R.A.M., Oct. 25, 1943

LIQUIDITY AND INFLATION IN THE POSTWAR PERIOD

I. Increase in liquidity -- the facts

Partly as an inevitable consequence of war finance, but also partly due to loose fiscal policy during the war, there will be an enormously high level of liquidity in the postwar period.

(1) The interest bearing debt of the U. S. Government, $55 billion in 1941, is close to $170 billion now, and will be over $200 billion at the end of this fiscal year. If the war continues for another fiscal year, it will be around $270 billion by June 1945. (See Table 1.)

(2) So far, much of the increase in the public debt has been taken by banks, -- from June 1941 to June 1943, commercial banks and Federal Reserve Banks took $37 billion out of a total increase of $85 billion. Recently, the record in this respect has been somewhat better. Nevertheless, bank purchases have resulted in a vast increase in the total money supply, and will result in substantial further increases. The total money supply in June 1941 was $73 billion and now is $102 billion; by the end of this fiscal year, it will exceed $120 billion, and, if the war continues for another year, may exceed $140 billion by June 1945. (See Table II.)

(3) The increase in liquidity is not only in the form of cash and deposits, but also in the form of security holdings. A substantial part of the securities held by the public are, in fact, demand obligations which may be redeemed at fixed prices at any time. Other obligations which are nominally not demand obligations actually come close to being so, since under present conditions the Federal Reserve System will probably have to maintain the security market should it threaten to break. Total liquid assets in the hands of the public (deposits, currency and U. S. securities) amounted to $139 billion in June of this year as against $60 billion in 1930. (Excluding commercial banks and life insurance companies). The total will be $190 billion by the end of this fiscal year and may be close to $250 billion by June 1945, should the war continue that long. Of the total, about one-third is held by business, two-thirds by individuals. (See Table III.)

(4) It is exceedingly difficult to estimate the distribution of liquid holdings by individuals between different income groups. Very roughly, it appears that about one-third to one-half of the total is held by people with incomes of under $5,000, constituting about 80% of income receivers. If this ratio is correct, these people will hold about $50 billion by June 1944 out of the estimated total of $122 billion. (See Table IV.)

II. Increase in liquidity -- the consequences

The consequences may be for the good or for the bad, but on balance, the increase in liquidity is more likely to prove a liability.

Desirable consequences:

People will have sizeable funds with which to buy and to finance their backlog demand for semi-durables and durables after the war. Also, the fact that they have accumulated some savings may mean that future net savings out of current income may be less (however, the opposite may happen: people may have acquired a savings habit and continue to save more).

Undesirable consequences:

(1) There is a danger that people will decide to liquidate their holdings at the wrong time, that is, when insufficient civilian supplies are available. Particularly, there is some danger in this respect in the transition period after the war. If this should happen, people will lose their savings in higher prices and considerable inflation might result.

(2) With a huge volume of public debt outstanding, public policy, most likely, will have to assure that the security market will be maintained. If public holders of securities decide to sell on the net, the Federal Reserve System will have to take up the slack, -- and this might happen at a time when a tightening of the money market would otherwise be desirable.

(3) On the whole, it appears that the large volume of liquid holdings by the public will make the whole economic mechanism more delicate and sensitive to fluctuations. It will be more difficult to maintain a high level of employment since we must be more careful not to risk an inflationary development. We shall be less able to afford making mistakes.

Financial Resources of Corporations 1/

(All corporations; billion dollars)

I. Corporate Net Income Before and After Taxes.

	1940	1941	1942	1943
Net income before taxes	7.3	14.3	20.1	22.2
Income and profits taxes	2.5	7.2	11.8	13.5
Net income after taxes	4.8	7.1	8.3	8.7

II. Corporate Net Income Before and After Dividends.

	1940	1941	1942	1943
Net income after taxes	4.8	7.1	8.4	8.7
Net dividends paid	4.1	4.5	4.1	4.0
Retained income	.7	2.6	4.3	4.7
Cumulative since 1940	.7	3.3	7.6	12.3

III. Estimates Business Investment and Depreciation.

	1940	1941	1942	1943
Net investment 2/ including inv.	11.1	18.1	8.1	1.4
Depreciation and related reserves	8.2	9.4	10.3	10.4
Excess of depreciation on investment	- 2.9	- 8.7	2.2	9.0

1/ Source: U. S. Treasury Department.

2/ In plant and inventory.

FINANCIAL POSITION OF CORPORATIONS IN POST-WAR PERIOD

I. The Facts.

Notwithstanding current arguments for tax relief, indications are that corporations will emerge from the war in a strong financial position. The following figures support this position:

(a) Corporate net income in 1943 is three times that of 1940, -- $22 billion dollars as against $7 billion dollars. After taxes corporate net income is still twice that of 1940, -- $8.7 billion as against $4.8 billion, -- and higher than it has ever been before. (See Table I.)

(b) Retained corporate income is similarly at a record level. Cumulative retained income since 1939 exceeds $12 billion dollars and is now running about $5 billion a year. (See Table II.)

(c) Depreciation reserves are now being accumulated at a rate much in excess of total investment (including plant and inventory). While investment exceeded depreciation allowances for 1940 and 1941, the excess of depreciation allowances over investment in 1942 was $2.2 billion dollars and for the current year is estimated $9 billion. If the war continues for several years, the current rate of reserve accumulation will grow into a very large total. (See Table III).

(d) Provisions under the present tax law will help corporations to strengthen their financial position in the post-war period.

(1) Under the Excess Profits Tax, corporations are accumulating reserves in the form of a 10 per cent refund of tax, amounting to about $1 billion a year.

(2) Under the Corporation Income Tax, corporations are permitted a two-year carry-back and two year carry-forward of net operating losses and under the Excess Profits Tax, the same holds for unused excess profits credit. This relief will, of course, be available only to corporations which suffer a drop in income after the war and which pay taxes during the war, but the total refunds that may be obtained might be very substantial due to the enormous war-time income against which the carry-backs can be made.

On the whole, it appears that the combined effects of the very extensive retention of earnings, accumulation of reserves and possible refunds under present tax provisions will be adequate to provide a very substantial base for post-war expansion and growth.

II Policy Conclusions.

If war contracts are settled promptly, particularly if corporations receive liberal advance payments on outstanding contracts, corporations by and large will have sufficient funds to take care of reconversion to civilian production. While this applies to the bulk of corporations, there are likely to be some marginal concerns which did not have large profits during the war period and thus do not benefit from tax carrybacks. Special provisions might be necessary to help such businesses through reconversion loans.

Some corporations will have adequate reserves to take care of reconversion costs, but these reserves may not be in liquid form. Also, claims for tax refunds will not be immediately available. Steps may thus be needed to facilitate rapid liquidation of assets for reconversion purposes.

There is no good case for permitting corporations to accumulate large tax-free reserves for purposes of expansion after the war. Any such provision would simply mean a reduction in corporate tax rates. It would amount to a subsidy paid particularly to high-profit corporations which would be less in need of funds after the war. If corporations want to undertake large and new capital developments in the postwar period, and do not have sufficient funds, it is altogether desirable that they should go to the capital market to obtain funds. This is the more desirable, since investors will have plenty of liquid funds to invest.

A reasonable case can be made for permitting certain costs -- which are incurred in the postwar period but which are really a reflection of wartime production -- to be carried back against wartime income for purposes of computing the final tax burden upon wartime incomes. Costs of this type would be dismissal wages and a part of reconversion costs. It may be considered whether the tax law should be amended to provide for the carryback of such costs.

POST WAR LIQUIDITY

I. Ownership of U. S. Government Securities 1/

(In billions of dollars)

	June 30, 1941	June 30, 1943	Estimates June 30, 1944	Estimates June 30, 1945
Total Interest-bearing Securities	54.8	139.5	206.1	270.6
U. S. Government Agencies	8.5	14.2	18.7	24.5
Federal Reserve Banks	2.2	7.2	11.2	15.2
Commercial Banks	20.1	52.1	68.1	84.1
Mutual Savings Banks	3.4	5.3	6.8	8.3
Insurance Companies	7.0	12.8	17.3	21.8
Other Investors				
Marketable Securities	9.4	19.4	34.2	47.5
Nonmarketable Securities	4.2	28.4	49.7	69.1

II. Total Money Supply 2/

(In millions of dollars)

	June 30, 1941	June 30, 1943	June 30, 1944	June 30, 1945
All Banks				
Deposits				
Demand 3/	37,317	55,952	(68,000)	(80,000)
Time	27,879	30,328	(34,300)	(38,300)
Total	65,196	86,280	(102,300)	(118,300)
Currency Outside Banks	8,204	15,800	(19,800)	(23,800)
Total Money Supply	73,400	102,080	(122,100)	(142,100)

1/ Estimates by Mr. Piser. Purchases by the Federal Reserve Banks are estimated at $4 billion dollars each for the fiscal years 1944 and 1945.

2/ Purchases of U. S. securities by the commercial banks and the Federal Reserve System are estimated at $20 billion dollars each for the fiscal years 1944 and 1945.

3/ Excludes float, Government deposits, and interbank deposits.

III. Liquid Holdings of Individuals and Businesses [1]

(In billions of dollars)

	Dec.1, 1930	June 30, 1943	June 30, 1944	June 30, 1945
Businesses (except insurance) - total	15	53	(71)	(90)
Demand deposits and currency	13	32		
Time deposits	1	1		
U. S. Government securities	1	20		
Individuals - total	44	86	(122)	(158)
Demand deposits and currency	10	28		
Time deposits	26	28		
U. S. Government securities	8	30		

IV. Distribution of Liquid Holdings by Income Groups [2]

(In billions of dollars)

	All groups	Estimated Range of Holdings by people with incomes of	
		under $5,000	over $5,000
Total individual holdings	86.0	33 - 47	39 - 53.0
Demand deposits	14.5	3 - 6	8.5- 11.5
Currency	13.5	7 - 11	2.5- 6.5
Government securities	30.0	8 - 10	20.0- 22.0
Time deposits	28.0	(15 - 20)	(8.0- 13.0)

Choosing $38 billion as the estimated holdings by people with incomes under $5,000, their share would amount to 43 per cent.

1/ Estimates for 1944 and 1945 assume $55 billion dollars borrowed each fiscal year from individuals, non-insurance businesses and banks. On the basis of the past year's experience, one-third of the resulting gross in liquid assets is allocated to businesses and two-thirds to individuals.

2/ The estimates in this table are extremely speculative and should only be taken as an indication of the general magnitudes of holdings by people with incomes below and above $5,000. With respect to time deposits, there are no indications at all upon which to base an estimate, so that the figures given in the table are not much more than a guess.

KBW
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POSTWAR MANPOWER

At the end of the war, we will have a total labor force of 66 million, 9 million more than in mid-1940.

The labor force increases normally by 700,000 a year, or over 1 per cent.

About 6 million of the war increase are extras not normally in the labor force. If these are forced back to school, kitchens, and retirement, we will have 60 million left.

Armed forces will be demobilized fast after Japan is defeated. Probably have about 2.0 in the services one year after victory.

About 2.0 million will be unemployed for frictional and seasonal reasons, even with full employment.

This leaves a minimum of 56 million jobs to be provided after the war, 8 million more than were employed in July 1940.

Output per manhour for all employed increases 2-3 per cent a year. War stimulus to productivity has been tremendous. Return to peace will find productivity about 20 per cent above 1940.

99.8 "

A return to 1940 production (~~$97~~ billion gross national product) at 1940 hours of work (about 39 for nonagriculture as a whole) with a 20 per cent war stimulated increase in productivity, and 3 million normal increase in labor force would leave ~~20 million unemployed at end of war.~~ 11 M to be employed at end of war.

To obtain full employment, it would require a gross national product of around $140 billion (at 1940 prices, $165 billion at 1942 prices) at the end of the war.

The employment pattern indicates the great difficulty of providing full employment by increasing industrial jobs. Service jobs must increase.

	Prewar July 1940	End of War July 1945	
	(In millions)		
Civil Employment	48	54	-11 - 1 = 66 M,
Agriculture	11	12	
Industry	16	23	
Manufacturing	10	17	
Mining	1	1	
Construction	2	1	
Transportation & Public Utilities	3	4	
Service	21	19	
Government	4	6	
Trade, Finance, Etc.	11	9	
Self-Employed & Domestics	6	4	

Agriculture will end the war with a labor surplus. Manufacturing will have to decline substantially. (Automobiles will not employ as [illegible] as aircraft) Mining will not increase. Transportation and public utilities are likely to contract. Construction is only industry which will increase materially.

Government will contract substantially; trade, finance, and service will increase and must. Self-employed and domestics will increase.