be felt. While expenditures for defense purposes have doubled since last summer as yet they account for only about ten per cent of total output. Moreover, they have thus far been met out of growing Government revenues and no new Federal borrowing has been needed. However, Federal expenditures for defense and related activities are scheduled to rise sharply and may account for as much as 20 per cent of total output within a year. This is the overriding consideration for national stabilization policy. If inflationary trends are to be held in check, public policy will need to limit private spending, especially such spending as is financed by borrowing or by the use of past savings. This is a time for saving, not spending.

Role of Credit Restraint

Credit expansion has financed a substantial share of the increased consumer and business spending since June 1950. Without the restraints provided by the Defense Production Act the expansion in credit and upward price pressures undoubtedly would have been even greater. From the end of June 1950 to the end of March outstanding loans and holdings of corporate and municipal securities by all banks increased by over 12 billion dollars. This increase was almost as much as occurred in the two years 1947 and 1948 together and these were both years of rapid credit expansion and inflationary trends. Credit extended by other lenders to businesses, municipalities, and consumers also was in unprecedented volume.

Such credit was supplemented by drawing on liquid asset holdings. Between the end of June 1950 and the end of March of this year, redemptions of savings bonds exceeded cash purchases by over a billion dollars, and savings accounts were reduced by close to three-quarters of a billion dollars.

Reflecting the demand for and use of ready cash, demand deposits of businesses and individuals increased by over 7 billion dollars in the last half of 1950 and showed only a moderate seasonal decline in the first quarter of 1951. The turnover or rate of use of these deposit balances rose sharply.

It has become increasingly evident during recent weeks that this acceleration of inflationary tendencies has been checked, temporarily at least. The prospects for getting inflation under control are now better than at any time since Korea. To succeed, however, will require full and continued use of all of the credit measures now up for renewal in the Defense Production Act. It would be extremely unfortunate if any of the means we have been using to stem the inflationary tide should be allowed to lapse at this critical moment when they are achieving a considerable measure of success.

There are tangible evidences that the availability of bank reserves has been reduced, that banks have become more restrictive in their lending policies, and that the over-all expansion of bank credit has definitely slackened despite acceleration of lending to finance defense production. Further evidences of the effects of the various measures of monetary and credit restraint may be seen in the markets for consumer credit, mortgages, and new capital issues. Consumer instalment credit has ceased to grow. New commitments by insurance companies and savings banks to purchase mortgages have been reduced. Plans for issuance of some new securities have been withdrawn or postponed and others have had to be revised, although the total volume of new issues has continued very large.

The record of the past year has clearly demonstrated that selective measures of credit restraint are an effective and necessary supplement to general credit measures and at the same time are an important line of defense for the Government securities market.

Continuing Authority to Regulate Consumer Credit

Regulation of consumer credit, reinstated last fall under authority of the Defense Production Act, has played an important part and as defense spending continues to expand should play an even more important part in the program to control inflationary forces. While consumer credit regulation alone cannot solve the problem of inflation, nevertheless, Regulation W, by establishing minimum downpayment requirements and maximum periods for repayment of consumer instalment debt, has effectively limited the expansion of consumer purchasing power in the form of credit dollars and is an essential part of any continuing comprehensive anti-inflationary program.

The terms initially established in September 1950, after extensive consultation with trade groups, were only slightly more restrictive than the average terms prevailing in consumer markets in the period just preceding the regulation. In announcing them the Board indicated that further tightening might be in order as the magnitude of the defense program and resulting inflationary pressures become more evident. Some weeks later, after careful consideration of current and prospective developments not only in the consumer durable goods field but in the economy as a whole, the Board announced, effective October 16, a more restrictive set of terms which has remained in effect since that time.

The regulation now provides that in buying an automobile on instalment a buyer must pay one-third down and repay the balance of his contract in not more than 15 months; for other durables such as washing machines and television sets, the minimum downpayment requirement is 25 per cent, and the maximum term allowed is also 15 months. More liberal terms are permitted for furniture and home repairs and improvements.

The present provisions of Regulation W are more lenient in some respects than those in effect during most of World War II. The regulation is also substantially less restrictive than the terms of similar regulations now in force in Canada, where the regulation of consumer credit is also included in the arsenal of anti-inflation weapons.

Under the present terms of Regulation W, the highly inflationary expansion of outstanding instalment credit has been stopped. In the six-month period October 1950 through March 1951, instalment credit outstanding declined by 364 million dollars. This decline contrasts sharply with the increase of 2.3 billion dollars in the preceding six months, and with the rise of 1.2 billion dollars in the period October 1949 to March 1950.

Recently there has been some reduction in demand for consumer durable goods from the exceptionally large volume of December and January, although sales of most continue close to the high levels reached a year ago. Conditions in these markets are being watched closely and frequent consultations are being held with representatives of the industries and trades which have been affected. Even though inflationary pressures may temporarily be checked, a highly volatile demand situation is to be expected as long as the defense program and international developments play such a dominant role in the economy. Let me assure you that the Board is prepared either to tighten or to relax credit terms whenever such action would be consistent with the objectives of the Defense Production Act.

Regulation of Real Estate Credit

In the field of real estate credit, several important steps have been taken to check inflationary developments and conserve materials and other resources. Last July, prior to the passage of the Defense Production Act, the Federal Housing Administration and the Veterans Administration tightened the terms under which they would insure or guarantee mortgage loans, both on new and on existing properties. Since the passage of that Act, further action has been taken to regulate real estate construction credit. The first step was the issuance, effective October 12, of Regulation X by the Board and companion regulations by FHA and VA covering credit extended in connection with purchases of 1- to 2-family houses. The next was amendment of these regulations as of January 12, 1951, to cover new multi-family units. Finally, another amendment to Regulation X, effective February 15, covered loans in connection with certain nonresidential construction. At every stage in developing the regulations valuable advice and assistance has been sought and obtained from lenders, builders, and other private groups, as well as from public officials.

Under the terms of Regulation X and companion FHA regulations, mortgage loans on houses are limited to various percentages from 90 per cent for houses valued at 5,000 dollars or less to 50 per cent for houses valued at over 24,250 dollars. With respect to loans guaranteed by the Veterans Administration, loan ratios 5 to 10 percentage points higher were authorized by the Housing Administrator to preserve the relative credit preference granted to veterans. At the time of their announcement the terms were widely regarded as being strict and likely to lead to sharp curtailment in the volume of residential building.

The effectiveness of the regulation was considerably limited at the outset by the large volume of building then under way and by the large volume of financing commitments outstanding. Thus, while construction activity and extensions of mortgage credit have continued at very high levels, the restrictions imposed have been important in helping to reduce the number of new units being started. During the winter months housing starts were equal to those a year earlier but were down more than seasonally from the extraordinary high level of last spring and summer. In March and April starts appear to have been about one-fifth below a year ago.

It now appears likely that under present regulations the effective demand for new houses will be less than in 1950 when a record total of 1,400,000 units were started. At the same time, with about 360,000 or 370,000 units started in the first four months of 1951, the total for the year will probably exceed the 800,000 to 850,000 units set as a target last October when the terms were first announced. Prospects for a smaller volume of construction this year together with recent high levels of production of most building materials have resulted in a leveling off of building material prices since the first of the year. Even so, these prices average about 20 per cent higher than in the spring of 1950 and shortages of some metal items are rather widely reported.

To make restrictions of mortgage credit adequately effective, the authority over such credit needs to be extended to cover loans made on existing properties. Since passage of the Defense Production Act prices of old as well as new houses have increased significantly, thereby raising the loan values of old properties and adding to the potential volume of credit based on this type of asset. Price increases for old properties in turn tend to support increases in prices of, and the amount of credit extended on, new houses. Thus, restriction of credit extended on existing properties would help to make the restraint of new construction credit more effective as well as to limit inflationary mortgage credit expansion generally.

The amount of mortgage credit extended on old houses during 1950 was the largest on record, almost 9 billion dollars or about three-fifths of all the credit extended on all 1- to 4-family properties. In the first quarter of 1951 lending on old houses was maintained at a very high rate and continued to account for a large share of the total volume of mortgage credit extension.

The President as well as the Council of Economic Advisers and the Joint Committee on the Economic Report have recommended that authority be granted to control credit on purchases of existing houses. The Board joins in this recommendation and urges that the authority be granted in the form provided in the bill presently under consideration.

Total mortgage debt outstanding on 1- to 4-family houses, new and old combined, is 2-1/4 times what it was at the end of World War II. Continuation of such rapid expansion of mortgage debt would not only threaten the stability of real estate markets but also have a serious inflationary impact on the whole economy.

Voluntary Credit Restraint Program

The recently inaugurated Voluntary Credit Restraint Program, to which I referred earlier, is designed to encourage financing institutions to conduct their credit operations in such a way as to contribute to meeting defense and other essential needs and at the same time to help limit the use of credit for other purposes. This program has been established as a result of the President's delegation to the Board of the authority contained in the Defense Production Act to encourage the making of voluntary agreements in the field of financing. It has been developed after consultation with and approval by the Attorney General and also after consultation with the Federal Trade Commission.

The Program is entirely voluntary on the part of participating financing institutions and its success is wholly dependent on the cooperation of such institutions. The Board and the Reserve Banks participate in it to the extent required under the terms of the program in order to be of assistance to the voluntary committees appointed under the Program. Governor Powell has been designated by the Board to be Chairman of the National Voluntary Credit Restraint Committee. This Committee originally consisted of four representatives each of banks, insurance companies, and investment banking houses chosen after consultation with the lending associations in these areas. More recently, two representatives each of mutual savings banks and savings and loan associations have been added to the Committee.

The National Voluntary Credit Restraint Committee has established initially 12 subcommittees for banks, one located in each Federal Reserve District, and 4 regional subcommittees each for insurance companies and investment banking houses. These subcommittees are available for consultation with individual financing institutions to assist them in determining the application of the Program to specific loans for which application has been made to financing institutions. Of course, the final decision with respect to making or refusing to make any particular loan or loans is wholly within the discretion of each financing institution, whether or not it has consulted with any of the subcommittees.

Members chosen to serve on the national committee as well as on the various subcommittees have been very carefully selected to provide broad participation by the financial community. I will submit for the record a list of the membership of the national and regional committees. You will agree, I'm sure, that this is an impressive roster of financial leaders.

The national committee has issued three bulletins, the first dealing with means of restraining inventory financing, the second with the principles to be followed in financing capital expansion programs and the third with State and local government financing. These bulletins, together with the Statement of Principles of the Program, have been distributed to all financing institutions participating in the Program to provide a common guide for combatting inflationary loan expansion in their respective fields. Other bulletins as may be appropriate and helpful will be issued from time to time.

While there has not yet been time to build up a body of statistical information to enable the Committee to analyze thoroughly the effects of the Program, there are indications that the initiation of the Program has had a salutary effect on the trend of credit. Expansion of bank credit, which was very sharp during the last half of 1950, has shown some signs of abating in recent weeks.

Endorsements of the Program and pledges of wholehearted cooperation have been received from many representative industry groups. In the circumstances, those connected with the Program are most encouraged, and it is the Board's view that the authorization for this unique cooperative effort as one means of restraining the further expansion of private credit should be continued.

V-Loan Program

Section 301 of the Defense Production Act provides the authority for the current guaranteed loan program under which loans made by private financing institutions to defense contractors are guaranteed by defense procurement agencies. Essentially this program is a revival of the so-called V-loan program which was successful in helping to finance war production during World War II.

Under the present program, there are eight guaranteeing agencies: the Departments of the Army, Navy, Air Force, Commerce, Interior, and Agriculture, the General Services Administration, and the Atomic Energy Commission. The twelve Federal Reserve Banks act as fiscal agents of the United States on behalf of these guaranteeing agencies. The Board, after consultation with the guaranteeing agencies, has prescribed regulations governing the guarantee operations of the Reserve Banks and rates, fees, forms, and procedures to be utilized in connection with such guarantees.

One of the special virtues of the V-loan program is the fact that the procedure for obtaining a guaranteed loan is relatively simple. Briefly, any defense contractor who requires financing in order to carry out his contracts first gets in touch with his local bank or financing institution. The financing institution, after working out the terms of the proposed loan, files an application for a guarantee with the Federal Reserve Bank of its district. The Reserve Bank makes any necessary credit investigation and submits the loan to the appropriate agency for approval. If the guaranteeing agency approves the application, it authorizes the Reserve Bank as its agent to execute the guarantee agreement.

A maximum interest rate of 5 per cent and a schedule of guarantee fees have been established by the Board after consultation with the guaranteeing agencies. The higher the percentage of guarantee requested by the financing institution, the higher the guarantee fee which it is required to pay. This encourages financing institutions to assume as much of the risk as possible and reduces the Government's contingent liability.

Up to April 30, 503 applications for guarantees totaling about 565 million dollars had been received; 327 applications were approved for about 422 million dollars, 105 applications for about 123 million dollars are under consideration, 57 applications aggregating about 11 million dollars were declined, and the remaining few applications were withdrawn. At present, applications are being received at a rate of slightly more than 100 a month.

Because of rulings of the Comptroller General, financing institutions have been reluctant to take assignments of Government contracts as security for defense loans. However, this situation will be remedied by a clarifying amendment to the Assignment of Claims Act recently approved by the Senate and the House of Representatives. With this impediment to lending on defense contracts removed, and with the anticipated acceleration in the defense production program, there is every reason to expect that the volume of applications for guaranteed loans under the V-loan program will increase greatly.

The basic purpose of the V-loan program is to utilize the private banking system so far as possible in financing necessary defense production. V-loan guarantees are especially useful to smaller contractors who may not be otherwise able to obtain necessary financing for defense contracts.

Continuing Need for Restraints on Inflation

Defense production is in the early stages and demand for civilian goods remains at high levels. Present schedules call for doubling defense outlays as a percentage of national output within a year. In addition, private outlays for new plant and equipment are expected to increase substantially, adding to inflationary tendencies. Although recently inflationary pressures appear to have moderated, the fundamental situation in this country and abroad is still strongly inflationary.

Estimates of possible increases both in total output and in output of particular products indicate that the defense and other essential goals cannot be realized unless civilian production and demand for important types of goods are curtailed. Present and prospective shortages of steel, copper, and other metals require restraint on competing civilian uses of metals, such as automobiles, appliances, houses, and commercial construction. Unless both public and private expenditures for nondefense purposes are limited, the only alternative is a further advance in prices. It is of paramount importance, therefore, that the anti-inflation programs now in operation be continued and strengthened.

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