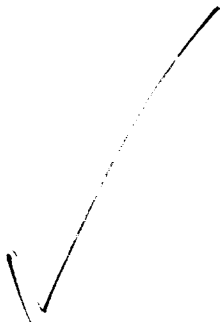
BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

MEMORANDUM

FROM THE OFFICE OF GOVERNOR M. S. SZYMCZAK

TO: Secretary John W. Snyder



Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

SELECTIVE CONTROL OF INVENTORY LOANS

File F.R.B

(Report and Recommendations of Task Force No. 5)

Following its report of March 19 to the Committee of Four charged by the President with the task of studying various measures to restrain private credit expansion and to maintain stability in the market for Government securities, the subcommittee on miscellaneous aspects of credit policy was asked by the Committee of Four to look further into the possibility of restricting credit for the purchase and carrying of inventory.

The probable advantages and disadvantages of the selective regulation of inventory loans, and the problems involved in designing and administering such regulations, have been carefully examined. The research staff of the Federal Reserve Board and representatives of commercial banks have assisted in the study. This report states the findings of the subcommittee.

1. Purposes of Selective Control of Inventory Loans

The regulation of credit for the purchase and carrying of inventory would have three distinct but related objectives:

(a) to check the inflationary expansion of bank credit;

(b) to facilitate the diversion of some materials into defense production and stockpiling, and the economical distribution of the materials among firms with defense contracts;

(c) to help allocate those scarce materials that will be available for civilian output, and substitutes for them, among the several industries and firms in a manner that is fair and that assures the greatest possible balance and continuity of non-defense production.

The selective restraint of inventory loans appears particularly appropriate as a measure of credit control to curb inflation because so high a percent of business loans by banks is related to the accumulation and carrying of inventory. A check in November 1950 of new business loans recently made by reporting member banks showed that, in the judgment of the lenders, about four-fifths were for inventory purposes. Retail and wholesale merchants and manufacturers typically use more bank credit to build up and hold inventories than for any other purpose; since Korea their demand for this kind of accommodation has been unusually large. Price ceilings would be difficult to hold if easy credit supported business bidding for goods in short supply in regular markets -- and maybe in black markets.

As for the diversion of resources into defense channels, selective credit measures do not have the efficiency of direct material orders, but credit controls are a useful supplement to such orders. They can help prevent the hoarding of scarce commodities and products; and they make possible less severe cutbacks of non-defense industrial consumption that might otherwise be required.

The third possible objective of the regulation of inventory loans is also of great importance. An uncontrolled scramble of merchants and manufacturers for raw materials and finished products not needed for mobilization and the unlimited accumulation of such goods could not only distort the composition of civilian output but also force curtailment of the production of many essential consumer and industrial goods.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

2. Problems of the Selective Control of Inventory Credit.

Desirable as its objectives may be, the selective mandatory control of inventory loans would face many obstacles:

(a) Few bank loans are specifically tied to inventories. It would, therefore, be almost impossible to hold this selective control on the target. In spite of the fact that bank advances are often characterized as inventory loans, the classification is far less precise in fact than that of mortgage loans, or of loans for the purchase or carrying of listed securities. Business concerns generally obtain their short-term loans under established lines of credit for various working capital purposes, and on unsecured notes that do not relate the loan to specific assets. Moreover, in granting lines of credit the banker is usually more concerned about the credit rating of the borrower than about his inventory position. A business concern with liquid assets may borrow to finance inventory accumulation, or it may use its liquid assets for the purchase of inventory and borrow to finance other working capital requirements such as payrolls or the carrying of receivables. To trace the flow of a given amount of funds into and out of a business and to determine exactly the uses made of funds is an extremely difficult task, in the absence of detailed accounting records which most business concerns do not maintain.

(b) Checking the use of credit to finance inventory accumulations would be quite ineffective as a means of dividing materials and supplies between defense and civilian production, and of assuring a balanced distribution of scarce resources among industries and firms. Many business concerns, both large and small, are so well supplied with cash and other liquid assets that, without resorting to borrowing, they can finance inventory expansions that might be highly disruptive of desirable production goals. Inventory accumulations financed by loans do not have a lower priority than those financed by other means.

(c) It is difficult to define or to distinguish between normal or necessary inventories and abnormal, speculative, or nonessential inventories. The problem of deciding what represents abnormal inventory accumulation is complicated by a general lack of precise and current accounting information and by the difficulty of selecting a normal or average base period. For example, while the ratio of inventory to sales might conceivably be used to relate current inventory holdings with those of same base period, there is no assurance that the average small or medium-sized firm could provide the necessary information, or that the relationship to the base period would indicate the minimum inventory required by current or prospective sales. The employment of a bank-credit-to-inventory ratio would not answer the question as to whether current inventory holdings were abnormal, but would show merely whether the use of bank credit for assumed inventory purposes was greater or less than during some other period, which might not be representative.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

(d) The type of ceiling or limitation on inventory loans that might be imposed by regulations also constitutes a problem. If a ceiling were placed on total loans classified as inventory credits that might be made by a bank, borrowers could define the purpose of loans to escape the ceiling, and the banker would be hard pressed to prove that funds borrowed for other use did not actually go into stocks of goods. Such an aggregate-type limitation would also be inflexible. It might not permit the expansion required by defense activities. It would also require exceptions because of abnormalities in some current loan portfolios.

If, on the other hand, the credit granted to individual firms were subject to restrictions, the problems, described above, of designing an administratively workable base of normal inventory volume for the firm would appear in an acute form.

3. Conclusions and Recommendations

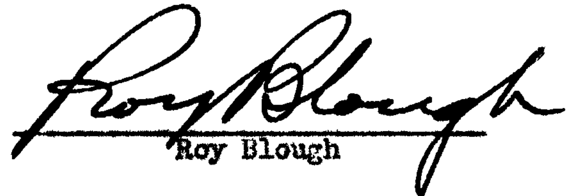
(a) We conclude that it is not feasible to extend selective credit control to the field of inventory loans. The difficulty of identifying inventory loans, the ease with which large numbers of firms can finance inventory acquisitions without borrowing, and the formidable, but not insuperable problem of distinguishing for purposes of practical administration between essential and nonessential inventories, make inventory credit regulation an unpromising method of controlling inflation or of facilitating the allocation of materials and supplies to meet the needs of the defense economy. If the only impediments of the control of inventory loans were real or imagined difficulties of the usual administrative kind, an attempt at such regulation might well be undertaken. But here the object to be controlled, the inventory loan, is so ill defined, so easily disguised, so easily replaced either by other kinds of loans that can transform themselves into inventory credits or by the employment of other liquid assets, that the common charge that administration would not be easy becomes in this case not the principal objection, but only a lesser accessory.

(b) Though mandatory restrictions should not be imposed, bankers and other lenders should, as a part of the voluntary program of credit limitation, try to hold down nonessential inventory credits. Though the bankers may have to use rule of thumb criteria in the effort to detect excessive accumulations of goods, it is possible that their efforts at restriction will be as successful as could be attained through formal mandatory regulation. Moreover, the voluntary approach allows the utmost flexibility, and should not interfere with essential needs for credit.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis

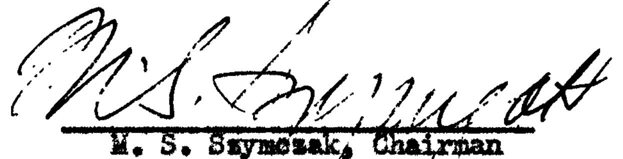
(c) Direct controls over materials should be, as they have been, relied on as the chief means of allocating materials and supplies for both civilian and defense production. The direct regulation of the flow, use and accumulation of materials can also contribute importantly to the anti-inflation objective by cutting down the demand for bank credit. Indeed, in the limitation of so-called inventory credits, the more feasible route of attack is through the demand for credit rather than the supply.

Regulation No. 1 of the National Production Authority, issued September 18, 1950 directed that inventories of listed materials be held at minimum working levels. Since that date, supplementary inventory restrictions have been applied to several specific commodities. At the present time NPA is preparing a new order to supersede Reg. No. 1. It will apply to nearly all materials, currently scarce or otherwise, including goods in process, will redefine the level of permissible inventories, will impose restrictions on the receipt, delivery, ordering and the processing of materials, and will provide for a system of reports from business firms. Measures of this kind are strongly recommended. They can formulate specific quantitative objectives concerning inventories in keeping with planned defense requirements, and can go about attaining these objectives by the most direct means. On the contrary, credit controls in this area, when imposed through lenders, are uncertain and indirect. Materials orders are in themselves a powerful method of credit restriction. They have the further merit of discouraging the spending by business firms of cash and other liquid assets, a method of financing second only to borrowing from banks in supporting inflationary demand.



Roy Blough

Edward F. Bartelt



M. S. Szymczak, Chairman

April 13, 1951.

Digitized for FRASER
http://fraser.stlouisfed.org/
Federal Reserve Bank of St. Louis