

FEDERAL RESERVE BANK
OF NEW YORK

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[December 20, 1951]

*To all Financing Institutions in the
Second Federal Reserve District:*

Enclosed is a reprint of the leading article in the *Federal Reserve Bulletin* for November 1951, entitled "Voluntary Action to Help Curb Inflation." It describes the events leading to the establishment of the Voluntary Credit Restraint Program, reviews the principles of the Program, and evaluates its effects. We believe that this information will be of special interest to you and will be useful in explaining the principles of the Program to your customers.

Additional copies of the reprint will be furnished upon request.

ALLAN SPROUL,
President.

VOLUNTARY ACTION TO HELP CURB INFLATION

Since the start of the Korean war, several new measures have been introduced and existing measures used more intensively for the purpose of curbing inflationary pressures which result in part from excessive credit expansion. One of the new measures, the Voluntary Credit Restraint Program, provides on a nationwide basis a means whereby all major groups of lending institutions can participate in an over-all effort to help check inflation. The cooperative efforts of participants in this Program to curtail the use of credit for speculative purposes and to divert funds from nonessential to essential uses have been very helpful in limiting over-all credit expansion while at the same time assuring adequate funds for the defense effort. The Voluntary Credit Restraint Program was established as a supplement to, rather than as a substitute for, general credit restraint measures. It is very difficult to appraise the over-all credit needs of the economy or to say whether the granting of a particular loan may have undesirable inflationary repercussions. By screening requests for short- and long-term financing on the basis of broad criteria for essential and non-essential uses, however, lending institutions can help to restrain over-all credit expansion and assure that available funds are employed for essential purposes.

The effectiveness of any measure of public policy depends to a great extent on a full understanding of its limitations as well as its capabilities. To expect the Voluntary Credit Restraint Program to do more than it is capable of doing would be as damaging to its success as would its own failure to employ fully the means at its disposal. Since the Program is dependent on the support which it gets from lending officers, public

officials, businessmen, and the general public, a brief statement of its objectives and methods of operation may be useful.

NEED FOR CREDIT RESTRAINT

It became apparent soon after the outbreak of war in Korea that comprehensive measures would have to be adopted for the purpose of restraining inflation. Speculative and scare buying by individuals and businesses in anticipation of defense needs and possible wartime shortages brought about a rapid advance in prices during the summer of 1950. Much of this buying was financed, from either choice or necessity, with borrowed funds, and the resulting expansion of the money supply helped to sustain and multiply inflationary pressures.

The Defense Production Act of 1950, which became effective September 8, authorized the establishment of selective regulations to restrain consumer instalment credit and some forms of real estate mortgage credit. While consumer instalment credit regulation had an almost immediate effect in that area, the impact of the real estate mortgage credit regulation was considerably delayed, largely because of loan commitments made prior to the effective date of regulation.

The Act did not, however, authorize, except on a voluntary basis, the regulation of such other important credit areas as business and State and local government borrowing or conventional mortgage lending on existing properties. During the last half of 1950, credit in these areas continued to expand in response to demand. Business borrowing from commercial banks rose 5 billion dollars, as shown in the table, while both State and local government and corporate new

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VOLUNTARY ACTION TO HELP CURB INFLATION

long-term financing remained at fairly high levels.

INCREASES IN SELECTED TYPES OF CREDIT, 1950-51

[In billions of dollars]

Period	Consumer loans	Real estate mortgage loans	Business loans of commercial banks	Security issues	
				Corporate new capital	State and local government
1950—1st Q. . .	-0.5	1.8	0.0	1.1	1.2
2nd Q. . .	1.3	2.9	-0.1	1.6	0.9
3rd Q. . .	1.7	3.0	2.5	0.9	0.8
4th Q. . .	0.8	3.1	2.5	1.3	0.7
1951—1st Q. . .	-0.7	2.5	1.8	1.6	0.6
2nd Q. . .	-0.1	2.9	-0.1	2.2	1.0
3rd Q. . .	0.1	2.3	1.0	1.4	0.8

Source.—Federal Reserve Board, Home Loan Bank Board, Department of Commerce, Securities and Exchange Commission, and Bond Buyer.

NOTE.—Data on consumer and real estate mortgage credit and commercial bank business loans represent net changes in outstanding amounts; those on corporate new capital and State and local government security issues are gross amounts of new issues with no account taken of retirements or redemptions.

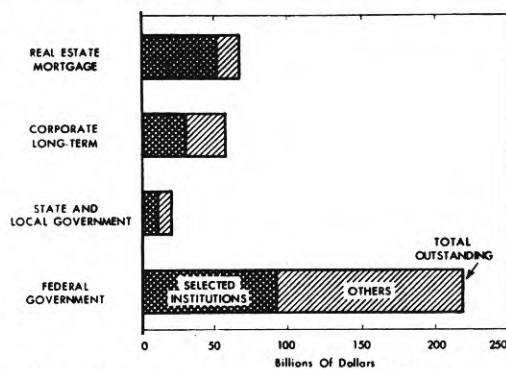
It was expected that materials allocations and shortages, building restrictions, and selective restraint of real estate mortgage credit would in time necessitate some overall curtailment of investment expenditures, including business inventory accumulation and plant and equipment expenditures, State and local government capital expenditures, and residential construction. Nevertheless, the outlook for 1951 was for a substantial volume of investment, some essential to the defense effort but some nonessential and deferrable. A total volume of investment as large as that anticipated for 1951 was bound to intensify inflationary pressures, especially if financed through borrowing which resulted in additions to the money supply, and even to some extent if financed from past or current savings. The problem, therefore, was one of diverting labor and materials from nonessential uses to defense production and the expansion of basic industrial capacity, employing whatever measures were available and could be used effectively to accomplish this diversion.

Since a substantial part of the investment contemplated by individuals, businesses, and State and local governments would be financed with funds obtained from banks, insurance companies, and other financing institutions, the restriction of such financ-

ing could aid in the diversion of labor and materials to essential projects. The Defense Production Act of 1950, in Section 708, authorized financing institutions to enter into voluntary agreements and programs to restrain credit in such manner as would further the objectives of the Act. Voluntary restraint of this type would require the active cooperation of suppliers of short-term working capital as well as long-term investment funds.

Institutional investors, including life and property insurance companies, commercial and mutual savings banks, and savings and loan associations, are at present the principal sources of long-term investment funds, while commercial banks have long been major sources of short-term business credit. During the postwar period 1946-50, additions to the investment portfolios of these institutions accounted for 88 per cent of the increase in real estate mortgage debt, and for 77 per cent of the increase in long-term corporate and State and local government debt.

INSTITUTIONAL HOLDINGS OF DEBT, DECEMBER 1950



NOTE.—Figures on total outstanding debt: Department of Commerce estimates. Figures on institutional holdings: life insurance companies—Institute of Life Insurance; property insurance companies—*The Spectator Insurance Year Book*; mutual savings banks—National Association of Mutual Savings Banks; commercial banks—Federal Reserve System; savings and loan associations—Home Loan Bank Board.

Total long-term corporate debt, defined as debt having an original maturity of one year or more from date of issue, excludes intercorporate borrowing. Federal and State and local government debt includes both short- and long-term but excludes portion held by agencies and trust and sinking funds.

At the end of 1950, as shown in the chart, they held three-fourths of all real estate mortgage debt, over half of all State and local and long-term corporate debt, and over two-fifths of Federal debt outstanding.

If the investment and lending activities of

these financing organizations could be directed, through a program of voluntary credit restraint, toward the restriction of speculative uses of credit and the diversion of funds from nonessential to essential purposes, there was a real possibility that such action would help to check inflationary pressures and facilitate the diversion of labor and materials to essential uses.

In accordance with the provisions of the Defense Production Act of 1950 and related executive order, and upon invitation of the Board of Governors of the Federal Reserve System, representatives of commercial banks, life insurance companies, and investment bankers undertook to set up such a program. Following a series of conferences that began in the fall of 1950 there emerged, on March 9, 1951, a program of voluntary credit restraint. With the approval of the Attorney General, a letter was sent by the Board to all private financing institutions in the United States, requesting their cooperation in accomplishing the objectives of the Program.

Adequate safeguards were established by the Defense Production Act to assure that there would be no infringement of anti-trust statutes. A representative of the Federal Reserve System is present to represent the public interest in practically all regional or national meetings of those taking part in the Voluntary Credit Restraint Program. Moreover, the Program by its very nature excludes one of the primary incentives to collusive action by calling for the limitation of lending activity and hence of lenders' profits.

In contrast to general measures which influence the over-all supply of credit, and selective restraints which influence the demand for specific types of credit through regulation of loan terms and conditions, the Voluntary Credit Restraint Program seeks to direct the flow of credit away from non-essential and speculative uses by the voluntary action of lenders in approving or disapproving applications for funds. To do this it has been necessary to have certain criteria that would be of aid in assessing

objectively the merits of individual loan applications and proposed bond and stock offerings in relation to over-all economic conditions and requirements.

Responsibility for formulating and applying such lending criteria rests with the institutions participating in the Program. For their guidance the Board of Governors has drawn leaders from the private lending field together in a National Voluntary Credit Restraint Committee. The functions of the National Committee include the formulation of appropriate general lending standards that may be applied throughout the country and the coordination of the work of numerous regional committees. The regional committees, whose members are appointed by the National Committee, assist the thousands of participating financing institutions in applying these standards. While neither the National Committee nor the regional committees have any authority to direct the policies of the cooperating financing institutions, they can and do exert considerable influence on the thinking and decisions of lending officers and upon prospective borrowers who know of the Program and are in sympathy with its principles and objectives.

The original conference group, in preparing the Statement of Principles, and the National Committee, in drafting the Bulletins which explain the application of these principles to specific credit areas, were fully aware of the difficulties that would be involved in formulating and applying comprehensive and precise rules and regulations to accomplish the purposes of the Program. Moreover, it was felt that detailed rules and regulations would not be compatible with the voluntary character of the Program, and might well discourage many institutions from even attempting to participate.

It was deemed better to phrase the standards in fairly broad terms, to try to express a point of view rather than a host of detailed and specific criteria for lending practices, and to rely upon the willingness of lending institutions to conform to the spirit

VOLUNTARY ACTION TO HELP CURB INFLATION

of the Program. Hence, lending standards set forth initially in the Program's Statement of Principles were very general in character, attempting primarily to distinguish between financing which contributed to the production and distribution of essential goods and services and financing which served merely to effect a transfer of ownership of existing securities or physical assets or to permit speculative purchases of securities and commodities.

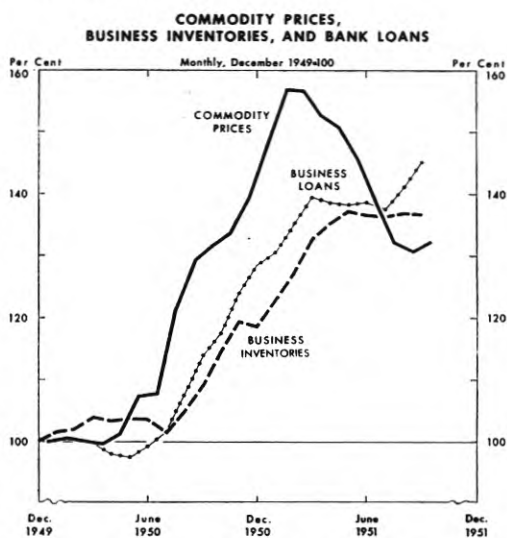
AREAS OF RESTRAINT

As the Program developed, more specific lending standards were formulated to guide restraint in particular credit areas. In general, the areas selected by the Committee have been those in which actual or anticipated expansion of credit was substantial, statutory selective credit restraints were not applicable, and for which the financial institutions participating in the Program were a major source of credit. Between March and September 1951, the National Committee issued six Bulletins, setting forth general principles to guide participants in meeting demands for inventory loans, business capital expenditure financing, State and local government borrowing, certain types of real estate credit, borrowing by foreigners, and borrowing on unlisted securities. Of these, the first four are of most widespread interest, and are discussed in some detail in the following sections.

INVENTORY LOANS

In the months following the outbreak of war in Korea, business inventories expanded sharply. Between June and December 1950, total book value of manufacturing and trade inventories rose nearly 8 billion dollars. Much of the increase was in raw materials, and a good part of it was financed with bank credit. For example, purchased materials in the hands of manufacturers increased nearly 3.5 billion dollars, or 30 per cent, in the last six months of 1950, and manufacturers' inventories of goods in process and wholesalers' inventories each rose about 18 per cent.

During this same period, as shown in the chart, business loans of commercial banks increased about 5 billion dollars. A major part of this increase appears to have represented loans for purchasing or carrying inventories. A special survey of business loans made by the larger weekly reporting member banks between June 28 and November 1 revealed that 60 per cent of the net funds advanced was estimated to be inventory loans, of which more than 80 per cent was advanced to dealers and processors of agricultural commodities.



NOTE.—Prices, Bureau of Labor Statistics index for 28 basic commodities, last week in month. Business loans include commercial and industrial loans of all insured commercial banks at end of month; June and December figures from call reports of Federal Deposit Insurance Corporation, other months estimated by Federal Reserve from weekly reporting member bank data. Inventories, U. S. Department of Commerce data on total manufacturing and trade inventories at end of month; book value, unadjusted for seasonal variation.

While these groups customarily borrow rather heavily from banks in the last half of the year, such borrowing and the inventory accumulation that it permitted were substantially larger in 1950 than was required for the orderly movement of agricultural crops. That speculation was an important element in this period is indicated by the sharp price increases which occurred. The average of 28 basic commodity prices advanced 50 per cent between end-of-June 1950 and mid-January 1951. Inventories continued to rise sharply through the early months of

VOLUNTARY ACTION TO HELP CURB INFLATION

1951 and were at extraordinarily high levels in mid-March when the National Committee held its initial meeting and selected this area as the subject of its first Bulletin.

The Committee pointed out that excessive inventory accumulation had contributed directly to a rise in wholesale and retail prices to levels beyond those justified by the supply situation and that an important part of the abnormal inventory increase was being financed with borrowed money. The Committee expressed the hope that all participating financing institutions would refrain from financing inventory increases above normal levels relative to sales, or reasonable requirements as determined by other available yardsticks, and also that all participants would encourage borrowers who already had excess inventories to bring them in line as promptly as possible in order to reduce the amount of credit outstanding.

PLANT AND EQUIPMENT FINANCING

Prospects of good business for some time to come and of materials and equipment shortages that would result from increased defense production, as well as the necessity of expanding productive capacity for such vital materials as steel, aluminum, and petroleum, encouraged businessmen to revise their capital expenditure plans sharply upward in the months following the outbreak of war in Korea.

Early in 1951, according to surveys made by the Department of Commerce and Securities and Exchange Commission, businesses as a group were planning to spend nearly 24 billion dollars during the current year for the enlargement and modernization of their facilities. These earlier expectations, which now appear to have understated the actual 1951 volume of plant and equipment outlays, called for a total expenditure one-fourth larger than the previous peak expenditure of 19.2 billion in 1948. Such major defense or defense-supporting industries as steel, aluminum, petroleum, electric power, and railroads accounted for roughly half of the anticipated capital expenditures. Of the re-

maining half, an important part represented expansion that appeared to be postponable without detriment to the defense effort.

Though many of these business expansion programs would be financed, as in previous postwar years, out of retained earnings, a number would necessitate external financing through bank or insurance company loans or the sale of securities. In 1948, for example, with business expenditures on new plant and equipment totaling 19.2 billion dollars, corporate new capital issues to finance plant and equipment amounted to 4.2 billion; similarly, in 1950, with expenditures of 18.6 billion, new capital issues for this purpose totaled 3.0 billion. While not much more than one-fourth of capital expenditures might be financed in this manner, a projected increase in capital expenditures of 25 per cent for 1951 could be expected to result in a substantial increase in the volume of security issues. Though many of these expenditures were in defense or defense-connected industries, it was recognized that this was an area in which voluntary action could prove useful in obtaining the postponement of nonessential projects and the diversion of the credit they would have required to more essential purposes.

While the Committee feels that capital expenditure programs should be held to a minimum during the present emergency, in the interest of reducing inflationary pressures and facilitating the use of labor and materials where most essential to the defense effort, its recommendations in this area have of necessity been somewhat circumscribed. For one thing, the Statement of Principles excluded from review loans guaranteed or insured, or authorized as to purpose by a Government agency. For another, the Committee has not been in a position to discourage directly outlays to be financed out of accumulated business savings or through previously arranged commitments. Thus, its recommendations have related to new financing for clearly nonessential investment purposes.

To the extent that nonessential capital expenditure programs were to be financed with the proceeds of security flotations, the participating institutions were in a strategic position to exert a restraining influence. In recent years, more than half of the dollar amount of new capital issues has been placed directly with financial institutions, especially life insurance companies, and most publicly offered securities are sold through investment bankers.

On April 20, the Committee issued Bulletin No. 2 citing long-term financing which might be postponed to a more propitious time. This included loans and security issues for such purposes as: (1) construction of facilities to improve the competitive position of an individual producer of nonessential goods; (2) expansion and modernization expenditures of concerns in distribution or service lines where the distribution or service is not defense supporting; and (3) expansion and modernization programs for the manufacture of consumer goods not related to the defense effort.

STATE AND LOCAL GOVERNMENT FINANCING

Credit expansion by State and local governments has been substantial during the postwar period. As discussed on pages 1356-60 of this BULLETIN, relatively large amounts of long-term credit have been obtained by States and localities to finance their postwar construction programs. Many of these programs are still far from completion. Moreover, the tax-exempt status of State and local government securities, which makes them very attractive to certain investors in a period of high progressive income taxes, facilitates the financing of continued large expenditures. In order to curb the potential inflationary pressures inherent in a situation of this type, the National Committee has recommended the deferment of public works not urgently needed for preservation of public health and safety or for purposes directly related to defense.

On May 3, 1951, in Bulletin No. 3, the Committee recommended postponement of such capital outlays as those for recreational facilities, war memorials, and the acquisition of privately owned utilities and of sites and rights-of-way not immediately needed. The Committee also expressed the view that soldiers' bonus issues were inflationary under the conditions then prevailing and should be postponed until such time as immediate purchasing power might be needed to counteract unemployment and when it might be more beneficial to the veteran. In addition, institutional lenders were urged to encourage local governments to balance their operating budgets and to hold to a minimum short-term borrowing in anticipation of revenues.

REAL ESTATE MORTGAGE CREDIT

The role of voluntary action in supplementing and reinforcing selective credit restraint measures is particularly well illustrated by developments in the real estate mortgage credit area. In an effort to curb the rapid expansion of real estate mortgage credit, the Board of Governors of the Federal Reserve System, exercising the authority granted it by the Defense Production Act of 1950 and related executive order, issued with the concurrence of the Administrator of the Housing and Home Finance Agency its Regulation X, effective October 12, 1950. Simultaneously the Federal Housing Administration and Veterans Administration adapted their regulations to the new standards developed by the Board.

The establishment of these regulations, which applied to Government-guaranteed mortgages on new and existing houses, to non-Government-guaranteed, or conventional, mortgage loans on newly constructed houses, and to loans on certain classes of commercial property, brought about a sharp decline in the number of new houses started in 1951. On the other hand, failure to include credit extended on conventional terms for the purchase of existing houses enhanced the competitive advantage of such properties

VOLUNTARY ACTION TO HELP CURB INFLATION

in the real estate market, and in many cases their transfers were accompanied by an expansion of real estate mortgage debt which added to inflationary pressures.

The National Voluntary Credit Restraint Committee, in Bulletin No. 4, issued on June 6 and revised in some respects on September 5, recommended that new conventional mortgage loans on existing one- to four-family residential units, together with other indebtedness outstanding on the property, should not exceed the limit which Regulation X imposes on new construction or a limit of two-thirds of the fair value of the property, whichever is greater. The Committee also recommended that loans on larger residential properties and on commercial, agricultural, and industrial property should in most cases not exceed two-thirds of the fair value and should be made only if careful screening as to purpose indicates that they are in harmony with the Voluntary Credit Restraint Program.

EVALUATION OF THE PROGRAM

The Voluntary Credit Restraint Program has been one of the factors contributing to the abatement of inflationary pressures during the late spring and summer of 1951. Its contribution, however, must be evaluated in the light of other factors.

For one thing, inflationary pressures have been lessened and credit demands have been reduced by a decline in demand for certain types of consumer durable goods, liquidation of some types of inventories, and a marked increase in individuals' current saving. For another, the Program is only one of a number of measures for curtailing the use of credit for speculative purposes and for diverting available funds from nonessential to essential uses.

Since the primary function of the Voluntary Credit Restraint Program is one of directing the flow of available credit rather than of regulating the over-all volume of credit expansion, its effectiveness as an anti-inflationary measure was greatly enhanced

by the Treasury-Federal Reserve accord reached in March 1951. Following the accord, the Federal Reserve System abandoned its policy of purchasing United States Government securities at largely predetermined and inflexible prices—a policy that had enabled holders to dispose of Government securities at will, generally without incurring losses, whenever more attractive loan or investment opportunities presented themselves. This policy had resulted in substantial additions to bank reserves.

The existence of a freer and more flexible market for Government securities has caused many financing institutions to restrict their lending activities and forward financing commitments and this has helped to check over-all credit expansion. Thus, with the Federal Reserve System acting to restrict the growth of total credit, it has been possible for the Voluntary Credit Restraint Program to function with greater effectiveness.

That the Voluntary Credit Restraint Program, together with other selective and general credit restraint measures, has achieved considerable success in diverting credit from speculative and nonessential activities to essential uses is suggested by the postponement of a number of proposed security offerings and by the shift in lending at member banks from nondefense to defense and defense-supporting industries. As shown in the table, the amount of new loans granted to

CHANGES IN COMMERCIAL, INDUSTRIAL, AND AGRICULTURAL LOANS, BY INDUSTRY, MIDYEAR THROUGH OCTOBER

[In millions of dollars]

Business of borrower	1951	1950
Manufacturing and mining:		
Food, liquor, and tobacco.....	+521	+413
Textiles, apparel, and leather.....	-217	+130
Metals and metal products.....	+537	-17
Petroleum, coal, chemicals, and rubber.....	+68	+19
Other manufacturing and mining.....	+75	+17
Trade—wholesale and retail.....	+40	+272
Commodity dealers.....	+394	+690
Sales finance companies.....	-104	+324
Public utilities and transportation.....	+318	+50
Construction.....	-61	+55
All other types of business.....	-6	+113
Loans classified as to business.....	+1,565	+2,065
Loans not so classified.....	-214	+809
Total.....	+1,351	+2,874

NOTE.—Data for 1951 were collected at the request of the National Voluntary Credit Restraint Committee from about 220 weekly reporting member banks. Data for 1950 are from a special survey of selected member banks in leading cities. Although the coverage is less complete for 1950 than for 1951, all of the large banks that cooperated in the 1950 survey are included in 1951.

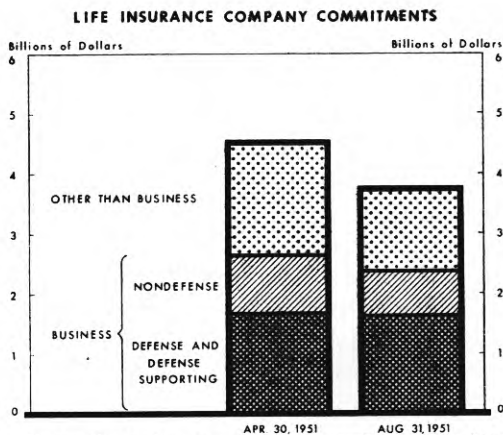
VOLUNTARY ACTION TO HELP CURB INFLATION

manufacturers of metals and metal products and to public utility and transportation concerns was substantially greater from midyear through October 1951 than in the corresponding period of 1950. On the other hand, the amounts granted to wholesale and retail trade concerns, commodity dealers, and sales finance companies were substantially less this year than last, as was the total of all commercial, industrial and agricultural loans.

No over-all figures on the number of loan applications denied or postponed by financing institutions in accordance with the principles of the Program are available. While, as noted in the statement on pages 1362-65 of this BULLETIN, a substantial number of cases have been referred to one or another of the regional committees for recommendations, financing institutions have themselves in the majority of cases taken the initiative in approving or denying financing requests on the basis of recommendations contained in the national Bulletins. In cases where proposed security offerings or loan applications have been referred to regional committees, and where such regional committees have recommended against the proposed security issue or loan, the financing institutions involved have almost without exception strongly supported committee recommendations.

One of the initial deterrents to the Program's success, the existence of legally binding commitments to provide funds that had been made before the Program came into existence, has in recent months become less important. Data collected in connection with the Program show, for example, that 45 life insurance companies, whose combined assets represent 85 per cent of all life insurance company assets, had 4.5 billion dollars of commitments outstanding at the end of April 1951. Of this amount roughly 1.7 billion represented proposed financing of defense and defense-supporting activities and the remainder nondefense business activities and mortgage financing of home purchases. By the end of August, however, the total

of such commitments had been reduced to 3.7 billion dollars, as shown by the chart. As other commitments are worked off, more



NOTE.—Outstanding commitments to acquire domestic loans and investments. Data compiled by Life Insurance Association of America from reports submitted by 45 life insurance companies whose combined assets represent 85 per cent of all life insurance company assets.

and more current financing will come under the Program.

In encouraging lending officers of financing institutions and businessmen in general to consider the role of credit in an inflationary situation and in providing them with standards by which to judge the relative essentiality of proposed uses of credit, the Program has perhaps achieved its greatest success.

CONCLUSION

Voluntary credit restraint is an extremely useful adjunct to general credit restraint measures and should be further developed for use whenever inflationary pressures threaten depreciation of the dollar. If the international situation does not worsen, there may be a tendency for the sense of urgency and the spirit of cooperation developed in this period of national emergency to become submerged in competitive self-interest as defense production goals are approached. With employment, personal income, and business expenditures on plant and equipment at record levels and defense expenditures increasing rapidly, further test of all credit restraint measures may lie ahead.