April 26, 1946

MONETARY ASPECTS OF INFLATION

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April 26, 1946

Monetary Aspects of Inflation

Brief Outline

It has been said that price controls attack symptoms of inflation and not causes; that real cause is monetary expansion; that cure requires monetary contraction and increased production.

Increase in available buying power without corresponding increase in goods is basic cause of inflation -- an inevitable result of war.

Situation exists, however, and until production can be increased to much higher level, direct controls are necessary.

As a result of war finance, the public's holdings of deposits and currency are nearly three times prewar level and in addition large holdings of Government securities can be readily converted into cash.

Efforts should be made to prevent further expansion; to obtain some contraction; and to shift holdings into firmer investments.

Various measures can be adopted to accomplish these purposes:

1. Create a surplus in the Government's budget.
   Do not reduce taxes.
   Reduce expenditures as much as possible without impairing essential functions of Government.
   Expedite disposal of surplus property.

2. Retire public debt from existing balance, as well as from any surplus that may be obtained.

   Program is now in process. Over 20 billion dollars of debt could be retired this year.

   Will reduce bank deposits because most of maturing issues are held by banks.

   Also reduce bank reserves and, thereby require banks to sell some of their large holdings of Government securities.

3. Push sales of securities to genuine investors.

   Permit larger purchases of Series G bonds, which are redeemable on demand at lower rate and are not shiftable to banks.

   Use proceeds to retire bank holdings.

4. Take measures to prevent further monetization of debt and decline in long-term interest rates, without increasing short-term rates.

   Present differentials in rates encourage banks to sell short-term securities to Reserve Banks and buy longer-term issues.

   Creates additional bank reserves, which are expanded into six times as much credit.

   Possible measures of restriction:

   a. Debt retirement program is helpful, but not adequate.

   b. Discontinuance of purchases of short-term securities by Federal Reserve would raise interest rates.

   c. Need to require banks to hold certain amounts of short-term securities or limit their holdings of long-term securities.

      Done by understanding in England and Canada. Would require legislation here.

5. Centralization of foreign funds in U. S. in Federal Reserve Banks might be used to withdraw 2 or 3 billion dollars of reserve funds frommarket.

Other measures may be needed to discourage speculation in existing assets -- securities, real estate, etc.

1. Capital gains tax would have been best measure.

2. Some credit restrictions exist, especially in securities market.
   Others may be necessary.

3. Should not make credit any easier as is provided in Housing Bill.

4. Exhortation to buyers and lenders -- indicating excessive prices and dangers of future losses.

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Monetary Aspects of Inflation

Wartime monetary expansion

The basic cause of inflation is war, which necessitates large payments to businesses and individuals for producing goods that are not available for purchase.

Since it is practically impossible to raise taxes fast enough and far enough to cover these expenditures, individuals and businesses have excess incomes, which correspond to the amount of Government borrowing.

Some of this borrowing absorbs a part of this excess income, but much of it must be obtained from banks and provides the basis for an expansion in bank deposits and currency.

Figures are familiar --

Government raised 150 billion in taxes and borrowed 230 billion. The banking system provided approximately 100 billion. Not only the 130 billion borrowed from other sources but some part of that obtained from banks represents the investment of genuine savings.

Expansion of total deposits and currency has been to nearly three times the prewar level from 67 billion in June 1940 to 175 billion. Demand deposits and currency have grown from 39 billion to 126 billion (including 25 billion of temporary U. S. Government deposits). Considerably in excess of current needs on the basis of any past standards.

Value of the nation's total annual product has not quite doubled -- from 97 billion in 1940 to about 180 billion at present. Thus if turnover of existing money should increase to prewar standards there would need to be a considerable further increase in production or a rise in prices.

In addition there has been an increase of 80 billion dollars in individual and business holdings of Government securities, which can be readily converted into cash as long as the Federal Reserve stands ready to buy them at par.

General Methods of Controlling Inflation

A. Price controls and allocations --
It has been said that these attack symptoms not causes.
This is true but the basic cause -- the increased supply of liquid assets relative to the limited supply of goods -- already exists.

Until that relation can be changed or we can be assured that it will not operate toward inflation, direct controls are essential.

B. Increasing production --
Will no doubt be eventual solution.

But this is a time-consuming process.

Production of many items already close to capacity but still far short of demand.

Unless properly directed resources could be channeled into production of goods for which demand is transitory -- and create basis for later reaction.

Increasing production also results in increased current incomes and buying power.
Does not absorb past accumulations of buying power.

C. Monetary and fiscal measures to reduce money supply or prevent further expansion.

These measures will be discussed more fully.

Monetary and fiscal measures for control of inflation.

1. Create budgetary surpluses.

Since deficits were principal basic cause of inflation, surplus can be powerful anti-inflationary force.
Government would take more from incomes in taxes than it would pay out.
Could repay borrowings at banks and reduce deposits. (Discussed more fully later).

a. No further tax reduction.

Some increases in taxes would be desirable now, but not legislatively feasible.

Good anti-inflationary taxes are:
Capital gains tax
Excess profits tax

b. Government expenditures should be reduced as rapidly as possible and increased expenditures should be avoided.

Should not curtail essential services of Government needed to expedite production and control inflation, as well as for other purposes.

War expenditures at 1/3 of maximum seem to be still very large in view of reduction in armed forces to 1/3 of peak and no more need for munitions or for accumulating supplies.

Public works programs should be kept to minimum.

Bulk of rest of expenditures are for veterans aid, interest costs, social security, and international finance. Probably not much leeway in these.

c. Expedite disposal of surplus property.

Total estimated surplus property of 55 billion (including 10 billion of aircraft not salable and 15 billion overseas).

Only 18 billion had been declared surplus and 3 billion disposed of by March 31.
Although disposals in last quarter, at 1.2 billion, were more than double those of previous quarter, progress is still slow.
(See attached memorandum)

d. Liquidate credit and assets of Government lending agencies and corporations.

Most of these assets are being transferred to War Assets Corporation for liquidation.

Remaining credits are mostly long-term obligations that are being liquidated according to contract -- Land Banks, H.O.L.C., some of R.F.C. etc.

e. Provide for sale of surplus silver.

Would put funds in Treasury and also supply a scarce commodity.

About 200 million ounces of "free bullion" in Treasury not otherwise pledged.

Various bills in Congress -- probably most likely of passage provides for sale of free Treasury silver for industrial uses at 90 cents an ounce. (See attached memorandum).

f. Possible changes in social security.

Present system is already anti-inflationary in that current receipts exceed benefit payments by about 1 billion dollars a year.

Bring in other groups of participants and raise limit on taxable wages from $3,000 to $3,600 -- would at first increase ~~pay-roll~~ receipts more than benefit payments.

Could be made more deflationary by permitting payroll taxes for Old Age and Survivors Insurance to increase to the 4 per cent scheduled for 1943 and postponed. Considered by some as undesirable from long-run point of view, as present 2 per cent tax is sufficient to sustain system for 5 to 10 years, and pay-as-you-go basis is sounder policy as a general matter.

(See attached memorandum)

Monetary and fiscal measures for control of inflation (continued)

2. Retirement of Government Debt

Use of any surplus to retire public debt would be anti-inflationary because such a large portion of maturing debt is held by banks.
Would therefore reduce deposits.

Use of accumulated cash balance by Treasury to retire debt is also mildly restrictive.

Treasury has through May 1 retired 6.4 billion of marketable debt, in addition to 1.2 billion of excess profits tax refund bonds and over a billion of tax and savings notes.

It has sufficient cash balance to retire about 16 billion more of marketable issues during remainder of this year.

Distribution of the holdings of issues that have already been and might be retired is shown in table.

Distribution of Holdings of Marketable Debt Maturing in 1946

(In billions of dollars)

Holders	Already Retired March 1 - May 1	Possible Retirements* June - Dec.
Commercial banks	4.0	9.0
Federal Reserve Banks	1.2	2.5
Nonbank investors	1.2	4.5
Total	6.4	16.0

* Assumes retirement of about 40 per cent of all certificates and 90 per cent notes and of 100 per cent of other maturing notes and bonds. No change in Treasury bills.

2. <u>Retirement of Government Debt</u> (continued)

Commercial banks hold about three-fifths of total.

Withdrawal of deposits from banks to pay off debt held by banks has largely a bookkeeping effect.

Reduces bank assets and earnings and Treasury interest payments.

Retirement of Federal Reserve holdings reduces bank reserves and puts pressure on banks to liquidate credit.

Does not <u>force</u> liquidation because banks can sell securities to, or borrow from Federal Reserve, to replace reserves.

Retirement of holdings by nonbank investors tends to increase bank deposits, but it also increases required reserves and puts a little more pressure on banks.

Other investors would be in market for replacements and might purchase some of the securities that banks would need to sell to adjust reserve positions.

3. Push sales of securities to genuine savers.

Available savings should be attracted into firm investment.

Increase in amount of Series G bonds purchasable by one investor.

Bonds are redeemable at any time, but at lower rate of return if before maturity.

Not salable on market at guaranteed high rate.

Could not be sold to banks.

Proceeds of sales could be used to retire issues held by banks.

<u>Monetary and fiscal measures for control of inflation</u> (continued)

4. Limit further monetization of debt and reverse trend if possible.

Some expansion in bank holdings of Government securities and consequently in bank deposits was necessary during war.

Federal Reserve supplied banks with reserves needed to support this expansion by purchasing Government securities at established rates.

Stability of market and differentials in rates on long-term and short-term issues encouraged banks to sell short-term low-rate issues to Federal Reserve and to buy longer-term issues.

These shifts created new reserves, which provided basis for six-fold expansion in bank credit.

Preferential discount rate also encouraged banks to borrow at Reserve Banks to purchase or hold Government securities or to make loans to speculators in such securities.

Result of this process has been to stimulate creation of new money at a time when there is already an excess. It has also caused further sharp decline in long-term interest rates, reducing returns to genuine investors and investment institutions.

This process needs to be stopped, and if possible reversed.

Situation discussed in statement recently presented to a group of New York bankers. (Attached)

Various methods for checking monetization of debt.

a. Debt retirement program, already described, operates in that direction.

Banks can, however, still sell short-term securities to Federal Reserve, and buy longer-term issues.

b. Federal Reserve could stop buying short-term issues.

This would result in rise in short-term interest rates.

Increase interest cost to Treasury, which has to refund or retire 70 billion of maturing issues in next year.

Increase earnings of banks, which hold large part of short-dated debt and whose earnings are already large.

Commercial banks hold 32 billion and Federal Reserve Banks over 20 billion of issues maturing within one year.

Might run risk of upsetting market for Government securities, which with debt of 275 billion, is a factor of unprecedented importance in our financial structure.

c. Increase member bank reserve requirements and have Federal Reserve take over large part of debt as banks are forced to sell. Federal Reserve could hold these securities at some low interest rate.

Then let market rates adjust to whatever relationship would stop shifting of issues.

Under existing law could only make small increase in reserve requirements for New York and Chicago banks.

New legislative authority needed to be able to meet future contingencies.

Increase sufficient to accomplish purpose might need to be drastic.

Would meet with opposition from banks, because it would decrease their earnings and also the flexibility of their operations.

Federal Reserve could pay some interest on reserve balances to compensate for loss of earnings, if necessary.

d. Require banks to hold certain amounts of short-term Government securities.

Would prevent shifting and still maintain short-term rates at low levels.

Legislation necessary.

e. Limit amount of long-term assets banks may hold.

Canadians have done this by informal agreement.

Legislation would be necessary in this country.

5. . Centralization of all foreign official funds in U. S. market into Federal Reserve Banks would withdraw considerable reserves from market.

These funds now total about	3.9 billion.
With Federal Reserve Banks	.9 billion.
With commercial banks	1.0 billion
In Treasury obligations	2.0 billion.

Deposits with commercial banks may be largely working balances of operating agencies.

Amounts invested in Treasury securities give foreign governments and central banks a return on reserve funds.

These reserves could be withdrawn from our market.

If domestic banks had to adjust by selling securities to Reserve Banks, then we would receive return instead of foreigners.

(See attached memorandum for further details and discussion.)

Control of speculation in assets -- securities, urban real estate, farm land, etc.

Rising prices and widespread buying of existing assets is a usual accompanimentof inflation.

Especially stimulated at this time by --
Large volume of investable funds held in liquid form.
Low level of long-term interest rates.

Certain direct controls might be applied to restrict these tendencies:

1. Price ceilings -- difficult to apply.

2. Tax on capital gains from sale of assets held short period -- to discourage buying for speculative profits.
Should have been applied earlier.
Requires legislation.

3. Control over use of credit.
May be an important means of control in some circumstances.

Has effect not only of restricting buying of particular assets but also of preventing general increase in buying power resulting from credit expansion.
Also limits disastrous consequences of post-boom liquidation.

Not so effective in this situation because of large volume of liquid assets, permitting cash purchases with little credit.

Has been applied in stock market by imposition of 100 per cent margin requirement. Has no doubt reduced speculation in that market, although not eliminating it.
Has also prevented credit expansion and caused some contraction.

Restrictions on credit in real estate field.

May be necessary.

So far there has been no great expansion in use of credit.

But price and demand situation is favorable for some expansion.

Restrictions on credit in real estate field (continued)

Special inducements for use of credit should be avoided.

For example, as in Housing Bill now before Congress.

For more detailed discussion of real estate situation, see attached memorandum.

RECENT PROGRESS IN DISPOSING OF SURPLUS WAR PROPERTY

Disposals of Government surplus war property have increased substantially since the beginning of this year. During the first quarter of 1946, sales of domestic surpluses totaled over one billion dollars, which was more than double the sales volume in the final quarter of 1945. Sales in the January-March quarter included about 300 million dollars each of plants and industrial property, production equipment and materials, and consumer goods. The goal set for the second quarter of 1946 for producers equipment and consumer goods alone totals about $1\frac{1}{4}$ billion dollars.

Despite recent progress, total disposals through the middle of March amounted to only six per cent of the estimated aggregate surplus, and the total inventory of property declared surplus and not yet disposed of increased during the first three months of 1946 by nearly $4\frac{1}{2}$ billion dollars. As shown in the table, Government-owned war property costing nearly 55 billion dollars is expected eventually to be declared surplus and available for disposal. As of March 31, 1946, the latest available date, only 18 billion of this amount had been declared surplus and only 3 billion had been sold or otherwise disposed of, leaving nearly 37 billion still to be declared surplus and over 51 billion still to be declared surplus or disposed of.

Disposal of Surplus Property: Progress to Date and the Job Ahead
(on basis of original cost, in billions of dollars)

Class of surplus	Total Estimated surplus	Progress through Mar. 31 1946		The job ahead	
		Declarations	Disposals 1/	Declarations	Disposals 1/
Grand total	54.6	17.7	3.3	36.9	51.3
Domestic, excl. probably nonsalable aircraft	29.6	10.8	2.3	18.8	27.2
Plants and industrial real property	11.2	3.6	0.4	7.6	10.8
Production equipment & materials	6.0	2.5	0.6	3.5	5.4
Consumer goods	5.3	2.0	0.8	3.3	4.5
Other 2/	7.1	2.8	0.6	4.3	6.5
Probably nonsalable aircraft	9.9	4.7	0.2	5.2	9.7
Overseas surplus 3/	15.2	2.3	0.8	12.9	14.4

1/ Disposals include, in addition to property sold, donations, abandonments, salvage and transfers without reimbursement.

2/ Includes: salable aircraft, parts and components, airports, agricultural land, surplus in U.S. territories and possessions, community facilities, marine equipment, foodstuffs and other agricultural products, mineral and grazing lands, and housing.

3/ Figures for declarations and disposal of surpluses located overseas are approximate.

Source: Figures for total estimated surplus are taken from the latest quarterly progress report of the Surplus Property Administration. Figures on declarations and disposal through March 31, 1946 are from releases of the War Assets Administration.

The slowness with which surpluses are being channeled into the peacetime economy is probably in large part unavoidable, resulting as it does from such factors as the following: the statutory requirement that surpluses be offered to priority holders before being made available to the general public; the very limited personnel available for handling such an enormous selling job; the time-consuming preliminary inspection and subsequent paper work; the isolated or scattered location of much of the property; and the retarding effect on both policy and administrative decisions of constant criticism from pressure groups to which the disposal agencies are subject. In addition, disposal of certain types of surplus property is made particularly difficult by special problems peculiar to them; among these types are the 11 billion dollars of Government-owned war plants, the 15 billion of surpluses located in foreign countries, and the nearly 10 billion of probably nonsalable aircraft. Earlier bottlenecks arising from the separation of responsibility for policy-making and actual selling functions, the lack of sufficient authority to sell on the part of the chief operating agency's field offices, an inefficient procedure of taking up surplus items for disposal, and the time required for mere establishment of selling procedures and a sales organization, are now being removed. Consequently, as illustrated in the table, disposals are now being stepped up. As noted earlier, however, total inventories continue to advance faster than disposals.

Disposal of Salable Domestic Surpluses, by Quarters
(on basis of original cost, in millions of dollars)

Class of surplus	Volume disposed 1/ of				
	through Mar. 31, 1946	Jan. 1- March 31 1946	Oct. 1- Dec. 31 1945	July 1 - Sept. 30 1945	Cumulative through June 30, 1945
Total domestic, excl. nonsalable aircraft	2,330	1,168	482	147	534
Plants and industrial real property	392	267	90	8	27
Production equipment and materials	596	302	111	36	147
Consumer goods	775	308	141	63	263
Other 2/	567	291	140	40	97

1/ Largely by sale, but includes also donations, abandonments, salvage, and transfers without reimbursement.

2/ Includes: salable aircraft, parts and components, airports, agricultural land, surplus in U.S. territories and possessions, community facilities, marine equipment, foodstuffs and other agricultural products, mineral and grazing lands, and housing.

Source: Figures through 1945 are from the most recent quarterly progress report of the Surplus Property Administration. Figures for 1946 are from releases of the War Assets Administration and are probably preliminary.

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SALE OF TREASURY SILVER

The Silver Purchase Act of 1934 declared it to be the policy of the United States that the proportion of silver to gold in the monetary stocks of the United States should be increased with the ultimate objective of having and maintaining one-fourth of the monetary value of such stocks in silver. Whenever the proportion of silver in the stocks of gold and silver is less than one-fourth, the Secretary of the Treasury is directed to purchase silver at such times and upon such terms and conditions as he may deem reasonable and most advantageous to the public interest, but at a price not to exceed its monetary value. He is required to issue silver certificates in face amount not less than the cost of all silver purchased under the Act. With the approval of the President, the Secretary is authorized to regulate or prohibit the acquisition, importation, exportation, or transportation of silver and silver contracts. The President is authorized, at his discretion, to require the delivery to the United States mints of any or all silver, in return for which shall be paid the monetary value of such silver in any form of United States coin or currency desired (less mint charges), provided that such value is not less than the market price of silver over a reasonable period previous to the date of the order.

During the period from the enactment of this legislation until our entry into the war a considerable amount of silver was purchased from time to time at varying prices by the Treasury Department. During the war period, however, very little silver was purchased by the Treasury, leaving most of the available silver for use in essential war industries with the War Production Board directing the distribution of the supply. The use of silver for essential war needs was apparently so large that it was impossible to meet the requirements from purchases abroad and from the newly mined domestic supply since the Treasury loaned 878 million ounces of its stock to the Defense Plants Corporation of the Reconstruction Finance Corporation. Under the Green Act of July 12, 1943 (which expired December 31, 1945) part of the Treasury stock of free silver was sold to essential industry.

On April 22, 1946, United States stocks of silver at the Treasury Department amounted to 1,989,000,000 ounces. Of this total, 1,729,000,000 ounces were held as security for silver certificates and the balance of 260 million ounces were in the general fund. Of the 260 million ounces in the general fund, 227 million were reported as "free bullion" and a portion of this free silver may be on loan to the Defense Plants Corporation since the Treasury statement footnotes this as one of the items from which the silver loan was made, the other item being the bullion backing the silver certificates.

There are several bills now pending before Congress directing the Treasury Department to sell its holdings of free silver bullion to the industry. The Green Bill now before the Banking and Currency Committee of the Senate stipulates that the Treasury's free silver bullion be sold to the industry at 71.11 cents per ounce. A similar bill has already been passed by the House. Senator McCarran of Nevada introduced a bill in December 1945 which called for the sale of the Treasury silver to the industry at $1.29 an ounce, and also stipulated that this price be paid for domestically mined silver. A compromise bill calling for $1.03 an ounce was put before the Senate Banking and Currency Committee by Senator McCarran. It is expected, however, that compromise legislation in the form of an appropriations rider will authorize the sale of free Treasury silver for industrial use at 90 cents an ounce. Under the terms of this rider the Treasury would be authorized to sell silver for two years at 90 cents an ounce and at $1.29 an ounce thereafter. In any case, not more than 227 million ounces of free Treasury silver would be available for sale to the industry.

The sale of this silver to the industry would, of course, be deflationary since it would reduce the amount of funds available to individuals and corporations and would build up Treasury funds that might possibly be used to retire debt. It would also reduce the amount of silver available to the Treasury as security for additional silver certificates.

GOVERNMENT CORPORATIONS AND CREDIT AGENCIES

One possibility to consider in an anti-inflationary program is liquidation of assets of Government corporations and credit agencies and the use of funds to retire public debt. A brief survey of these assets indicates, however, that the problem is largely one of terminating wartime activities and disposing of property acquired for war purposes. Loans of Government credit agencies have generally declined during the war period, except in a few lines.

Assets of these corporations and agencies totaled 33.8 billion dollars on December 31, 1945, according to the latest figures published by the Treasury Department shown in the table. The tremendous growth during the war period -- 19 billion -- was largely in corporations with war related activities; hence the major portion of the liquidation problem will be limited to a small number of agencies.

Principal Assets and Government Corporations and Credit Agencies
December 31, 1941 and 1945
(In millions of dollars)

	1945	1941 1/
Cash	925	496
Investments		
U. S. Government securities, direct and guaranteed	1,683	999
Other	325	726
Loans	5,290	8,487
Land, structures, and equipment	21,017	
Commodities, supplies, and materials	2,288	
Undistributed charges	472	2/ 3,952
Other assets	1,844	
Total assets, excluding interagency items	33,844	14,660

1/ All items are shown on a gross basis, i.e., before reserves for losses, and are therefore not entirely comparable with figures for 1945, which are shown net of reserves.
2/ Similar details not available.

At the end of 1945 about 21 billion dollars, or 2/3 of the total assets of all Government corporations and credit agencies represented land, structures, and equipment, a substantial proportion of which may eventually be declared surplus war property. Major owners of this property are: U. S. Maritime Commission and War Shipping Administration, 11.2 billion, largely ships, and Reconstruction Finance Corporation (largely war affiliates), 6.9 billion, principally industrial plant and equipment. Among peacetime agencies the largest investment was about 3/4 billion of the Tennessee Valley Authority.

Government corporations held some 2.3 billion dollars of commodities, supplies, and materials, which for the most part will be offered for sale. About half of this represents holdings of the Reconstruction Finance Corporation and consists of commodities acquired for strategic and other war purposes; about half is owned by the Commodity Credit Corporation in connection with its various programs. The liquidation of these assets is a part of the broad problem of terminating war activities, and declaring and disposing of surplus property. About 90 per cent of the sales of surplus war property are being handled by the War Assets Administration.

The principal other type of asset of Government corporations and credit agencies is their loans. These totaled 5.3 billion dollars at the end of 1945, compared with 8.5 billion at the end of 1941.

About 2/3 of the outstanding loans at the beginning of the war, as shown in the table, reflected emergency financing of the depression years, largely for financial institutions and for owners of farms and homes. Liquidation of such loans had been in process for some time before the war; liquidation continued during the war mainly because of the ample funds for debt reduction.

Outstanding Loans of Government Corporations and Credit Agencies
December 31, 1941 and 1945
(In millions of dollars)

	1945 1/	1941	Decrease(-) or increase (+), 1941 to 1945
Home Owners' Loan Corporation	852	1,777	-925
Other home mortgage agencies	527	865	-338
Federal land banks and Federal Farm Mortgage Corporation	1,330	2,361	-1,031
Other agricultural credit agencies	666	837	-171
Reconstruction Finance Corporation			
Loan to the United Kingdom	271	-	+271
Loans to industrial and commercial businesses			
For war purposes	194	106	+ 88
Other	145	110	+ 35
All other (largely emergency financing of the 1930's)	380	1,217	-837
Farm Security Administration	2/ 467	467	0
Rural Electrification Administration	407	323	+ 84
Export Import Bank	252	139	+113
All other	237	285	- 48
Total, excluding interagency items	5,728	8,487	-2,759

1/ Adjusted to a gross basis, i.e., before reserves for losses.
2/ Not entirely comparable with earlier data.

Liquidation of the Home Owners' Loan Corporation is proceeding ahead of schedule set by law, and by December 31, 1945, outstanding home mortgage loans of that agency had declined to 850 million dollars, compared with their peak of 3.1 billion dollars in 1936. Recent legislation amending the farm credit system liberalized the lending authority of the Federal land banks, and this is expected to make unnecessary any further lending activity on the part of the Federal Farm Mortgage Corporation. Farm mortgage loans made largely during the depression years and held by the Federal land banks and the Federal Farm Mortgage Corporation declined more than 1 billion dollars from 1941 to 1945. The Reconstruction Finance Corporation has also continued to liquidate its loans acquired during the early 1930's; the volume still outstanding at the 1945 year-end was about 1/3 that at the beginning of the war.

The need for lending activities of certain agencies will continue -- and may even increase -- in the postwar period. Some of this will appear among home mortgage agencies as progress is made in meeting the acute housing shortage, and some will appear in such activities as development of small business, the extension of the use of electricity in rural areas, and loans abroad for reconstruction purposes. The Reconstruction Finance Corporation is encouraging small business activities through a guaranteed loan program. Actually, however, the agency's loans for other than war purposes increased only 110 million dollars from August 31, 1945, to February 28, 1946. The war brought to a halt major extensions of rural electrification, but in recent months Rural Electrification Administration loans have been increasing; as additional materials for further expansion become available, these loans will increase still further. Outstanding loans of the Export-Import Bank had increased to about 1/4 billion dollars at the end of 1945, and the Bank has outstanding commitments for a much larger total.

April 23, 1946

SOCIAL SECURITY AND INFLATION

We are attaching a memorandum on the current social security situation, and also a report by Mr. Stettner which appeared in last week's current comments.

The relation of social security policy to current inflation controls is as follows:

(1) The social security system as it currently stands is on balance a deflationary factor.

The old-age insurance system (OASI) is financed by a pay roll tax of 2 per cent on the first $3,000 of wages of covered workers. The contribution is divided equally between employers and employees. The combined rate was scheduled to increase to 4 per cent in 1943 and to 6 per cent in 1949, but the scheduled increases were postponed. Benefit payments are now running at an annual rate of 300 million dollars, while the receipts from the OASI pay roll tax run at about 1.3 billion dollars, so that under current conditions the annual addition to the OASI fund (which now stands at 7.3 billion) amounts to about 1 billion. To this extent, securities are being absorbed in the trust fund which otherwise might be held by the public or the banking system. 1/

The present unemployment compensation program is financed by a pay roll tax of 3 per cent (subject to reduction by experience rating) payable by the employer. Collections are now at an annual rate of over 1 billion while disbursements are somewhat higher. The trust fund now stands at 6.8 billion. Whether, and by how much, it will decline depends on developments.

(2) The deflationary effects of the social security system could, of course, be increased greatly if pay roll taxes were raised without a corresponding increase in benefits, thus leading to greater accumulations in the reserve funds. However, this would be undesirable from the point of view of long-run

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1/ The result depends on whether the surplus of pay roll tax receipts is used to redeem outstanding debt or as a substitute for debt addition which otherwise might have been needed. In either case the effect is deflationary.

social security policy, which should tend towards a pay-as-you-go system, avoid excessive reserve accumulations, and be based on pay roll tax receipts as well as a contribution from general revenues. The present OASI rates are adequate to sustain the system for 5 or 10 years, at which time it will be preferable to rely on some general contribution rather than to raise pay roll rates. If the present situation calls for tax increases, they should be undertaken in an area where they do not handicap the sound long-run development of social security.

(3) Various amendments in the social security system now under consideration are considered briefly with respect to their bearing upon the inflation problem:

(a) The Social Security Board does not propose comprehensive expansion of the system at this moment. It recommends, however, that the coverage under OASI be expanded to include all gainful workers, including the self-employed. If we assume that this would mean an increase in both pay roll receipts and benefit payments at about the same ratio applicable to those already covered, some increase in the rate of fund accumulation would result. Under expanded coverage the annual increase in the fund might reach 1.5 billion dollars as against the 1 billion dollars under the present system. The net effects would thus tend to be deflationary. Also, the Social Security Board recommends raising the limit on taxable wages from $3,000 to $3,600 and extending certain additional benefits, such as somewhat liberalized old-age payments and permanent disability, which probably would tend to balance out.

(b) A health insurance program is now considered by Congress. The Bill, itself, contains no financing provisions. The authors of the Bill chose this strategy because otherwise it would have been necessary to submit the Bill to the Ways and Means Committee where it would have been throttled. However, if the health insurance bill were passed, some financing provision would obviously have to be made, probably a 3 per cent pay roll tax as contemplated for the rather similar health insurance provision under the Wagner-Murray-Dingell Bill. With such a tax the Health Bill is not likely to be deflationary, except perhaps initially when facilities are not yet available and benefit payments would lag.

(c) The Ways and Means Committee is currently holding hearings on social security amendments as proposed in a staff report prepared for the Committee. The major change under consideration is the extension of OASI coverage. Health insurance is not being considered and the other provisions are mostly administrative, with little bearing on the inflation problem. However, it is not expected that the Committee will recommend an increase in present OASI pay roll tax rates as current rates are sufficient to finance the OASI for at least a 5-year period.

Attachments

5

April 26, 1946

Extract from Address by Chairman Eccles at
the Ninth Annual Reunion Conference of the
Graduate School of Banking, New York City, April 6, 1946

So far as the present inflationary dangers are concerned, it should be of deep concern to the banking community to help in stopping and reversing the process by which the commercial banking system creates more and more money through purchase of Government securities, that is, the process of further monetization of the public debt. To halt and reverse this trend requires not only a balanced budget, but a badgetary surplus and continued sale of savings bonds to the general public, using the proceeds both from the surplus and the savings to pay off Government obligations held by the commercial banking system. It would also be helpful if ways could be found to bring about the sale to nonbank investors of some of the longer term Government securities held by the commercial banks.

Too much of the public debt has already been financed by the commercial banking system. The excessively low yields on Government securities is due to the intense competition by the banks to add to their holdings of longer-term, higher-coupon securities. They continue to sell their shorter-term securities to the Federal Reserve Banks and with the reserves thus created, the banking system as a whole is enabled to purchase six times that amount. In a word, the market today is largely made by the commercial banks.

This process of shifting from the shorter to the longer-term securities cannot be stopped unless the shorter-term rates are permitted to increase until the shifting is no longer profitable, or unless Congress is willing to give the Federal Reserve adequate authority to deal with the situation. The first method, that of increasing the shorter-term rates, would be ill-advised as it would increase the cost to the Treasury of carrying the debt, thus adding to bank earnings which are already very large.

The way banks in this country have been permitted to buy Government securities of their own choosing is in sharp contrast to British and Canadian methods of debt management. Those countries have determined the amount of bank credit they would use and the rate they would pay. They have confined their bank borrowings to short-term paper at what, I understand, is a 5/8ths rate, and prohibited banks' owning other Government securities except as related to savings funds.

Until some adequate control can be exercised over the amount and kind of Government securities our commercial banking system can hold, it would be inadvisable to make available to the market for the purpose of absorbing surplus money additional long-term securities, even though they are not eligible for banks to buy, because the eligible securities held outside of the banks would in all probability be sold to the banks and the proceeds used to purchase the higher yielding new issues from the Treasury. Even though the funds thus obtained by the Government were used to pay off short-term maturing debt largely held by the banks, the banks would be likely to replace through market purchases the amount that was paid off. Hence, nothing would be accomplished towards halting the monetization of the debt and reducing the money supply.

We must not shut our eyes to the realities of the situation as I have outlined it if we expect to stop a further decline in the long-term interest rate, or to bring about an improvement in the rate more in line with the longest term 2-1/2 per cent rate being paid by the Government on the last market issue. A serious by-product of the increasingly low long-term rate is to intensify inflationary forces, particularly in the field of capital assets such as in the stock market as well as in the entire real estate field, including homes, farms and business properties. The low rate also discourages savings and has a serious impact on all insurance, pension and savings funds.

April 26, 1946

POSSIBLE REDUCTION OF MEMBER BANK RESERVES THROUGH TRANSFER OF FOREIGN OFFICIAL FUNDS TO DEPOSIT WITH FEDERAL RESERVE BANK OF NEW YORK

At the end of 1945 foreign official funds in the United States amounted to $3,865 million, of which $860 million were held on deposit with the Federal Reserve Bank of New York. Of the remainder $1,955 million was invested in United States Treasury obligations and $1,050 million was held on deposit at various commercial banks, mainly in the New York market. The largest holders of Treasury obligations and market balances were as follows:

Country	Total	Treasury obligations	Accounts with commercial banks
	(In millions of dollars)		
Canada	1,125	1,115	10
China	568	441	127
Norway	162	144	18
Brazil	134	4	130
Sweden	124	111	13
Netherlands East Indies	102	67	35
France	87	—	87
Netherlands	57	—	57
	2,359	1,882	477
All other	646	73	573
Total	3,005	1,955	1,050

The entire $1,955 million of Treasury obligations could be allowed to run off and the proceeds put on deposit with the Federal Reserve Banks. If the obligations were paid off by drafts on the Treasury accounts with the commercial banks or with tax revenues, member bank reserves would be correspondingly reduced.

The $1,050 million of accounts with commercial banks could not be transferred in their entirety to the Federal Reserve Banks. It is necessary to bear in mind that (1) some of these accounts are those of central banks which combine commercial with central banking business and some are accounts of purchasing missions or other Government agencies. The New York Bank is not fully equipped to handle accounts that are utilized actively for small transactions, letters of credit, remittances, etc.; (2) a number of foreign central banks and Governments desire to maintain their standing as good customers of commercial banks because they hope, as opportunity offers, to obtain credits from them. Hence they feel it is advantageous to maintain as large deposits with them as they can. If weight is given to these two considerations it is evident that serious inconvenience would be caused if some of the $1,050 million of balances in the market were not retained in commercial banks.

In addition to Treasury obligations and official accounts in the market, there was a substantial amount of private short-term assets which might be requisitioned. At the end of the year private short-term assets amounted to $2,700 million and private holdings of long-term securities are estimated to have been $3,600 million. In general, however, it may be said with regard to these private assets that the countries which are requisitioning them are doing so for the purpose of meeting urgent needs and that no country would requisition the bank deposits and investments of its private citizens merely for the purpose of holding the proceeds on official deposit with the Federal Reserve Bank.

April 26, 1946

WHAT CAN BE DONE ABOUT REAL ESTATE VALUES

B.A.E. has come to the conclusion that the farm land value problem can not be treated separately from the urban problem. For that reason, and because the measures required are of essentially the same types, the possible courses of action are listed below without distinction as to farm or urban real estate.

1. Exhortation

Efforts might be made to bring before each prospective purchaser the information concerning present prices of real estate and the great risk involved in most purchases at the present time. No such program would be worth while, however, unless all available governmental and private resources were to participate energetically. The Federal Reserve System should be ready to carry such a program to each member bank.

2. Legislative

The following measurew might be recommended to the Congress but it is not believed that the necessary legislation could be passed.

a) Modification of preferential treatment accorded capital gains in the Federal income tax. At present only 50 per cent of the gain from the sale of capital assets held six months or more is taxable, and the tax cannot exceed 50 per cent of such taxable gain. Capital gains might be treated as ordinary income, or the six months' period in which capital gains are treated as ordinary income might be extended.

b) A special tax on profits from resale of real estate, with the tax rate decreasing the longer the property is held.

3. Executive action

a) The extension of credit might be regulated under executive order. A heavy down payment of cash, say of 60 per cent of the value of the property, could be required. The terms on which loans are granted could also be made more stringent.

b) Veterans Administration could tighten their measures to protect veterans from borrowing to buy houses at excessive prices.

April 26, 1946

RESIDENTIAL REAL ESTATE

Increase in prices

Between the spring of 1940 and February 1946, the price of houses and of land for building rose, on the average, a little over 60 per cent. Since the end of the war, the rise in prices has been more rapid, averaging, between September 1945 and February 1946, about 17 per cent for houses and 23 per cent for building land.

In general, the greatest increase in house prices has been for those houses which were valued before the war at under $6,000. There are also marked regional differences -- the greatest increases are found in those areas which rapidly gained population during the war.

Significant details are shown in Table I, and footnotes to the table indicate how the survey was conducted.*

Reasons for the increase in prices

The increase in prices reflects the fact that during the war the amount of new building and conversion of existing structures was not sufficient to meet the demand for housing. Since September 1945 the rapid demobilization of the armed forces has resulted in the formation or reestablishment of families at a more rapid rate, and in the attempt of many families to adjust their housing accommodations to family composition. The rapid removal of controls on building in October 1945 brought many would-be buyers into the market in anticipation of an easier supply, and also encouraged builders and others to compete for land and materials thus raising costs and providing a talking point to justify higher prices for existing houses. Amendment, at the end of December 1945, of the Servicemen's Readjustment Act of 1944, and the presence of more and more veterans to take advantage of it, probably also added to the pressure on prices early this year. Speculative buying for resale has been reported in numerous instances, but it is hard to tell how far this has gone as yet. All of these influences have been added to the effects of the growth in number of families, the rise in family incomes, and the migration of population which took place during the war.

Prospects

Prices of houses cannot continue to increase indefinitely at the rate of between 4 and 5 per cent of 1940 prices per month. But it seems likely that the advance will continue for some months at least and for a time will be stimulated by a growing volume of speculative buying. Prices are already high. If incomes continue stabilized at recent levels, further increases in the price of houses will reduce the size of the market. Eventually a collapse in the housing market is to be expected.

* Not yet available.

Special problems in the housing market

Special problems are created in the housing market by the price disparities that have developed. The prices for old houses, which are subject to no form of control, have advanced 60 per cent on the average since before the war; costs of new houses, which are subject to partial but not wholly effective control, have increased roughly 50 per cent, including cost of the lot; the rent on old houses, subject to strict OPA control, has risen very little; the rent on new houses has been less rigidly controlled and is believed to have been adjusted in some measure to the rising costs of building.

To a considerable extent the inducement to build new houses depends upon the price of comparable old houses. If old houses are high in price there is a strong tendency for the costs of new houses to rise to that level, the nature and structure of the building industry being such that contractors and others tend to charge "what the market will bear".

Under these conditions any advance from current levels in the prices of existing houses, which are not subject to control, will increase the difficulty of holding down the costs and prices of new houses.

If price stabilization in residential building is to be successful, therefore, it is important that the advance in the prices of old houses be halted. Unless this is done, an increasing volume of indebtedness will be created on the basis of unsound values, prices of new houses will inevitably rise -- as they may anyway -- to a level at which the market for such houses will dry up, as in 1920; and the collapse, when it comes, will be more serious than if it occurred earlier and at a lower price level.

TABLE I

CHANGE IN PRICES OF SINGLE-FAMILY HOUSES

City and value class in Spring 1940	(Index, Spring 1940 = 100) Spring 1940	September 1945	February 1946	Increase, September 1945 - February 1946 Points in index	Per cent
All cities					
Under $6,000	100	140	165	25	18
$6,000-$12,000	100	137	157	20	15
Cities in selected regions					
Under $6,000					
New England	100	131	150	19	15
South Atlantic	100	144	170	26	19
West South Central	100	150	177	27	18
Mountain	100	151	168	17	11
Pacific	100	165	196	31	19
$6,000-$12,000					
New England	100	129	149	20	15
South Atlantic	100	146	161	15	10
West South Central	100	141	162	21	15
Mountain	100	146	162	16	11
Pacific	100	160	187	27	17

Note: The data shown in the table were obtained by the National Housing Agency in answer to questions sent in the latter half of March to the presidents of the Federal Home Loan Banks, the regional managers of the Home Owners' Loan Corporation, the insuring offices of the Federal Housing Administration, and the regional expediters of the Office of the Administrator of the National Housing Agency. The data shown are averages of the replies received, after the extremes, whether high or low, were eliminated.

April 26, 1946

FARM LAND VALUES

Indications of Inflationary Developments in the Land Market.

Farm land prices have risen rapidly during the war period and are now at very high levels.

1. Land values were 69 per cent higher on March 1, 1946 than on March 1, 1940; at the peak in 1920 they were 65 per cent above 1914.

2. In seven states land values on March 1, 1946 were more than 90 per cent above the 1940 level.

3. In the Census divisions of the East South Central states (Kentucky, Tennessee, Alabama, Mississippi) land values on March 1 were 89 per cent above 1940; and in the Pacific state 80 per cent.

4. On March 1, 1946 land values were above the 1919 level and within 16 per cent of the peak reached in 1920.

5. Land values in 15 states on March 1, 1946 were above the 1920 level.

6. It is estimated by the Bureau of Agricultural Economics and the Farm Credit Administration that land values in many areas are above levels that can be maintained in the longer period. Such estimates take into account probable farm income and mortgage interest rates.

The rate of advance seems to be increasing.

1. The 13 per cent increase in the year just ended was exceeded only twice in the 35 years of record. From March 1943 to March 1944 the increase was 15 per cent; in 1919-1920 it was 21 per cent.

2. The rate of increase in the four months ending last March was greater than in the preceding eight months.

The volume of voluntary sales is very high.

1. Voluntary sales (i.e., excluding foreclosure and related types of sales) in the 12 months ending March 1946 were above those of the preceding year, although slightly below 1943 -- the highest year on record.

2. The greatest increase in volume of sales was in the East South Central states.

Reselling after a limited period of ownership is increasing.

1. In 1945 about 1/7 of all farms sold had been held under two years, compared with 1/8 in 1944.

2. In the Western Region (Pacific and Mountain states) resales of farms held under two years made up 1/5 of all sales.

The financial situation in agriculture is less favorable than the war-time decline in aggregate farm indebtedness suggests.

1. The total farm mortgage debt decreased from about 6.5 billion dollars in 1940 to 5.3 billion in 1945. This was a result of large repayments rather than a curtailment in new mortgages, since farm mortgage recordings increased from about 3/4 billion in 1940 to slightly over 1 billion in 1945. The rate of decline in farm mortgage debt has leveled off and the figures for the beginning of 1946 may show an increase. It should be remembered that usually a different group of farmers make new debts than repay old ones.

2. It is estimated that some 48 per cent of the farms sold as complete units were paid for entirely in cash in 1945, compared with about 46 per cent in 1944 and 44 per cent in 1943. The limited data in the first world war indicate only 10 per cent cash sales in Iowa and about 20 per cent in Kentucky.

3. One-third of all credit-financed sales of farm properties in 1945 were encumbered to 75 per cent or more of the selling price; three-fourths were encumbered to 50 per cent.

4. The average encumberance was 58 per cent of the selling price. On the average, this would approximate the full value of the property in 1940.

5. Commercial banks and individuals have been of increasing importance in financing farm sales.

LENDERS FINANCING FARM SALES

Lender	Percent of sales financed 1943	1944	1945
Individuals	44	45	47
Commercial banks	16	21	23
Insurance companies	13	12	10
Land banks	13	12	10
Others	14	10	10

The period of greatest danger is in the months ahead.

1. The period of greatest activity in the land market is from November to March. The November to March period in 1946-47 may correspond to the November to March period of 1919-20 when prices rose the greatest amount.

2. So long as the general inflationary situation continues a high level of farm income will be maintained and optimism will prevail. This seems likely to last through the coming winter at least.

3. Machinery and labor are becoming more available, increasing the incentive to expand holdings, and making it possible for new operators to become farmers if they can secure land.

4. Farmers and others have large amounts of savings and the patriotic urge to purchase bonds is not as strong as it was during the war. There is ample credit available.

5. Veterans are returning to farms with large supplies of credit available for farm purchases. Farm loans under the guarantee privilege totaled about $10 million from January 1, 1945 to April 12, 1946, with nearly the maximum of 50 per cent being guaranteed. About 7 3/4 million (estimated) of these loans were made from March 16 to April 12, 1946; this compares with some $90 - $110 million of farm mortgages recorded by all lenders in that period. Not all of the veterans loans were used to purchase land, however.

April 26, 1946

EXTENT AND EFFECTIVENESS OF EXPORT CONTROL

Control of United States exports is authorized by Section 6 of the Act of July 2, 1940 (54 Stat. 714), "An Act to expedite the strengthening of the national defense." Section 6 has been continued in effect by subsequent Acts until June 30, 1946. On April 12, the Senate passed S. 1980 to extend operation of the Section until June 30, 1947. This legislation has been referred by the House to the Military Affairs Committee.

Administration[1/] of export control now rests with the Requirements and Supply Branch of the Commerce Department's Office of International Trade. Mr. John C. Borton, Director of that Branch, described an important change in export control procedure in the following words:

> "September 10th saw a complete reversal in the general procedures for export control. The system of listing those commodities which might be freely exported was replaced by the Positive List which enumerates those commodities for which specific export license is required, all others being free of controls.
>
> "The Positive List includes only about 20% of the items formerly under export control. This list was agreed to by CPA and a few of the items were included at the instance of OPA. Since September 10th, the list has been revised several times. The original assumption that it would be progressively shortened has not proved altogether correct. Some commodities initially listed have been dropped, but a good many others have been added. There is a certain amount of pressure at all times to add commodities to the list. Congress has from time to time shown a lively interest in such additions."

While the number of items controlled is a somewhat unsatisfactory indicator of the extent and effectiveness of current export control operations, it is apparently the only available measurement. Mr. John Garrett, Chief of the Programs Coordination Staff of the Requirements and Supply Branch, states that the organization has no estimate of the comparative values of controlled and uncontrolled exports; he expressed the opinion that the proportion of controlled exports to free exports might be roughly

1/ For an account of the policy-making hierarchy in this field, see attached memorandum of March 7, 1946.

the same as that of the number of items on the Positive List to the total number of export items — roughly 20 per cent. Lack of more accurate information was explained by the fact that the focus of attention was more frequently on tonnage data than on value figures.

Mr. Garrett explained the operating procedure of the Branch in the granting of export licenses. For practically every item on the Positive List there is a more or less formal "quota" of exports to be permitted in a given period. These quotas are of four types. Group "A" includes formal quotas assigned by the Department of Agriculture (for agricultural products) and the Civilian Production Administration. In this group, careful records of licenses granted are kept for comparison with the assigned quotas. Group "B" quotas are set by industry groups of the C.P.A., but operations under these quotas are less formal and no records are kept. Mr. Garrett estimated that perhaps 25 per cent of the licenses currently granted were for items exported within these quotas. Group "C" quotas are still less formal; the agency licenses exports in a given quarter to a value or volume related to exports in the previous quarter. Group "D" quotas are undoubtedly misnamed; exports of items in this group are permitted or curtailed on the basis of the judgment of commodity experts as to the reasonableness of the relationship being maintained between domestic and foreign sales.

In addition, it should be pointed out, the licensing operation provides an opportunity for checking selling prices of exported commodities against O.P.A. ceilings.

Attachment