Form F. R. 131

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date January 20, 1948

To Chairman Eccles

Subject:

From Woodlief Thomas

Attached is an outline that might be suggestive for you in connection with your talk to the McGraw-Hill editors Thursday.

W. T.

Attachment

January 19, 1948

INFLATION AND BANK CREDIT

Country continues to experience an inflationary spiral, which,unless checked by positive measures, is likely to lead to eventual economic collapse.

Causes of inflation -

- Large volume of effective demand in excess of available supplies of goods and services
- Origin was in development of wartime
  - Deferred demands, due to shortages of many products, and widespread destruction and disarrangement of resources
  - Accumulation of savings from portion of large incomes that could not be spent
- Stimulated in postwar by continued large incomes--broadly distributed by high farm prices, wage increases, and large profits of businesses, large and small
- Premature removal of allocations and price controls before equilibrium between demand and supply was possible
- Reduction in tax rates and especially repeal of excess profits tax, were also premature
- Inflation being continued through wage-price-profit-credit spiral
  - As long as this spiral continues, prices will rise further
  - Difficult to stop without positive action

Current heavy demand is reflected in large volume of spending by all groups

- Government expenditures greatly reduced from wartime peak, but several times prewar levels
  - Federal Government spending 40 billion dollars a year for all purposes
  - State and local governments spend 10 to 15 billion

Private capital formation--including construction of all kinds, capital equipment, and inventory accumulation--is now at annual rate of more than 30 billion, double largest prewar years

Consumer expenditures now at annual rate of about 170 billion--2-1/2 times prewar maximum
- Expenditures for nondurable goods at over 100 billion are three times prewar
- Durable goods (other than housing) bought by consumers exceed 20 billion a year--more than double 1929

Foreign expenditures in this country are also large, showing an excess of about 8 billion over our purchases abroad. Some of this excess is included in Government expenditures

How can it be said that expenditures by any one group are responsible for inflation?

Combination of all exerts pressure on short supplies. Reduction in any one would relieve pressures, only if not offset by increase in some other expenditures

What groups are contributing to further expansion in incomes and current buying power?

Government, which was the origin of the inflationary development, is now receiving more than it is spending and is retiring debt.
- The wartime processes are being reversed
- Excess tax receipts over expenditures, together with proceeds from the continued sales of bonds to savers, are being used to retire Government securities held by Federal Reserve Banks
  - This is a multiple deflationary process

Businesses, on the other hand, which accumulated liquid assets during the war, are not only drawing on past accumulations but are borrowing from banks, as well as using retained earnings and borrowings from savers, to expand capital expenditures
- More will be said about this

Consumers individually are drawing on past savings and borrowing. Borrowings are reflected in growing consumer credit and home mortgages.

In the aggregate and on balance, they still are saving part of their current incomes

These net current savings, however, have declined sharply from wartime peak and in relation to current incomes compare closely with prewar averages

Individual savings, moreover, are being invested to a larger extent in homes and in business, than was true during the war, when they were largely accumulated in the form of liquid assets--cash, bank deposits, and Government securities.

Capital expenditures, taxes, and bank credit

Borrowing by businesses for capital expenditures and by individuals for housing and for consumption expenditures if obtained entirely from current savings by others would not add to inflationary pressures

Apparently, however, borrowing demands have exceeded the supply of savings available, and borrowers have had to rely on banks

Bank credit consequently has expanded rapidly

Loans by commercial banks to businesses, to consumers, and on real estate have expanded by 8 million dollars this year--mostly in the last half of the year.

Bank deposits, which were reduced by the Treasury surplus in the first quarter of the year, expanded rapidly in the other three quarters

Thus business and consumer borrowing has nullified the anti-inflationary effect of the Government surplus

Programs for dealing with current problems recently presented by some business groups would have the effect of increasing rather than decreasing inflationary pressures. They suggest that

(1) To increase production, business should expand plant and equipment, that is increase capital expenditures

(2) To provide funds other than through bank credit, taxes should be reduced, especially on business and on individuals receiving large incomes

(3) To prevent bank credit expansion, the Federal Reserve should bring about a rise in interest rates

The first of these planks sounds plausible, but it would be inflationary at this time to divest scarce resources to capital formation in order to expand production in the future. Overall production cannot be increased much because of basic scarcities. It would only be a question of building up prices and costs. It is also questionable business policy to expand capacity under existing ~~abnormal~~ conditions of abnormal demand and high prices. Better to wait until labor and materials are more abundant and demands more normal.

To reduce taxes in order to provide industry with funds for capital formation is thoroughly unwise

First it would reduce the ability of Government to exercise an anti-inflationary influence through using its surplus for retirement of Federal Reserve credit

Then it is doubtful whether this step would accomplish its avowed purpose, namely, make it unnecessary for business to borrow from banks

There is no assurance that persons receiving the tax reduction would invest in business, rather than increase expenditures

In any event, it would make possible an increase in overall expenditures, rather than bring about a desired decrease

Monetary and credit restrictions to combat inflation

Banks are able to supply credit in any amounts to business and consumer borrowers because they have large amounts of Government securities, which they can readily sell
(The same is true of insurance companies and other investors)

In the absence of other buyers, the Federal Reserve System purchases securities offered in order to maintain an orderly and stable market for the vast amount of Government securities outstanding

Federal Reserve purchases supply banks with additional reserves which can be multiplied into six times as many loans by the banking system

It has been suggested that inflationary credit expansion could be checked if the Federal Reserve would not buy Government securities. Such a policy is not feasible.

The System has a responsibility for maintaining an orderly market

Hundreds of millions of transactions weekly and often daily

Result of normal shift of funds, as well as investment and liquidation

Outside market not capable of handling

- Rise in interest rates also suggested
  - Questionable whether it would deter borrowing
  - Would demoralize market--fear of decline in bond prices would cause a wave of selling
  - Actually create more reserves
- Suggestions for these restrictive credit policies have come from some people, who at the same time recommend tax reduction to facilitate capital formation
  - Not consistent
  - Credit restriction can be effective, as an anti-inflationary measure, only if it restrains the use of credit by business
  - To restrict credit and at the same time provide business with funds to expand by reducing the Government's ability to pay off debt serves no useful purpose

Dilemma presents a difficult problem

- Bank credit expansion is clearly contributing to inflation by financing capital expenditures in excess of current savings
  - Resulting in further growth in money supply
  - Building up volume of debt that will have to be liquidated under less favorable conditions
  - Making possible long-term commitments at high cost that are based on abnormal demands
- Inevitable readjustment will be more severe because of these developments
- No satisfactory way of restricting credit expansion by available measures
  - Attempt would demoralize bond market
  - Might stimulate rather than check inflation
  - Cause subsequent collapse rather than moderate readjustment