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Chairman Eccles — Controlling the Inflation

Mr. Musgrave — of Capital Values

The prevention of an undue inflation of capital values during the war and in the immediate post-war period is an important part of the stabilization program. Although capital values have not risen excessively as yet, potential dangers of inflation are increasing and effective controls should be established. The policy to be applied must be comprehensive, that is, furnish a control over all sources of capital inflation. It must also be selective so as to discourage drastically transactions of a speculative nature with minimum interference with legitimate purchases. To achieve these objectives it may be necessary, eventually, to apply various types of controls. But, as a first step, these objectives are served best by a heavy tax upon profits derived from the resale of property purchased during the remainder of the war and in the immediate post-war period, the rate to be the heavier the shorter the period of holding. These transactions would be subject to the special wartime tax on capital profits and exempt from the regular capital gains tax.

It is urged, for the following reasons, that a heavy tax of this type be imposed first and credit controls be applied later:

1. An expansion of credit is by no means the only source from which a speculative increase in capital values might be generated. Due to extensive reliance on borrowing from commercial banks, the financing of our war effort has led to an enormous increase in the amount of money held by the public. Deposits and currency in the hands of the public now amount to over $110 billion, and should the war continue for two years, may well rise to approximately $170 billion by the middle of 1945. The potential sources of demand appear even greater if we allow for the fact that certain savings, particularly those invested in savings bonds sold on a voluntary basis, are highly liquid and may be readily transformed into cash. Should the holders of these balances (individuals and corporations) decide to purchase capital assets as inflation hedges, a drastic inflation of capital values might result even though credit were expanded little.

   Certain aspects of an inflation in capital values financed by credit -- such as the difficulties resulting from inability to meet debt payments -- would not be present with respect to an inflation financed by cash purchases. However, the maladjustments in the post-war economy due to distorted capital values would be most serious in either case. A policy must therefore be designed by which both sources of inflation may be controlled. A tax on profits from resale of properties would apply comprehensively to all purchases however financed, whereas a tightening of credit would provide no check whatever to speculative purchases made on a cash basis. Credit controls, for this reason, will be ineffective unless applied against the background of a broader measure covering all types of purchases.

2. Although there has been some increase in capital values, credit has contracted in most areas and expanded but slightly in others. In short, there are no signs to date of credit inflation for purposes of speculation in capital values.

   a. In the field of farm real estate the increase in values has been most pronounced and, in some regions, has given indication of a possible future boom in land values. Yet, farm mortgage debt has declined by $350 million in 1942. It now stands at $6,350 million, that is, $1 billion below its 1935-1939 level or $4,400 million below its peak in 1922. The recent decline is the net result of two opposite tendencies, the demand for new mortgages which is more than offset by the willingness of farmers to apply their increased incomes to debt reduction. While there is some indication that the average size of new mortgages is increasing relative to the value of the mortgage property and that total indebtedness in certain areas showed a pronounced increase, it is evident that the behaviour of farm credit as a whole stands in drastic contrast to its spectacular increase during World War I.

   b. Although the present level of common stock prices is 50 per cent above that of 1942, it is still below the 1939 level. In view of corporate earnings (after tax) present prices are far from too high. The expansion in credit has been similarly moderate. Although customer debit balances with members of the New York Stock Exchange have risen 50 per cent above their 1942 low, they have not yet recovered their 1939 level. Present balances are slightly more than one-half those of 1937. The increase in brokers' loans has been similarly moderate particularly if the increase in requirements for Treasury financing is allowed for.

   c. Non-farm real estate values have risen sharply in some localities where war activity is concentrated but have changed little in others. During 1942 the increase in war housing was reflected in increased mortgages but has slowed down now while repayment of mortgages is increasing. As a result total mortgages outstanding are likely to decline for 1943.

3. It would be unnecessary and undesirable to apply controls which would hamper the accommodation of legitimate credit needs. There are certain transactions to which there is no objection on grounds of economic policy such as purchases of farms by tenants, or by other operator-owners, sales connected with the liquidation of estates, sales of real estate due to changes in locality of occupation, and so forth.

Also it would be mistaken to label all increases in capital values as "inflation". Unless we are to loose the peace tragically we must succeed, in the post-war period, to maintain national income at a level not altogether out of line with the enormous productive capacity shown by our economy during the war. And if national income is maintained at a level of, say, $130 billion, it is only sound that the corresponding increase in the earning power of capital assets should be reflected in a level of capital values distinctly above that to which we have been accustomed at a level of national income of, say $70 billion. This is the more so since long term interest rates may be expected to continue at a low level. Viewed against this background the increase in capital values recorded so far does not seem alarming. The task ahead of us is not so much to curtail any and all increases in capital values whatever. Thattask is to curtail speculative increases that is increases which reflect a merely temporary wartime addition to earning power and not the more permanent level of higher earnings that will prevail in the post-war economy.

Controls must, therefore, be selective. A tax of the proposed type will drastically discourage speculativeppurchases made with the intent of resale after a relatively short period. It should have little effect upon other types of purchases made by bona fide investors who plan on continued holding of their assets. Credit controls, to be sure, permit some selectivity -- if farm credit were restricted, for instance, purchases of farm properties by tenants could be exempt -- but to a much lesser degree.

The special wartime tax on gains derived from the resale of capital assets should be distinct from the capital gains tax now in force. It should apply to the resale of capital assets purchased from the date on which the tax is introduced to Congress until some time after the war is ended. Transactions subject to the special tax should be exempt from the capital gains tax now in force. The tax on profits derived from resale should be steep. For instance, if the property has been held for a short period only, the rate might be 90 per cent and then taper off to a level of say, 50 per cent for holdings beyond, say, ten years. Detailed provisions regarding the rate schedule and the period of holding to which the schedule applies remain to be worked out.

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