Strictly Confidential

Controlling the Inflation of Capital Values

Summary of Statement Made
by
Chairman Eccles
Board of Governors, Federal Reserve System

The conference at which this statement was made was called by Judge Vinson on August 26, 1943, to discuss a possible executive order directing the application of credit controls to prevent an inflation of capital values.

The following were present at the meeting:

Judge Vinson	Director of Stabilization
Daniel W. Bell	Under-Secretary, U. S. Treasury
John B. Blanford, Jr.	Administrator, National Housing Agency
James F. Brownley	Deputy Administrator, Office of Price Administration
Benjamin V. Cohen	General Counsel, Office of the Director of War Mobilization
Leo T. Crowley	Chairman, Federal Deposit Insurance Corporation
Marriner S. Eccles	Chairman, Board of Governors of the Federal Reserve System
George C. Haas	Director of the Division of Research and Statistics, U. S. Treasury
Ganson Purcell	Chairman, Securities and Exchange Commission
Harold D. Smith	Director, Bureau of the Budget
James Twohy	Governor, Home Loan Bank System
Claude R. Wickard	Secretary of Agriculture

The prevention of an undue rise in capital values during the war and in the immediate post-war period is a proper part of the stabilization program. To date the rise in capital values has not been excessive but the dangers of a potential inflationary development become increasingly apparent. A preventive policy is thus called for. This policy should be directed squarely at the source of a potential inflation of values, that is, short-term transactions undertaken to capitalize on temporary wartime profits or to hedge against inflation. A policy must be devised which will discourage all transactions of this kind whether they be financed by cash or credit. This objective is met most effectively 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 higher the shorter the period of holding.

There follows a more detailed statement of the reasons why a heavy tax of this type should be imposed now as the basic step in the control of capital inflation.

1. A tax on profits derived from the resale of capital assets would apply comprehensively to all purchases, however financed. It would be equally effective with respect to cash or credit transactions. This is of crucial importance since a drastic inflation of capital values might result even though credit were expanded little. Due to extensive reliance on borrowing from commercial banks the financing of our war effort has led to an enormous increase in the liquidity of individuals and corporations. Deposits and currency in the hands of the public now amount to over $100 billion and, should the war continue for two years, may well reach 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 purchased on a voluntary basis, are highly liquid and may be presented to the Treasury for redemption at any time. Should the holders of these balances, individuals and corporations, decide to purchase capital assets as inflation hedges, a boom in capital values might result which could in no way be controlled by credit restrictions, however tight. Hence, all purchases, cash as well as credit, must be made subject to control. For this purpose we need not develop elaborate controls which would check each individual transaction. A heavy tax on the profits from capital transactions would do the job more effectively and more simply.

Certain difficulties which arise from an inflation of capital values based on credit expansion -- e.g., the debtors' default in meeting their obligations and its effect upon the position of the creditors -- are absent if the inflation has been financed largely by cash purchases. However, the maladjustments in the post-war economy to which a distortion of capital values would give rise would remain most serious in either case. We must therefore be protected against an inflation in capital values based on either type of financing.

2. Whereas cash balances have expanded enormously and promise to increase further, credit has contracted in most areas and has expanded but slightly in others. <u>In short, there are no signs to date of credit inflation for purposes of speculation in capital values</u>.

a. In the field of <u>farm real estate</u> 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. At the beginning of this year it stood at $6,350 million, that is $1 billion below its 1935-1939 level or $4,400 million below its peak in 1922. This decline which has continued during the first half of the year 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 while total indebtedness in certain areas has gone up markedly, it is evident that the behavior of farm credit as a whole stands in drastic contrast to its spectacular increase during World War I.

b. Although the present level of <u>common stock</u> prices is nearly 50 per cent above the 1942 average, it has not yet reached the 1939 peak. Compared with corporate earnings (after) tax) present prices are far from excessive, particularly if viewed in relation to the low level of money rates. Investors now have shown little indication to borrow at a rate of 1 per cent to purchase securities carrying an investment yield of about 5 per cent, whereas in the late 1920's they found it profitable, because of rising capital values, to borrow at a rate of over 8 per cent in order to purchase securities carrying a rate of 3 per cent or less.

Such expansion in credit as has occurred has been 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. <u>Non-farm real estate</u> 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 construction has slowed down now while repayment of mortgages is increasing. As a result total mortgages outstanding are likely to decline in 1943.

If a heavy tax on profits derived from capital transactions were imposed, any marked change in the picture in the direction of credit expansion would be very unlikely. Rather, we should expect an accentuation of the present tendencies for credit to contract. If indications of credit inflation should develop, notwithstanding the retarding effects of a tax on capital profits, it will then be necessary to tighten credit in those areas in which the danger arises. In particular, the terms granted by Government credit agencies should be tightened.

3. <u>A tax on profits derived from the resale of capital assets will drastically discourage speculative transactions but interfere little with legitimate purchases</u>.

In controlling capital transactions a distinction should be drawn between transactions of a speculative kind and others which are economically sound. It would be undesirable, for instance, to interfere with such transactions 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 occupations, and so forth.

Also, it would be mistaken to label all increases in capital values as "inflation". Unless we are to lose the peace tragically we must succeed, in the post-war period, in maintaining 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 to curtail any and all increases in capital values whatever. What must be curtailed are those increases which are of a speculative nature and reflect a merely temporary wartime addition to earning power rather than a more permanent level of higher earnings which may be expected to prevail in the post-war economy.

The control of capital values, therefore, must be directed specifically at those transactions which are of a speculative sort. Unless checked, speculative purchases, even where small in value relative to legitimate purchases, will inflate prices and thereby force the legitimate buyer to partake in a general inflation of values. A heavy tax on profits derived from capital transactions will curtail or eliminate the incentive for speculative purchasers but it will interfere little with bona fide investments made with the intention of a continued holding of the asset. A drastic curtailment of credit, on the other hand, would interfere severely with credit transactions of all kinds without particular discrimination against the speculative buyer.

4. A tax on profits derived from the resale of capital assets is the most equitable method of controlling capital transactions.

A tax of this kind would make it impossible for anyone to profiteer from an increase in capital values. And, since the current increase in values is but a reflection of the enormous war activity financed by Government expenditures, it is fair that nobody should be permitted to profiteer from it. If a restriction were applied on credit purchases only, speculators would be left free to profiteer through cash purchases. This would be highly inequitable since people in the higher income groups are in a better position to finance their purchases by cash payments. Under the proposed tax all buyers would be restrained equally.

A heavy tax on the profits obtained from capital transactions is the more desirable since the taxation of capital gains under the present income tax law places a premium on income in the form of capital gains and grants a special advantage to the taxpayer in the higher income brackets. So-called long-term gains, defined as gains from the sale of assets held for six months or over, are taxable at a top rate of 25 per cent only, that is, at a rate much below the marginal rates of income tax applicable in the upper income brackets against income derived from other sources. It need be emphasized that the tax here proposed would apply only where the purchase was made within a stipulated period, terminating as soon as the economy has returned to a peacetime basis. Whatever the merits of the contention that a high tax on capital gains will be a deterrent to investment in the peacetime economy, it does not apply to the tax here proposed. As a wartime policy it is altogether desirable that speculative capital expansion be discouraged.

The wartime tax on profits derived from the resale of capital assets should be considered as a control device only, the more successful the lower its yield. The tax 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. Thereby, speculators would be prevented from rushing into purchases prior to the date when the tax becomes effective. Transactions subject to the war tax on capital profits should be exempt from the capital gains tax now in force and both taxes should be kept separate. Under the war tax steep rates should be imposed. 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 periods of holding to which the schedule applies remain to be worked out.

August 31, 1943