

*Fall  
Federal Reserve Bank*

Representative Reed submitted the following questions to the Secretary of the Treasury for written reply:

1. Mr. Secretary, as I understand it, the purpose of increased taxes is to reduce or eliminate the Government's deficit and thus the need for Treasury borrowing, which under the conditions facing us would have an inflationary effect. Do you think that that is all that is necessary to prevent inflation?
2. Since Korea, the Government's budget has been in balance; in fact for this fiscal year to date it has shown a substantial surplus. Nevertheless, we have had a very large amount of inflation. What have been the causes of that inflation?
3. Inflation, as I understand it, results from a situation in which demands for goods exceed available supplies. One of the principal reasons why this can happen is borrowing from banks, which puts into circulation an increase in the supply of money. During the past eight or nine months, bank loans have increased by about 9 billion dollars -- supporting inventory expansion by business and buying of homes and durable goods by individuals. This increase, I am informed, was an exceptionally large one. Wasn't this expansion, in a period when the Government has a surplus, one of the important causes of inflation, or at least a reason why inflation was possible?
4. Is it not true that banks were able to expand credit so rapidly and thus contribute to inflationary pressures, because the Federal Reserve System bought large amounts of Government securities in supporting the market for those securities at a fixed pattern of yields?

[The record shows that Federal Reserve holdings of Government securities from June 30 of last year to March 14 of this year increased by over 4 billion dollars and that member bank reserves increased by about 3.5 billion. About 2 billion of the increase in reserves was to meet a raising of reserve requirement percentages, the remainder was available to support an expansion in bank credit of many times the amount of reserves. Many of the Federal Reserve purchases of securities were from insurance companies and savings banks which used the funds thus obtained to increase their mortgage loans and other investments, which, under the circumstances, have the same inflationary effect as bank credit expansion.]

5. If inflation is to be curbed, would it not be good policy to supplement higher taxes, which are designed to reduce Government borrowing, by more effective restraint on credit expansion? Can such restraints be effective if the Federal Reserve follows the practice of buying any amount of Government securities solely for the purpose of keeping interest rates from rising?

[Interest rate changes are the result of the relation between the demands for credit and the available supply. In an inflationary period, demands for credit are certain to increase; therefore, a rise in interest rates can be avoided only by adding to the available supply of loanable funds. But this helps to promote inflation. Restrictive credit policies are bound to result in higher interest rates.]

6. It has been announced that the Treasury and the Federal Reserve "have reached full accord with respect to debt-management and monetary policies to be pursued in furthering their common purpose to assure successful financing of the Government's requirements and, at the same time, minimize monetization of the public debt."

May we interpret this statement to mean that in the future the Federal Reserve will be in a position to follow policies with respect to support of the Government securities market that may be more restrictive upon credit expansion than has been the case in recent months?

The first five of the foregoing questions are interlocked in subject matter, and it is difficult to answer each one separately without a great deal of repetition or without referring directly to answers to some of the other questions. Accordingly, the five questions have been answered together in the following statement on inflation since Korea and bank credit expansion.

#### I. The Role of Credit Expansion in the Inflation Since Korea

Since the outbreak of hostilities in Korea, there has been a significant rise in the general price level. This increase has been accompanied by a rapid expansion in bank loans. There has been a tendency for many observers to conclude that the increase in commercial bank loans is the major cause of the price rise and that general monetary controls would have been effective either in eliminating the inflation or in reducing it to a bare minimum.

Bank credit expansion is, however, only one of the many factors contributing to the price rise since Korea. The primary cause of the inflation has been an unprecedented rush for goods by business and consumers generally (see Chart 1). The price of the goods purchased was often a secondary factor in the events of the period; means of financing were often secondary, too. The important thing in the minds of the purchasers was to obtain the goods as soon as possible.

The expansion of bank credit contributed to the inflation, and it is clear that unnecessary loans should have been curtailed. Nevertheless, much of the expansion in prices probably would have taken place without any extension of bank credit at all. This is because individual consumers and businessmen, if they had wished, could have drawn on their large supply of liquid assets -- assets which amounted to \$245 billion on June 30, 1950 (see Chart 2). Moreover, they could have increased the turnover in their checking and savings accounts and in their savings bonds more than they did -- although even with the great loan expansion, the turnover increase was significant (see Chart 2 also).

The ease with which money became available last year is shown strikingly by an examination of the sources from which corporations derived funds to pay for their expenditures on plant and equipment, and on inventories; and to cover the net increase in receivables. Some \$28 billion was needed. How was this \$28 billion of expansion financed? Almost \$20 billion came directly from retained earnings and current depreciation allowances. Some of the balance came from new security issues. One billion dollars came from new mortgages. Only \$2-1/2 billion came from expansion in the commercial and industrial loans made by banks.

Thus, private bank credit only accounted for about a tenth of the 1950 needs of corporations. Had bank credit been unavailable, more of the \$44 billion of cash and Government securities held by these corporations at the time of the Korean attack would undoubtedly have been utilized. Borrowing happened to be a simpler and more comfortable avenue of approach to many corporations to meet their immediate needs. It was not necessarily the only approach. If the increase in borrowing had been cut down drastically, there is no assurance that the price rises since Korea would have been much less dramatic.

Somewhat the same sort of analysis is pertinent in characterizing the consumer buying rush. The desire for acquisition of the goods was primary. The fact that there was a small rise in price may have been distasteful, but it obviously offered no effective deterrent to anyone who believed that prices were going to rise still further. The means by which the purchases were financed was in many cases of even less importance, although everyone will admit that the expansion of consumer credit was a contributing factor. Immediate imposition on July 1, 1950, of stringent consumer credit controls would have helped significantly. In itself, however, even that would not have been adequate.

Increased turnover of liquid assets is one important reason why this is so. At the present time, individuals have a reservoir of liquid assets, out of which vast amounts of consumer spending can take place without one iota of bank credit extension. As a matter of record, the rates of turnover on demand deposits, on savings accounts in both mutual savings banks and savings and loan associations, and on savings bonds, all increased during the third quarter consumer buying spurt. This turnover of liquid assets -- really the velocity of money as it is referred to traditionally -- is a factor which has a potential for inflation not generally appreciated.

Private bank credit has a somewhat less important role in the economy today as compared with years past. In contrast, the role played by accumulated private savings is much greater. For example, before World War I, the outstanding amount of private credit extended by commercial banks (loans plus corporate and municipal securities) was equal to about 85 percent of the amount of total liquid assets of individuals and corporations. Just before World War II -- 25 years later -- private bank credit was only 35 percent of the amount of liquid assets; now, the ratio is approximately 25 percent. The point can be made another way, too. In 1914, the amount of private bank credit outstanding was 40 percent of the amount of total output in this country. By 1939, it had fallen to 25 percent; and it is now only 20 percent (see Chart 2).

This does not mean that private bank credit has become a minor factor and that we need not worry about it. Quite the contrary; it is important, and strenuous efforts should be made to restrain its expansion in specific areas. It does mean, however, that private bank credit is only one of a number of factors involved in the financing of the increases in demand for goods during the last half of 1950. And it was the demand for goods which was the basic cause of the inflationary price rises, not the way in which the buying was financed.

## II. Credit Restraint and the Government Bond Market

The argument is often advanced that much of the credit expansion which did take place since Korea could have been avoided if prices in the Government securities market had been permitted to seek their own level rather than being supported by open market purchases. It is argued that the cessation of open market purchases would have pulled prices sufficiently below par so as to force credit institutions to hold their Governments rather than to sustain a capital loss. Therefore, it presumably would have a desirable effect in restraining not only bank credit, but also credit extended by nonbank institutions (such as life insurance companies) as well. This argument is open to question, however.

As far as commercial banks are concerned, a large proportion of their holdings is in short-term obligations. Even if interest rates rose appreciably, that fact in itself would have no significant effect on discouraging bank credit expansion, except in a few isolated instances. Commercial banks on June 30, 1950, had almost \$18 billion of securities which would mature during the ensuing 12 months. These maturities are scattered throughout the year and were distributed widely throughout the country. Obviously, therefore, all that most commercial banks had to do if they wished to expand their loans was to wait until appropriate amounts of their Federal securities matured and turn them in for cash at the Treasury. Even if one takes the case of a bank that doesn't happen to have any securities maturing at the precise time it wants to expand loans, it can make up any capital loss on a sale of its short-term Government securities on the open market within a matter of a very few months even if short-term Government interest rates went up by 1/2 percent, by 1 percent, or even more. At the same time the Government rate was rising, of course, there would be a commensurate rise in the rates which commercial banks could earn on their loans.

A price decline in Governments would have more of a deterrent effect on long-term investors than it would on banks; but even there, the effect has definite limitations. In the first place, only about 35 percent of the expansion of private credit by life insurance companies during the last half of 1950 took place from liquidation of Government securities; the rest of it represented investment of new funds. The percentage was quite a bit higher for mutual savings banks (in part, because of seasonal factors); but, on the other hand, all of the credit expansion by savings and loan associations and other insurance companies took place without selling any Governments.

Credit expansion by mutual savings banks which came about as a result of their selling Governments could have taken place very easily even if interest rates had gone up by 1/2 percent. In June 1950, mutual savings banks had \$3.8 billion of securities maturing in less than 10 years, or more than 5 times the amount of Governments they liquidated in the last half of 1950. Had interest rates risen by 1/2 percent, they could have sold any or all of these securities at a loss and they still would have been money ahead by investing in new higher rate private investments (say, at a rate 1 percent above Governments) before the end of two years. As a matter of fact, the period would be even shorter than that if account is taken of the investment of new funds and mortgage repayment money at the new higher rates.

As far as life insurance companies are concerned, their holdings of securities due or callable within 10 years on June 30, 1950, were in the aggregate some 50 percent greater than the total amount of Governments they sold during the ensuing 6 months to finance credit expansion. A 1/2 percent rise in interest rates would mean that they, too, could sell any or all of these Governments at a capital loss and still come out even within two years.

It would appear, therefore, that the effectiveness of capital losses on Governments as a deterrent to credit expansion has been considerably overrated by many observers. No real deterrent effect at all seems to be involved as far as commercial banks are concerned. The effect on mutual savings banks and life insurance companies is tempered, first of all, by the existence of fairly sizeable holdings of under 10 year maturities, in which area a capital loss would be easily made up by increased earnings on private obligations at the higher rates; and, in the second place, by the fact that typically most credit expansion by nonbank institutions comes from the accretion of new funds, not from the sale of Governments.

The answer to the control of credit expansion is, in the last analysis, not to be found in the field of general credit controls. It is to be found primarily in the field of selective controls (1) on the mandatory credit control side through such instruments as Regulations W and X; (2) on the physical side through direct controls over materials and manpower; and (3) through the cooperation in a vigorous program of voluntary credit control by all lending agencies.

### III. Details on the Price Rise Since Korea

The Korean attack served not only to stimulate inflationary factors which were either dormant or were effectively counterbalanced in the pre-Korean period; it also served to stimulate a host of new inflationary pressures. The threat of an immediate all-out war had an electrifying effect on businessmen and on consumers, in whose minds the memories of World War II shortages were still fresh. Businessmen were particularly sensitive to the situation and it did not take them long to realize that the imminence of Government stockpiling of strategic materials and the needs of military procurement were matters of critical importance to them. Speculators saw the point, too; and wasted no time in taking advantage of it.

It is not surprising, therefore, that the Bureau of Labor Statistics spot index of market prices for 28 key commodities rose by 12 percent within one month after Korea. The climb continued, so that just 8 months after Korea the rise was almost 50 percent. The prices of industrial raw materials led the procession, with an increase of close to 60 percent for the 8-month period, with foodstuffs up a little less than 25 percent. Among specific commodities, the price of steel scrap rose by 20 percent in the last 8 months. Cotton was up over 30 percent, lead almost 50 percent, print cloth over 50 percent, shellac over 60 percent, cottonseed oil over 70 percent, rosin 80 percent, lard 80 percent, wool-tops over 105 percent, burlap over 105 percent, silk about 115 percent, tin 140 percent, rubber over 160 percent, and tallow 280 percent. There is typically

a significant lag in the reflection of these prices in the overall indexes. The slower moving B.L.S. all-commodity index has, however, already gone up by more than 15 percent since June; and there has been a rise of nearly 7 percent in consumers' prices through January alone. (See Chart 1 for a further exposition of the demand and price situation since Korea.)

These price increases for specific commodities are indicative of areas which responded swiftly to the changed environment after Korea. They are areas of price increases which occurred not necessarily as a result of any monetary phenomena, but rather as a direct result of the anticipation of physical shortages in their impact upon thousands of individual businessmen. It is no wonder, then, that business inventories rose substantially during this period to new all-time highs, despite the existence of a huge buying wave by consumers. The buying of metals is a case in point. Smelter stocks of refined copper and lead, for example, both reached peaks for the last decade during the year before Korea. By December 1950, stocks of copper had declined 77 percent from the peak, and stocks of lead were down 64 percent. In addition, zinc stocks were down 90 percent during the calendar year 1950. The prospect of shortages was uppermost in the minds of many consumers as well; and the decision as to whether to buy a new automobile loaded with extras today, or to wait 6 months and either get no car at all or have to pay 10 percent more for it, was not difficult to make.

The sixth question submitted by Representative Reed asks whether the Federal Reserve will be in a position to follow policies that are more restrictive upon credit expansion in the future than has been the case in recent months. The Treasury and the Federal Reserve are working closely together to develop policies which will restrict as much as is necessary credit expansion that does not relate to the defense effort. In this connection, within the past few weeks, the Federal Reserve has initiated a voluntary credit restraint program; and on March 14, announced the appointment of representatives of commercial banking, investment banking, and life insurance as members of the National Voluntary Credit Restraint Committee. The Committee, under the chairmanship of Reserve Board Governor Oliver S. Powell, is now in active operation. It will designate subcommittees throughout the United States to be available for consultation with individual financing institutions and to assist them in determining the application of the program with respect to specific loans. Participation in the program is entirely voluntary, but the Board of Governors and the National Committee hope that all financing institutions will join in the program and cooperate in making it effective.

In discussing the first meeting of the National Voluntary Credit Restraint Committee, Mr. Thomas B. McCabe, who was then Chairman of the Federal Reserve Board, said:

"Up to now, voluntary efforts on an individual basis have not been very successful, even though many individual institutions have done a statesmanlike job of holding down loans in their own organizations. With this new approach, groups of institutions in a community will be able to band together under legal sanction to halt the 'shopping around' for loans which has been the principal weakness in voluntary efforts to date. If lenders will really go to work on this new program, it is not too much to hope that the expansion of private credit will be greatly curtailed. I have no use for the cynics who say that credit will inevitably continue to rise even under this new program. There are always loopholes for those who are looking for them, but I think the financial leaders of this country, given this opportunity, will look at the spirit and intent of the program and make it a success."

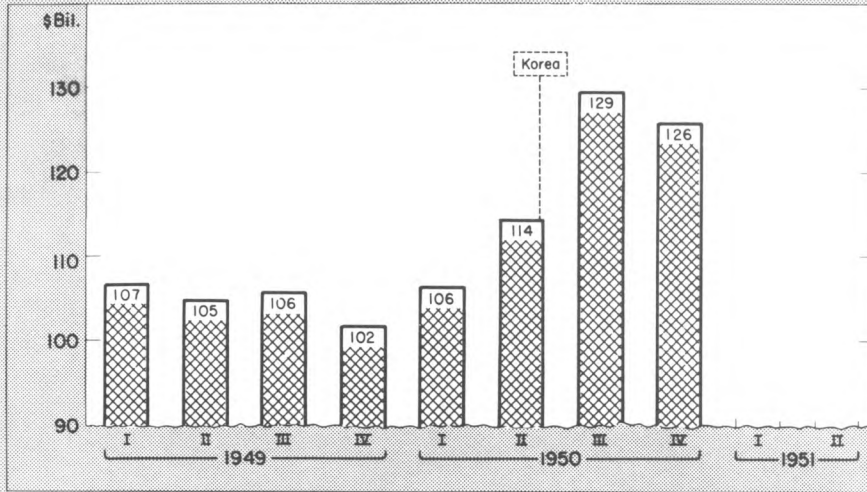
In addition to the activities of the National Voluntary Credit Restraint Committee, the Treasury and the Federal Reserve worked out a program looking toward the conversion of a substantial proportion of the longest-term restricted marketable 2-1/2 percent Government securities into nonmarketable obligations. The books were opened for this conversion on March 26; and on April 3, it was announced that they would close at midnight April 6, 1951. In making this announcement, it was stated that subscriptions received and tabulated by Federal Reserve Banks as of Monday, April 2, (including about \$5,365,000,000 for Federal Reserve and Treasury investment account) exceed \$11,000,000,000.

Attachments

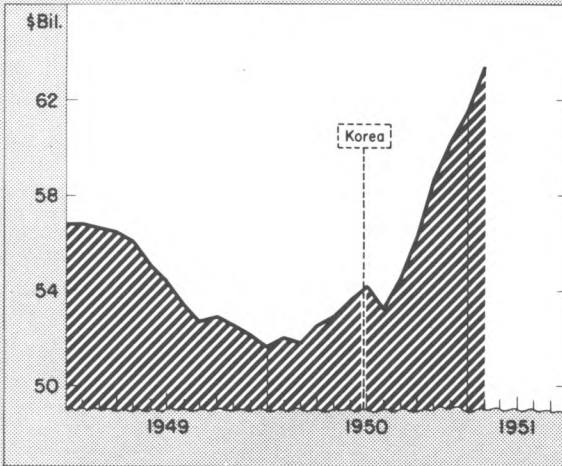


# DEMAND FACTORS IN THE INFLATION PICTURE

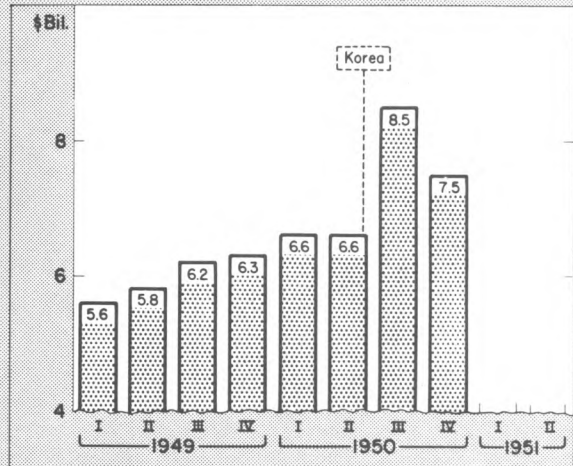
① *Total business sales zoom with Korea*



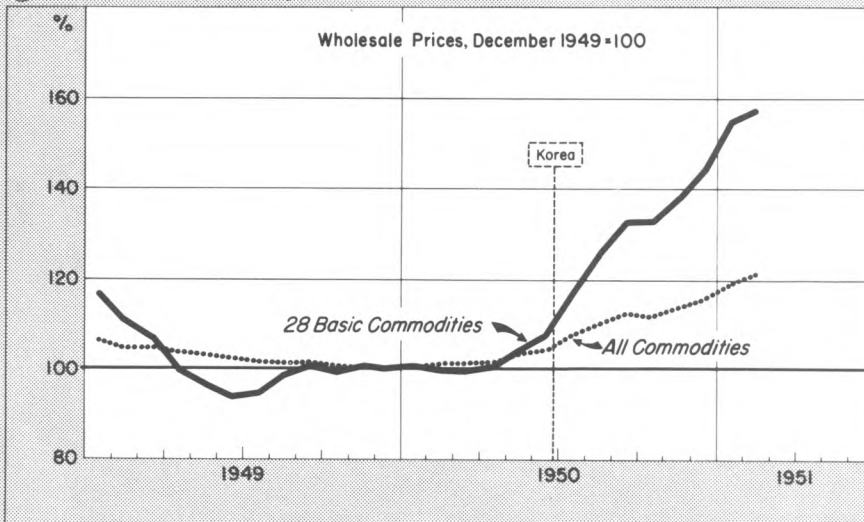
② *As inventories pile up*



③ *And consumer expenditures for durables jump*

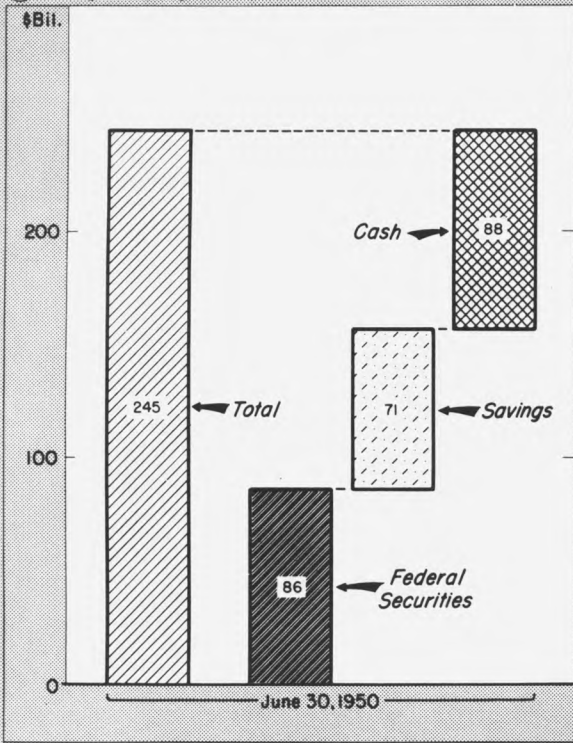


④ *Resultant impact on prices*

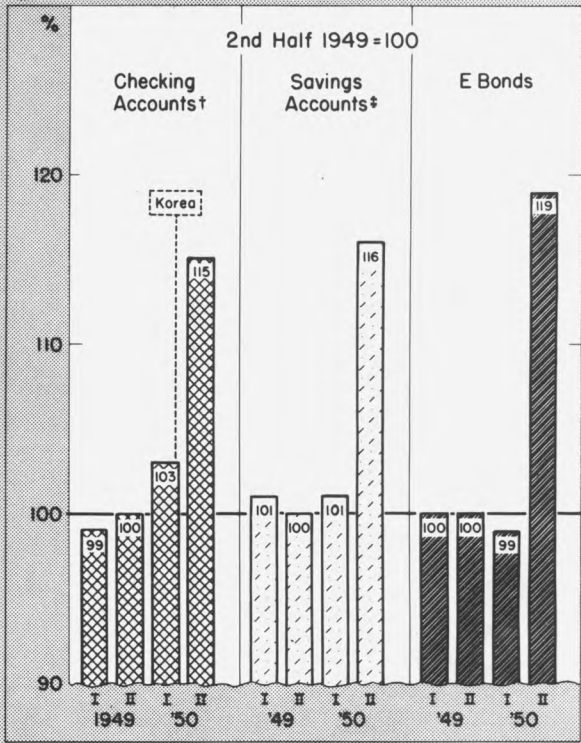


# FINANCING THE DEMAND SINCE KOREA

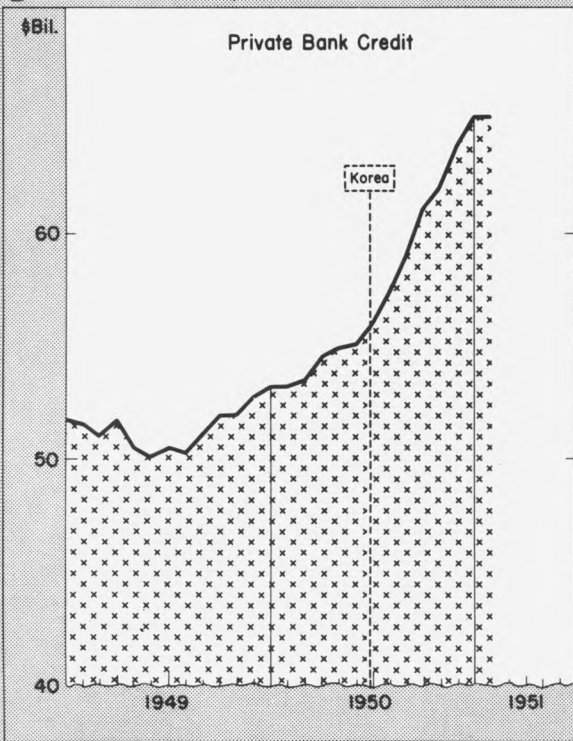
① Large supply of liquid assets\*



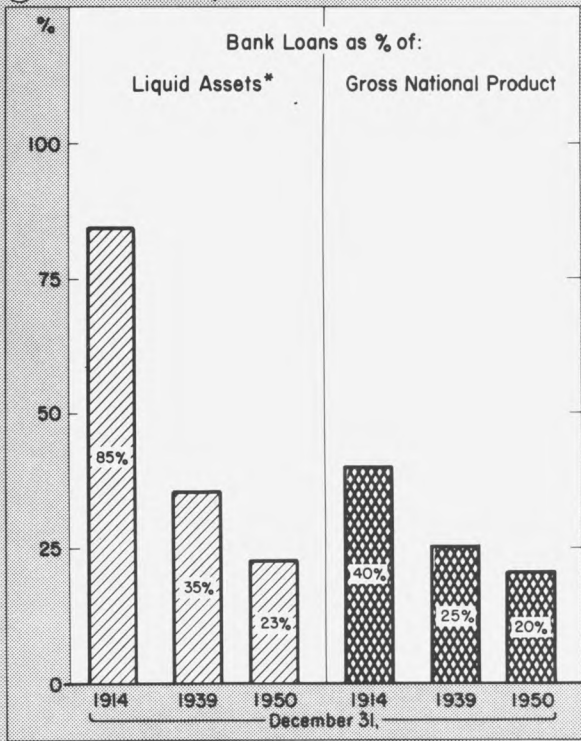
② With significant increase in turnover



③ Bank loans are up



④ But are less important now



\* Held by individuals and corporations. † Banks in leading cities. ‡ In mutual savings banks and savings and loan associations.