July 19, 1950.

Mr. Carpenter -

Marriner Eccles requested that copies of the attached statement be sent to each Federal Reserve Bank and Branch. Could they go out under a letter from you stating that the statement is merely an expression of his personal views on the inflation problem which has been accentuated by the Korean developments?

Attachments

Remember in Salt Lake

July 17, 1950.

It is apparent that the inflationary pressures arising from the Korean situation demand immediate action. The important question to decide is what controls should be applied at this juncture. The choice is between a complete war-time harness of direct controls or selective controls that are functional rather than direct which will put a stop to further excessive growth of credit. It is my belief that we should not at this time cover the economy with the blanket of controls such as were applied during World War II, including a wide range of allocations, building permits, price and wage controls, rationing, etc. Such an integrated harness on the economy should be a last resort in case the situation should lead to a general mobilization. I believe that fiscal, credit, and monetary controls will be adequate to curb dangerous growth of credit which means an increase in the money supply. This is the basic cause of inflation, i.e., when active demand for goods and services exceeds supply.

If a boom is permitted to get out of hand now the result will be a sharp reversal and industrial collapse when the crisis passes. In my judgment the Government should take the following steps:

I. Request all commercial banks to unite in a nation-wide voluntary agreement:

First, to stop bank credit at its source by extending no new credits <u>on balance.</u> This means that the volume of new loans made by any bank should not exceed the volume of loans paid off. Thus, the essential loans which need to be made would be advanced out of the liquidation of loans that could and should be called. In effect this would mean that the banking system would voluntarily ration credit where it was most needed. If the voluntary program does not succeed the Reserve System would be expected to request special authority to increase reserve requirements as would achieve the necessary curb on overexpansion of credit.

Second, to prevent further monetization of the public debt, that is, selling Government securities to obtain reserves on which to pyramid new loans and investments. Banks that gain deposits should invest in Government securities; banks that lose deposits would sell such securities. This will balance out in a way that will be a steadying influence toward an orderly market.

Similarly, savings banks, insurance companies, and other fiduciary institutions should be requested to refrain from obtaining funds for new loans and investments by selling Government securities which the Federal Reserve System would have to purchase as the residual buyer in the Government bond market. Such purchases automatically create excess reserves which press upon the market and, if invested by the banks, result in a manifold pyramiding of credit.

In order to help effectuate the foregoing program, the Treasury should issue 15-year, 2-1/2 per cent non-marketable bonds which would absorb funds that otherwise would seek outlet in private loans and investments. At the same time, the Federal Reserve should be relieved of pegging a 1-1/2 per cent certificate rate which should be allowed to rise sufficiently to take pressure off intermediate and long-term Government bonds. Coincidentally, the Federal Reserve should increase the discount rate to 2 per cent.

II. Curb further excessive expansion of credit for housing and construction. The most important inflationary factor at this time is the demand for housing. To reduce the demand for new as well as existing houses, the Government should stop pumping Government credit freely into the housing market. Restrictions should be applied, whenever existing law permits discretion, to reduce the flow of credit to the public, including veterans. I understand that the Administration is preparing to tighten up wherever whever the law permits on Federal financing of housing and construction. Reducing demand for housing and construction will be a most effective step in conserving basic, critical materials. It is probable, however, that allocation and requisitioning of some critical materials, such as steel, copper, etc., will be necessary to supplement restrictions on the flow of housing and construction credit.

III. Put stiff consumer instalment credit terms in effect at once with down payments high enough and maturities short enough to halt further swelling of the already excessive volume of these borrowings to buy automobiles, refrigerators, washing machines, and other appliances. Stopping further growth of this credit -- preferably causing a shrinkage on balance -- would help to relieve the drain on critical metals and other materials, as well as reduce the inflationary impact of excessive demands for goods.

IV. Reduce, so far as possible, the budgetary gap, by a ban on new tax cuts, by closing existing loopholes, by increasing the postal rates to a pay-as-you-go basis, and by other steps, the most important of which is to levy an excess profits tax of 75 per cent based on percentage of invested capital, since there is no existing base period to use as a guide because corporate profits in the post-war years have been phenomenally large. The excess profits tax should exempt the first $5,000 of earnings. While this would apply to all corporations, it would be of particular benefit to small business. The base for calculating excess earnings could be ascertained by applying the 75 per cent tax to earnings in excess of 10 per cent in the case of corporations with up to $1 million of invested capital; 8 per cent on invested capital of from $1 million to $5 million and 6 or 7 per cent on all invested capital above $5 million.

V. Request organized labor to forego demands for increased wages during the crisis; this would do away with need for a wage freeze and would counterbalance imposition of the excess profits tax on corporations.

VI. Call upon the public, which is remarkably united in this crisis and will respond to firm leadership, to save and invest in U. S. Savings bonds, thus further contributing to reducing the demand for civilian goods.

By such a credit, fiscal, and monetary program as the foregoing, the need will not exist for the harness of direct controls, and the additional inflationary pressures resulting from increased Government spending for military needs can be effectively offset. This program can be quickly reversed when the time comes. In the meanwhile, the economy will be safeguarded against a flash boom that would inevitably be followed by a sharp recession when the crisis is over.