Governor M. S. Eccles

Ribbon copy delivered to Mr. Eccles,
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Jones 9/17/48

# Draft Outline: Governor Eccles' NICB Speech

September 23, 1948

## I. Introduction

1. Spoke four years ago at NICB on question - "Postwar Price Problem - Inflation or Deflation?" Stated that did not have this choice because if we have inflation we shall certainly have deflation following it.

   Since then we have had inflation; at least wholesale prices have risen nearly 60 per cent and consumer prices nearly 40 per cent, with practically all the rise in the past two and a half years.

2. Question today is "Must the Inflationary Bubble Burst?"

   a. Another look in light of new facts.

   b. If the question is taken to mean "will the bubble burst immediately," I would call attention to the strong inflationary forces still in the picture and note that these inflationary forces have been strong enough so far to ride through:

      (1) Reconversion.
      (2) The stock market crash in the fall of 1946.
      (3) Weakness in the spring of 1947 in markets for many commodities, including not only nondurable goods but also real estate and building materials.
      (4) The farm price break in February 1948.
      (5) The fastest and largest reduction of public debt in history.
      (6) The bumper crops this summer.

      The general level of wholesale prices has risen since March, is above the peak at the beginning of this year, and 120 per cent above 1939. Consumers prices are also at record heights. (See Attachment A) Basic commodities, it is true, are considerably below the January peak because prices of grains, fats and oils, cotton, burlap, and turpentine are down sharply while the only important increases have been in prices of iron and steel, nonferrous metals, and livestock.

c. If the question is "Can we make piecemeal adjustments so as to level out and continue the boom indefinitely," my answer is that this should be our goal but that we should expect to find this goal extremely difficult to achieve.

   (1) Idle resources, mass unemployment, and subprosperity living standards are bad not only for the people directly affected but also for all who have a stake in our economic and political institutions and peaceful development of a decent world economy. The consequences of unemployment are far reaching and unacceptable.

   (2) However, in view of extent to which inflation has already gone, prospects for piecemeal adjustment of an automatic sort are not bright. In any case, we cannot reduce the present maladjustments by continuing to feed them. The sooner we take corrective action the better our chances for (a) avoiding drastic deflation and depression, and (b) attaining a sustainable equilibrium of production and employment at high levels.

II. <u>Why do we have inflation?</u>

1. War financing, war destruction, and accumulated shortages of goods. (See Attachment B)

2. Postwar situation and programs.

   a. Have not had peace. This is a primary factor. Resulted in high and increasing defense expenditures.

   b. Slow and spotty recovery of production abroad.

   c. Large export demand, much of it financed by the Government.

   d. Reconversion. As inventories were replenished and capital equipment expanded, incomes were paid out to consumers in excess of the value, at previous prices, of consumption goods coming on the market.

   e. Premature removal of transition safeguards:

(1) Price and wage controls.
(2) Excess profits tax.
(3) Allocation controls.
(4) Consumer credit controls.

f. In some cases, the taking of deflationary measures came into conflict with other domestic programs or policies which seemed desirable or expedient.

(1) Generous provision for veterans added to inflation problems.

(2) The extreme gravity of the housing problem led to easy mortgage financing.

(3) The agricultural program resulted in price supports for farm products which prevented large crops, particularly this year, from having as deflationary an effect as they might otherwise have had.

(4) Desires to grant tax-payers some relief after the long years of high taxation brought income tax reduction at a time when incomes were already excessively high in relation to goods available.

(5) Any control over expansion of bank credit was softened by the Treasury and FRB responsibilities in the support of Government bonds.

g. In terms of economic effects, the postwar period has been one of applying tools to deal with a depression during an already inflated restocking and preparedness boom. Consequences are exceedingly high and still rising prices and costs.

III. <u>What is the Nature of Factors of Instability Growing out of the Inflation?</u>

1. The test is one that looks to the future, not to the past. Merely high general level of prices relative to prewar or high prices of some goods relative to other goods in terms of prewar is not an adequate test of distortion or maladjustment. The tests are whether a given factor is likely to

a. Initiate a downturn in general activity, or

b. Aggravate a decline if a decline occurs.

2. In my judgment the following things operate toward instability in varying degrees:

   a. High military expenditures.

      (1) To accept current levels as normal implies serious preparation for war is normal and peace has become abnormal. When peace comes, reduction in military expenditures will have extensive economic repercussions.

      (2) Even if military expenditures remain high, they will not necessarily be stabilizing. Such expenditures are dictated by considerations of national security, not by considerations of economic balance. Current stockpiling expenditures an example of destabilizing military outlays.

   b. Large export balance, financed to substantial extent by Government loans and grants.

      (1) To the extent that the export balance is determined by relief and reconstruction needs, it is temporary.

      (2) To the extent that the balance is influenced by national security, it is influenced by same considerations that apply to defense expenditures. By design, these considerations are not compensatory.

      (3) In view of world tension, it is unlikely that private financing of the export balance will replace Government financing.

   c. Inventories have been built up.

      (1) No need for further large scale accumulation of business inventories.

      (2) Consumer stocks are becoming much more adequate, particularly of durable goods, purchases of which are deferrable.

d. Crops are large and stocks more ample. Present level of important crops is almost certainly excessive on basis of prospective long-term foreign and domestic requirements.

e. Urgent accumulated demands are being increasingly satisfied for:

   (1) Consumer nondurable goods generally.

   (2) Many consumer durable goods, except for automobiles and refrigerators.

   (3) Housing. People are now housed in some fashion and high prices are forcing acceptance of unsatisfactory accommodations.

   (4) Many postwar business expansion plans are being completed.

      (a) Expenditures for expansion of manufacturing already are declining. Public utilities, railroads, and some special lines such as oil production are continuing large expenditures.

   (5) Many schools, hospitals, and other public facilities have been constructed, but backlog demand remains very large.

f. The rate of expenditures for producers' durables is exceptionally high.

   (1) The ratio of such expenditures to GNP is currently 8.3 per cent, a rate substantially above previous peacetime periods.

   (2) Over-investment is being stimulated by

      (a) Easy and very large profits.
      (b) Cheap and readily available credit.
      (c) Rising prices, opportunities for inventory profits, and encouragement they give to optimistic expectations.
      (d) Miscalculation of the temporary nature and size of foreign and domestic backlog demands.

g. Exceptionally high demand and prices of houses.

(1) Prices and costs are high relative to incomes of the mass of buyers. Also high relative to prices of alternative goods.

(2) Very sharp rise in mortgage debt encouraged by:

(a) Low down payments and interest rates.
(b) Government supports and guarantees.
(c) High current incomes and general optimism about their continuation.
(d) Turnover and refinancing of old houses.

(3) People forced to buy houses because of unwillingness of owners to rent in view of rent controls and profits available from selling instead of renting.

h. Private debt is increasing. (See Attachment C) This will become particularly important after the downturn when it will be liquidated:

(1) Incurred by consumers.
(2) Incurred by business.
(3) Mortgages.

i. Distribution of income is becoming less favorable.(See Attachment D)

(1) Fixed income groups are being squeezed.
(2) Real wages of many are declining.

j. Liquid asset position is becoming less favorable.

(1) Gradual shift evident toward higher income groups.
(2) In any event, the purchasing power of the assets has been sharply reduced by rising prices. (See Attachment E)

IV. <u>Prospects for "Piecemeal" Adjustment are not Good</u>

1. Our economy has always been characterized by alternate booms and recessions, whether as a result of the clustering of innovations and investment, bank credit policy, speculation, poorly distributed incomes, etc. Our major war and postwar periods have been especially susceptible to considerable debt and monetary expansion and great upward sweeps of prices. These periods have been followed by sharp price deflation, substantial liquidation of debt, and severe economic depression.

2. Piecemeal adjustment assumes a sequence of difficulties so ordered that each problem is solved before the next one presents itself.

   a. To maintain income levels this means that Government, foreign, or consumer spending must increase to offset a decline in business spending; or that business spending must increase to offset declines in Government, foreign, or consumer spending; etc., etc.

      (1) Actually, expenditures from all these sources are interrelated, and all types of expenditures and incomes affect business and consumer expectations; i.e., one form of spending increases income which in turn stimulates additional spending. As a result of this interrelationship, the various sectors of the economy tend to go up and down together.

      (2) The Government, however, is relatively free, except for the compulsions of military and foreign aid necessity, to take planned compensatory action. The assumption of piecemeal adjustments and sustained stability, from a realistic point of view implies that the Government will direct its fiscal and other policies to this end, that the Government's foresight in planning needed policies will be largely free of error, and further that its policies will be successful.

3. In this specific postwar situation, piecemeal adjustment assumes that when the heavy, war-induced backlog of demands for exports, consumer durables, housing, inventory, public works, and business investment has been satisfied, normal demands arising out of current incomes will increase enough to compensate for the reductions in backlog demands. This further assumes that

   a. Income is so distributed as to make possible increased normal demands, or that

   b. Our large liquid assets are so widely distributed that holders of such assets can and will use them to increase consumption enough to maintain total expenditures, and that

   c. A high degree of price flexibility and resource mobility obtains.

4. In view of our past experience, it seems unlikely that we shall satisfy enough of these conditions to achieve stabilization. This is especially likely if we permit inflationary forces to continue unchecked.

V. The situation, in spite of the inflation, is still more favorable for making corrective adjustments without drastic consequences than it will be later:

1. This is the case because:

   a. We still have some backlog demands remaining to cushion a decline.

   b. We still have a large and fairly widely distributed volume of liquid assets to serve as a cushion.

   c. Income distribution is still favorable by past standards.

   d. We still have demands for a large export surplus.

   e. The debt structure is still not seriously impaired.

   f. We still do not have openly wild speculative excesses.

2. For these reasons, we can afford to accept restraints and the risk of a recession in attempting to correct the maladjustments growing out of the inflation.

   a. Underlying forces are such as to make the risk at this time one of recession, not severe depression.

   b. If required, compensatory action of only a moderate sort will probably be enough to reestablish high activity and production levels.

3. If we wait and do not apply restraints, we run great risks of

   a. Accentuated over investment in important areas.

   b. Creating an untenable debt structure that requires drastic and protracted liquidation.

   c. A still higher and more inflexible cost structure.

4. If we delay taking corrective action -- even at some risk -- until a depression comes, we shall then face far greater liquidation, bankruptcy, and unemployment which can be dealt with only by heroic Government measures, if they can be handled at all within the framework of the free enterprise system.

Attachment F

PRICE MOVEMENTS
1939-1948

| | 1939 | Dec. 1941 | June 1945 | June 1946 | June 1947 | June 1948 | July 1948 |
|---|---|---|---|---|---|---|---|
| Consumer Price Index (1935-39 =100) | 100.5 | 110.5 | 116.4 | 133.3 | 157.1 | 171.7 | 173.7 |
| Wholesale Price Index (1926 = 100) | 77.1 | 93.6 | 106.1 | 112.9 | 148.0 | 166.2 | 168.6 |
| Wholesale Price Index (1939 = 100) | 100.0 | 121.4 | 137.6 | 146.4 | 192.0 | 215.6 | 218.7 |

ATTACHMENT B

The source of the present inflation is war financing and the enormous Federal deficits incurred in preparation for and prosecution of global war. During the six-year period, June 30, 1940 through June 30, 1946, the Government raised about 398 billion dollars, but only 176 billion dollars, or 44 per cent came from taxes. The remainder of 222 billions, or about 56 per cent, was raised by borrowing. And of this total which was borrowed, approximately 90 billion dollars, or 23 per cent of total needs, was raised by selling Government securities to the commercial banking system, including those purchased by the Federal Reserve Banks.

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ATTACHMENT C TO BE PREPARED

Attachment C

Estimated Total Net Debt in the United States, 1939, 1945 and 1948
(in billions of dollars)

| | June 30 1948 | Dec. 31 1945 | Dec. 31 1939 |
|---|---|---|---|
| Grand total | 413.4 | 406.2 | 184.6 |
| Public - total | 233.0 | 266.5 | 58.9 |
| Federal 1/ | 217.3 | 252.7 | 42.6 |
| State and local | 15.7 | 13.8 | 16.3 |
| Private - total | 180.4 | 139.7 | 125.7 |
| Consumer | 14.1 | 6.6 | 8.0 |
| Mortgage | 49.5 | 32.6 | 33.0 |
| Corporate 2/ | 101.7 | 84.2 | 73.5 |
| Other 3/ | 15.1 | 16.3 | 11.2 |

1/ Gross debt of Federal Government and Federal agencies less debt held within the Government and agencies.

2/ Includes corporate mortgage debt.

3/ Includes short-term agricultural debt, nonmortgage debt of other unincorporated businesses, and such financial debt as debt owed to banks for purchasing and carrying securities, customers' debt brokers, and policy loans of life insurance companies.

Source:--1939 and 1945, Department of Commerce, 1948, Federal Reserve estimates.

ATTACHMENT D

DISTRIBUTION OF SPENDING UNITS AND INCOME
BY INCOME CLASSES

| Annual money income (before taxes) | 1935-36 | | 1941 | | 1945 | | 1947 | |
|---|---|---|---|---|---|---|---|---|
| | Spending units | Income | Spending units | Income | Spending units | Income | Spending units | Income |
| Under $1,000 | 53 | 20 | 35 | 9 | 20 | 5 | 14 | 2 |
| 1,000 - 1,999 | 31 | 33 | 30 | 21 | 27 | 16 | 22 | 10 |
| 2,000 - 2,999 | 10 | 17 | 20 | 24 | 23 | 23 | 23 | 17 |
| 3,000 - 4,999 | 4 | 11 | 10 | 18 | 22 | 32 | 27 | 31 |
| 5,000 and over | 2 | 19 | 5 | 28 | 8 | 24 | 14 | 40 |
| TOTAL | 100 | 100 | 100 | 100 | 100 | 100 | 100 | 100 |

Attachment ~~D~~ E

LIQUID ASSET HOLDINGS OF INDIVIDUALS*

| | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| Asset holdings in current dollars (Dec.) | 49.6 | 52.4 | 59.5 | 76.8 | 100.5 | 128.4 | 154.5 | 165.2 | 172.0 | 172.0 |
| C.P.I. Dec. | 99.6 | 100.7 | 110.5 | 120.4 | 124.4 | 127.0 | 129.9 | 153.3 | 167.0 | 173.7 |
| Asset holdings in 1935-39 dollars | 49.8 | 52.0 | 53.8 | 63.8 | 80.8 | 101.1 | 118.9 | 107.8 | 103.0 | 99.0 |

* (Includes currency, demand deposits, time deposits, saving and loan shares, and U. S. Government Securities.)