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CREDIT, MONETARY, AND FISCAL PROSPECTS, 1947-1948

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At the last meeting of the Council, Mr. Thomas presented an analysis of current economic tendencies and prospects for 1947-1948. His diagnosis indicated that a number of critical maladjustments were developing in the current situation of inflationary boom and over-full employment and that, in consequence, a period of recession and readjustment was likely to set in at some stage in the not too distant future. The indications available since his report lend additional support to this general view.

Mr. Thomas' report stressed that prospects pointed to what might be described as recession, but by no means depression, with the corrective period possibly having a relatively short duration. No developments have been noted since his report that would warrant a revision of this general conclusion. The science of economic projection is far from exact, however, and error is apt to be wider with regard to timing and size of change than with regard to direction of change.

The present report is a supplement to the one presented at your last meeting, but limited in focus to prospective financial tendencies. It is directed to the question: In the light of the current economic outlook for early moderate recession, what tendencies will likely characterize banking, monetary, and fiscal developments during 1947 and the early part of 1948?

Financial Factors in Recent Inflationary Pressures

As background for our projections, the strategic forces in recent inflationary pressures need brief review. The most important of these have been the war-created backlog of domestic and foreign demand, the superabundant bank credit and money supply expanded directly by war finance, and the further expansion of bank credit and money supply during the past year.

Because of the public's large accumulated holdings of liquid assets, consumers in 1946 were able to supplement substantially their current disposable income of nearly 150 billion dollars by spending liquid assets. The buying power added to consumption markets (including residential real estate) from this source amounted to approximately 10 billion

*Statement before Federal Advisory Council, Washington, D. C., May 19, 1947.

dollars. Many billions more were added from consumer credit and mortgage credit sources, including banks. The active demand for consumer goods at rapidly rising prices has been sustained by these factors.

The extremely active demand from consumers within the country, combined with unprecedentedly heavy demands for manufactured goods from world markets, has encouraged manufacturing and trade enterprises to expand rapidly holdings of inventory and receivables and to spend in record volume for replacements of and additions to equipment and plant facilities. Equipment and property expenditures of railroads and public utilities have also been in heavy volume. High and rising prices relative to costs at capacity operating levels, aided by lowered tax rates on corporate income, have made for widespread profits and high levels of profitability. Under these conditions, the abnormally large business expenditures for current asset expansion and for equipment and plant have been financed largely by retained earnings and by other funds from operations. Many businesses, however, have found it necessary to draw down their war accumulated liquid asset holdings, to obtain equity capital, or to incur new debt. Business borrowing demands on banks for short and medium-term credit have been especially heavy.

Strong consumer and industrial demands for agricultural products, together with urgent demands for foods and other farm items from world markets, have raised prices of farm output above the post-World War I peak and carried agricultural income to new high levels. While farmers have spent freely for consumption goods, for farm equipment and buildings, and for land, these expenditures for the most part have been financed out of income and liquid asset holdings with expansion in debt largely limited to financing the purchase of farms or farm land. Because of their favorable income situation, total liquid asset holdings of farmers have shown continued rapid growth.

With the war-created backlog of domestic and foreign demand and a superabundant supply of money and liquid assets available for spending, capacity output has been assured at some advance in prices without further monetary expansion. Notwithstanding, expansion of the money supply held by the public continued to occur in 1946 at a rate of nearly 13 billion dollars or close to two-thirds of the wartime average annual increase, and has only recently been brought under check by seasonal and other temporary factors. About half of last year's expansion in the public's money supply represented desirable readjustment in the Treasury's position to peacetime conditions, and was brought about by the use of excess Treasury balances to retire public debt held by nonbank investors. The remaining half of the monetary increase reflected not expansion of bank loan portfolios resulting from a record demand for bank credit to finance business, to finance ownership of residential and farm properties, and to finance various consumer needs, but mainly the purchase of durable goods.

While some of the recent bank credit expansion has also increased production and in this way has helped to reduce inflationary pressures, there can be little question but that on balance the further monetary expansion has added materially to such pressures and has helped to carry the advance in prices to levels higher than otherwise would have been reached. At the same time, the bank credit and monetary expansion did not go as far as was potentially possible. It was held down in part by reduction in security loans accompanying termination of war financing, maintenance of high margin requirements, and uncertain security market conditions. Another factor was consumer credit regulation which helped to check credit demand and to maintain a high rate of repayment on outstanding consumer paper. Lastly, Treasury debt retirement, particularly of bank-held debt, contributed to a continuing moderate pressure on bank reserves and restrained additional rapid expansion of bank investment in Government securities.

Bank Credit and Monetary Expansion, 1947-1948

The crucial role of private credit expansion in recent monetary developments raises the question as to whether business, farm, urban real estate and consumer credit demand will continue to increase further the money supply even in the face of prospects for moderate economic recession. The current outlook is in this direction, but the pace of credit expansion will probably be at a much slower rate than during last year. The important tendencies that will likely characterize bank credit developments over the months ahead may be summarized as follows:

Business Loans: - At the end of 1946, business loans at all banks (including open-market paper but excluding loans secured by real estate) stood at 14 billion dollars. Another billion dollars of growth was added in the first quarter, but the slackening of inflationary expansion of national product together with the outlook for recession is softening business credit demand and tightening credit availability. Close to an additional billion dollars of growth seems an outside possibility for the year, taking into account seasonal influences near the year-end. Some small net reduction in business loan outstandings will likely occur during the first half of 1948.

There are a number of uncertain factors, however, that might swell loan demand during the second half of this year. Financial readjustments, which will confront many businesses, especially small and medium-size enterprises in the face of declining sales, may bring about an unexpected volume of new borrowing. In retailing, for example, there will be increased emphasis on credit sales at a time of retarded collections, which may present problems in some cases of receivables financing, and a further rise in receivables will likely characterize manufacturing business. With declining sales, involuntary inventory accumulation by manufacturers and retailers may be a source of special credit demand. Another source of underestimate is the possible credit demand of various consumer credit agencies, such as sales finance and personal finance companies. Finally, if securities market conditions are unfavorable, contemplated expenditures by railroads and public utilities may need to be supported by more bank financing than is now projected.

Farm Loans: - Continuing profitability of farm operations will result in little, if any, increase in farm production loans during this year. Indications from the Board's annual survey of consumer finances, made early this year, point to a moderately reduced volume of farm equipment and hence a smaller credit demand for purchase of such equipment. Some further increase may occur in the farm real estate category as a result of continuing transfers of farm property. With lower farm prices, as generally expected, borrowing for production purposes may rise during the production season in 1948, but lower farm prices would probably reduce farm transfers temporarily and check the availability of farm mortgages.

Urban Real Estate Loans: - Expectations of consumers regarding the purchase of homes, as shown by this year's survey of consumer finances, indicate a smaller volume of transactions for residential properties than in 1946. On the other hand, a larger proportion of these purchases will be for new houses than characterized transactions last year. This will mean a reduced volume of repayment of outstanding mortgages resulting from property transfers, and a steady, though smaller, flow of new mortgages. As a result, urban mortgage loans may increase by nearly 1.8 billion dollars during the current year, and because of the large backlog of demand for housing, further expansion may be expected in the first half of 1948.

Consumer Loans: - Consumer purchase expectations, as reported in the 1947 survey of consumer finances, indicate a continuing strong demand for automobiles and the purchase of all the cars that can be produced, as well as all of the used cars that become available. Growth in demand for other consumer durables, however, seems to be slackening. A special factor in consumer credit demand, because of the narrowed margin between income after taxes and expenditures and the prospects of some rise in unemployment, will be borrowing to meet family deficits and emergencies. Income tax relief may, of course, moderate such demand somewhat. A declining rate of collections on consumer credit outstandings during the months ahead will mean a longer average period of consumer indebtedness and will help to sustain expansion in consumer credit outstandings.

All in all, the outlook is for a steady rise in consumer credit outstandings of banks, amounting to perhaps 1 billion dollars this year and continuing at that annual rate during the first half of 1948. Total consumer credit is currently increasing at an annual rate of about 2.8 billions.

Loans for Purchasing and Carrying Securities: - Of all the loan categories, only security loans have the prospect of registering a decline. Sluggish and uncertain stock market conditions are expected to continue through the year, with the result that a decrease in security loans of about 1 billion dollars is not unlikely. Prospects for 1948 depend on the willingness of smart money to discount optimistically the business outlook at that time and on margin requirement policy.

Total Loans: - Addition of bank loan prospects, as summarized above, yields a net increase for this year of 4 billion dollars and this projection appears to be on the conservative side. The possible advent of recession the latter half of 1947 makes loan tendencies for early 1948 uncertain, but the odds of over-all loan market prospects at this stage favor a small net increase in the first half of next year.

Bank Investments: - Debt retirement for the year, less replacements of retired securities as banks may make, is expected to reduce commercial bank holdings of Government securities by about 3 billion dollars. On the other hand, holdings of other securities will likely expand by at least 1 billion, so that net decline in commercial bank investments would amount to 2 billions. Some further moderate decline in bank holdings of U. S. Governments may be assumed as likely during the first half of 1948, but the prospect is for this decline to be more than offset by increased holdings in other securities.

Increased holdings of other securities will reflect bank purchases of about half of the offerings of State and municipal issues, which will be in record volume during this year, plus some bank purchases of issues by the International Bank and some further buying of corporate issues. Retirement of corporate bonds may about equal new issues during 1947; therefore, little change in the total supply of corporate securities having bank investment quality is to be anticipated.

Bank Reserves: - On the assumption of some recession in business starting in the near future, a less than seasonal increase in money in circulation is expected towards the end of 1947. For the year as a whole, in consequence, bank reserves will be augmented by perhaps half a billion dollars from a return of currency from circulation, most of which has already occurred. Foreign needs for dollar exchange will bring about a steady gold inflow, with the total for the year possibly amounting to 1 billion dollars. Because of continuing deposit expansion, individual banks will probably sell Government securities to the Reserve Banks from time to time to maintain reserve positions, but banks generally will be under no great pressure to obtain reserves through this mechanism. At this stage, further currency and gold inflow appears to be a reasonable expectation for the first half of 1948.

Deposits and Total Money Supply: - Deposit changes at commercial banks during this year will comprise: (a) a reduction of 2.2 billion dollars in war loan deposits carrying such deposits by the year-end to a level of about half a billion; (b) an increase of nearly 3.5 billions in adjusted demand deposits, and (c) an increase of 1 billion, or more, in time deposits. In addition, time deposits at mutual savings banks and postal savings will probably increase about 1 billion dollars.

Altogether the picture presented is one of moderate expansion in total money supply this year. A subatantially larger expansion, however, is in prospect in the money supply held by the public. This increase will amount to around 5 billion dollars, or about one-third of last year's expansion in the public's money supply. Tendencies likely to be encountered in the first half of 1948 may reduce this rate of increase; but some further monetary expansion seems possible in that period.

We thus confront the anomaly of prospective moderate business recession combined with further monetary expansion resulting from private credit expansion. Since economic recession may be accompanied by important downward price adjustment in certain sectors, this continuing bank credit and monetary expansion cannot be appropriately described as immediately inflationary. The resulting addition to the nation's money and liquid asset stocks, however, will be a source of inflationary pressures in the revival that will ensue in due course; in fact, the existence of larger money and liquid asset stocks may check recession and hasten and accelerate revival.

It is important to emphasize that the sources of prospective credit expansion are not demands especially responsive to moderate increases in short-term interest rates. Another point of emphasis is that the projected bank credit and monetary expansion is reasonably conservative. It assumes no general tendency for banks to expand holdings of Federal debt, and only a moderate increase of private debt and of municipal and State debt as a source of bank assets. Because of discontinued pressure on bank reserve positions from further debt retirement, tendencies in the direction of further bank credit expansion through bank shifting from short to longer-term Government securities may be stronger than expected. Another factor that might accelerate monetary expansion would be a more ample availability than now seems reasonable to anticipate of other types of bank assets.

<u>Bank Earnings and Bank Capital</u>: - Gross earnings of member banks in 1946 exceeded the previous high reached in 1945. Expenses, however, also rose to new high levels with the result that the average return after taxes on stockholders' investment declined somewhat from the 10.9 per cent attained in 1945. The average return in 1946 of 9.6 per cent was still the highest peacetime level for member banks since 1920.

Banking developments in prospect will likely lower further the level of bank profits on stockholders' investment in 1947. Gross bank earnings in 1947 will equal or exceed earnings in 1946 but expenses will be higher, recoveries and profits on securities will be lower, and losses and charge-offs will probably rise. On balance, the outlook is for a decline in the average return on stockholders' investment, perhaps to a level close to 8.5 per cent.

Banks have added substantially to capital through retained earnings since prewar days and bank capital is now higher than ever before. Recent bank loan expansion has reduced the ratio of capital to risk assets, which had attained the highest levels since 1914 during the war period; in fact, the ratio at the end of last year was below levels that prevailed during most of the Thirties. During 1947, the decline will continue but will probably be arrested in 1948. This development suggests that a bank capital problem may be taking shape and that a growing number of banks will be confronted in the next period of business expansion with a need to strengthen their capital positions by the sale of additional stock.

Treasury Finance, 1947-1948

Fiscal developments will likely continue to exert a moderately anti-inflationary influence, but the outlook for Treasury finance is still very uncertain. It can be said with certainty, nevertheless, that by mid-1947 the period of large-scale retirement of marketable debt will be over. The Treasury balance at the end of June will be in the neighborhood of 2.5 billion dollars, including 1 billion of gold, or close to a working minimum. Accordingly, any future debt retirement will have to be out of current budget surplus and from receipts from nonmarketable debt. Whatever the actual budget for the fiscal year 1947-1948 may turn out to be, reductions in the marketable debt during that year will hardly exceed 2.5 billion dollars (which total represents an estimated amount of voluntary redemptions if all maturing issues are refunded) as compared with about 21 billion dollars in the fiscal year just closing.

This means that the debt management problem henceforth will be one of refunding. Total maturities during the next fiscal year, not counting Treasury bills, will amount to 36.5 billion dollars. Of this nearly 7 billions will be in bonds, about 4.5 billions in notes, and just over 25 billions in certificates. The way in which the refunding is handled will be an important element in determining the pattern of market interest rates and the shift in the ownership distribution of security holdings.

Budget for the Fiscal Year 1946-1947: - Expenditures for the current fiscal year are estimated at 41.5 billion dollars and receipts at 42.5 billions. The resulting surplus of 1 billion, together with about 8 billions from receipts on nonmarketable securities (over 2 billions of which was in the form of securities issued to the International Fund and Bank) and a reduction in the General Fund balance of nearly 12 billions has permitted retirement of public marketable debt of around 21 billion dollars.

Budget Outlook for the Fiscal Year 1947-1948: - For 1947-1948, the President's budget recommendations provided for an expenditure level of 37.5 billion dollars. The House Committee on the Legislative Budget voted that this total be reduced to 31.5 billion dollars and the corresponding Senate Committee vote provided for a reduction to 33 billion dollars. It is entirely improbable, however, that expenditure reductions of anywhere near the size indicated will be enacted. As far as can be figured, reductions which have been voted on to date provide for a cut of little more than 1 billion dollars, and will be offset by the additional appropriation of 400 million dollars for aid to Greece and Turkey. The maximum cut that might be expected is, say, 2.6 billion dollars which would include a cut in national defense expenditures of 1.6 billions. However, these cuts are uncertain. The President's budget for total expenditures may well be reached; indeed, it might be exceeded.

The estimate of receipts involves a double uncertainty: first, with respect to revenue legislation and second with respect to the level of income upon which tax receipts depend. It may be assumed that reductions in personal income tax rates will be enacted involving a revenue loss equal to 20 per cent of income tax yield and that this reduction will become effective July 1. Also, it may be assumed that the statutory increase in payroll tax rates, scheduled for January 1, 1948, will be again postponed.

If the projected moderate recession of business is realized, income payments may decline from an annual rate of about 170 billion dollars in the third quarter of this year to an annual rate of 152 billions in the first half of 1948. On this basis net receipts of the Federal Government may approximate 36.6 billion dollars. This is about 6 billion dollars below receipts for the current fiscal year.

With expenditures of about 35.3 billion dollars and net receipts of 36.6 billions we arrive at a budget surplus of 1.3 billion dollars for the coming fiscal year. Broken down by quarters this reflects deficits of three-quarters of a billion dollars each for the third and fourth quarters of this calendar year, a budget surplus of nearly 4 billions for the first quarter of next year, and a renewed deficit of slightly more than 1 billion for the second quarter of 1948.

<u>Fiscal Developments and Debt Retirement</u>: - For this calendar year as a whole, the fiscal outlook is for budget balance or a very slight budget deficit, the deficit for the second half of the calendar year of 1.5 billion dollars about offsetting the surplus for the first half. Income from nonmarketable debt and reduction in Treasury balances will be the source of funds for this year's net retirement of public debt exceeding 8 billion dollars.

During the first half of 1948 there may be a surplus of receipts close to 3 billions. Retirement of another 2 or 3 billions of marketable debt might be possible from the expected budget surplus and a further increase in nonmarketable debt.

Our projection for changes in holdings of Federal debt by the banking system for the calendar year 1947 is a decline of about 5 billion dollars, distributed - 3 billions to commercial banks and 2 billions to Federal Reserve Banks. This implies a decline in holdings of marketable debt by nonbank investors during the year of more than 3 billions. Probably insurance companies and mutual savings banks will increase their holdings somewhat, while under the impact of full-employment followed by recession readjustments, business corporations, and to some extent individuals, may decrease their holdings. In all likelihood, the pattern of change in holdings during the first half of 1948 will be similar but the size of the changes will be smaller because of a prospective low volume of retirements.

Potentialities of Sharper Recession: - A sharper recession than has been projected would have different fiscal repercussions than we have outlined. The budget surplus assumed for the fiscal year 1947-1948 would be converted into a deficit; marketable debt would increase rather than undergo any further decline; holdings of Government securities by commercial banks and Federal Reserve Banks would increase rather than decline; holdings by corporations and individuals would fall off more sharply than projected; and additional investment by insurance companies and savings banks might be larger than anticipated. In the event of more than moderate recession, furthermore, bank loans would probably be reduced, but this might well be more than offset by additional credit released from new bank financing of the Government's deficit. On balance, expansion in the money supply would probably be greater than this report has indicated.

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The foregoing projections of banking, monetary, and fiscal tendencies for the period ahead are set forth to indicate the general pattern of financial developments that might be expected on the showing of current information and the potentialities indicated by projections of national product and income. The projections are not to be considered as forecasts; there are many possibilities for different results to emerge. While they are based on assumptions that appear reasonable, it is important to keep in mind that the period ahead promises to be one of rapid economic change. Many unanticipated factors will undoubtedly influence the course of developments.

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Table 1
Factors Affecting Deposits and Currency
(Billions of dollars)

	Dec. 1945	Dec. 1946	Dec. 1947*	Change during 1946	Change during 1947*
Expansive Factors					
Commercial Banks					
Loans - total	26.1	31.1	35.1	+5.0	+4.0
Commercial	9.5	14.0	15.8	+4.5	+1.8
Agricultural	1.3	1.4	1.5	+0.1	+0.1
Real Estate	4.7	7.1	9.0	+2.4	+1.9
Rural	(0.5)	(0.7)	(0.8)	(+0.2)	(+0.1)
Urban	(4.2)	(6.4)	(8.2)	(+2.2)	(+1.8)
Purchasing Securities	6.8	3.1	2.1	-3.7	-1.0
Consumer	2.4	3.7	4.7	+1.3	+1.0
Other	1.4	1.8	2.0	+0.4	+0.2
Investments - total	97.9	82.9	79.9	-15.0	-2.0
U. S. Government Securities	90.6	74.8	71.8	-15.8	-3.0
Other Securities	7.3	8.1	9.1	+0.8	+1.0
Federal Reserve Banks					
U. S. Government Securities	24.3	23.4	21.4	-0.9	-2.0
Treasury					
Treasury Currency	4.4	4.6	4.7	+0.2	+0.1
Gold Stock	20.1	20.5	21.5	+0.4	+1.0
Contractive Factors					
Treasury deposits at banks	24.6	2.7	0.5	-21.9	-2.2
Treasury deposits at Reserve Banks	1.0	0.4	0.2	-0.6	-0.2
Nonmember deposits and other Federal Reserve accounts	1.8	1.4	1.5	-0.4	+0.1
Treasury Cash	2.3	2.3	1.3	n.c.	-1.0
Net Bank Capital and Other	10.6	11.4	11.9	+0.8	+0.5
Deposits and Currency					
Deposits					
Demand deposits, adjusted	75.9	83.6	87.0	+7.7	+3.4
Time deposits (commercial banks)	30.1	33.9	35.0	+3.8	+1.1
Currency					
Currency Outside Banks	26.5	26.8	26.2	+0.3	-0.6
Memorandum					
Time Deposits at Mutual Savings Banks and Postal Savings	18.3	20.1	21.1	+1.8	+1.0

* Estimated.

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PROJECTED TREASURY FINANCES
(Provisional estimates. In billions of dollars1/)

	1946	1947			1948		Calendar year 1947	Fiscal year	
	July Dec.*	Jan. June	July Sept.	Oct. Dec.	Jan. Mar.	Apr. June		1947	1948
Treasury cash balance, start of period	14.0	3.1	2.5	1.9	1.7	5.7	3.1	14.0	2.5
Net receipts	18.5	24.0	8.8	7.7	12.1	8.0	40.5	42.5	36.6
Expenditures 2/	18.9	22.6	9.6	8.4	8.2	9.1	40.6	41.5	35.3
Surplus or deficit	- .4	+1.4	- .8	-.7	+3.9	-1.1	- .1	+ 1.0	+1.3
Change in nonmarketable debt	+ 2.7	3/+5.8	+1.0	-.1	+ .1	+ .5	+6.7	+ 8.5	+1.5
Retirement of marketable debt 4/	-13.0	-8.1	- .8	+.6	**	**	-8.3	-21.1	**
Net change in cash balance 5/	-10.9	- .6	- .6	-.2	+4.0	- .6	-1.4	-11.5	
Treasury cash balance, end of period	3.1	2.5	1.9	7/1.7	6/5.7	6/ 5.1	7/ 1.7	2.5	

* Actual   ** No estimate

1/ Estimates are based on certain assumptions with regard to expenditures, tax legislation, and debt retirement policies; (1) expenditures for fiscal 1948 are assumed reduced by 2.6 billion dollars from the President's Budget, (2) personal income tax rates are assumed reduced by 20 per cent beginning July 1, 1947.

2/ Including net expenditures in trust account.

3/ Including 1.8 billion dollars of securities held by the International Monetary Fund and 400 million by the International Bank.

4/ For the third quarter of 1947, the reduction in marketable debt is assumed to equal voluntary cash redemptions, notwithstanding full exchange offerings for maturing issues. For the fourth quarter of 1947 the increase allows for some new financing. No marketable debt figures are shown for 1948.

5/ The Treasury's budgetary surplus or deficit plus changes in debt may not necessarily add to changes in the cash balance due largely to estimated or actual differences in timing of receipts and expenditures.

6/ The balance for 1948 will be lower or higher, depending on changes in marketable debt.

7/ Consisting of 200 million dollars in deposits with the Federal Reserve Banks, 500 million in war loan deposits and 1.0 billion of free gold of which 832 million gold transferred to the cash balance as a result of payments to the International Monetary Fund.