Form F. R. 131

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date Sept. 30, 1947

To Chairman Eccles

Subject:

From Woodlief Thomas

Attached are (1) your copy of the Third Quarter Review of the Council of Economic Advisers, (2) a summary memorandum by Garfield and Williams, and (3) a suggested insert regarding powers of the Board.

I gave this insert to Mr. Nourse over the telephone and also passed on your suggestions about recommending a budgetary surplus, imposition of an excess profits tax, and deferment of various public expenditures. He expressed agreement with the idea of including all of these suggestions.

W. T.

Attachments.

STRICTLY CONFIDENTIAL

September 30, 1947

MEMORANDUM FOR THE PRESIDENT

FROM: The Council of Economic Advisers

SUBJECT: Third Quarter Review

Superficially, the third quarter of 1947 presents an economic picture which continues the favorable impression of the first half of this year and of the year 1946.

THE QUANTITATIVE VIEW

Civilian employment has continued close to the 60 million level attained in June (latest figure 59.9 million). Against a normal seasonal reduction in agricultural labor, we are seeing a marked increase in textile and apparel employment. The increase in number of housing starts during the second quarter also promises a longer-than-normal extension of building trades labor in the fourth quarter. The overall number of claims for unemployment benefits is now at the lowest level since shortly after the end of the war.

Production indexes have in total maintained the level of mid-year, though not fully up to marks set in the first quarter. Advances have recently been registered in such important industrial indicators as bituminous coal, petroleum, steel, electric power, motor vehicles, and freight-car loadings. Motor vehicle production and freight-car loadings registered highs for the year during September, and electric power production, by crossing the mark 5 billion kilowatt hours, registered an all-time high. On the other hand, agricultural conditions have been less favorable since late spring, so that the index of agricultural production is moderately down. Reports for the next few months will be more significant and may on the whole be less satisfactory.

<u>Purchasing power</u> has reflected the high level of employment and production. With strikes or other work stoppages relatively few and brief, the substantial wage advances granted in important industrial areas during the first half of the year have been reflected in an increase of workers' spending money. The sharp advance in prices of many agricultural products has brought farm income to a record level, and the high rates of earnings over most of the industrial area have sustained liberal spending for plant and supplies and have permitted an increase in dividend disbursements. Cash income from current operations has been augmented by continued drafts on savings, the cashing of terminal leave bonds, and extension of credit at home, and by the inflow from foreign countries which have needed to draw down their dollar balances to meet pressing import needs. The free flow of monetary purchasing power has outpaced the increase in the production of goods for the market to an extent which has been reflected in a marked inflationary advance in the general price index, particularly during the last two months.

THE QUALITATIVE ANALYSIS

When we look below the superficial manifestations of continuing prosperity during the third quarter, the picture is much less reassuring. While it is not a cause for immediate alarm or panicky action, it does demand sober consideration of the probable trends during the fourth quarter of 1947 and of what steps should be taken to adjust ourselves to these trends as they may be projected into 1948.

Employment and labor input. While the number of jobs has been satisfactory, these jobs have not been as regular as would have been necessary to attain full production. This has been due in part to labor-management friction resulting in work stoppages. But more seriously it has been due to shortages of material and, back of that, to shortages of equipment.

Production and its limiting factors. This brings us immediately to the disappointing conditions of national production which have developed in the third quarter. On the side of agriculture, this untoward development is due entirely to adverse weather conditions. The number of farmers and the time devoted to farm work has been ample, and materials and equipment have not shown any crippling shortage (though there has been some tightness in the fertilizer supply and farmers are still eagerly taking improved equipment as fast as it becomes available).

On the industrial side, however, we have encountered some unforeseen limitations in the process of converting from war production to full-scale peace production on a level of high efficiency. Industrial technology sets its own pace, and the new equipment provided to give men employment is of the most efficient kind. If that is not available, men are partially idle rather than used full time at lower efficiency. The first rush of reconversion was amazingly rapid. Where the same plant and equipment could in the main merely be rearranged to produce a different design or product, the change was largely a matter of organization and managerial skill. Likewise, procurement of the early instalments of new equipment encountered no great difficulty. But now we are finding that the problem is not limited to opening the last of the bottlenecks, but involves delay at least in providing an ample supply of basic materials and of crucial types of equipment, notably railway rolling stock and power units and steel-producing capacity.

Steel-using industries have not been able to keep up to full production schedules because of delays in getting needed steel. To some extent this shortage has furnished the opportunity to use more of our aluminum capacity, which had been over-expanded by war demands. Probably aluminum use will become established in part of this expanded area and thus permanently reduce the need for steel capacity in a stabilized high employment economy. But in the area where substitution of aluminum, plastics, plywood, or other materials is not possible, there is still a demand for steel which is not being currently met. This results in both lowered production in many dependent industries and higher prices at initial points, which contribute strongly to the general inflationary pressure.

It is quite possible that there will be production cutbacks in the steel industry during the winter months due to shortages of (a) coal, (b) scrap metal, and/or (c) pig iron. Any shortage of coal would be due to shortage of coal cars to bring it from the mines. Car-building has been lagging for lack of steel. Shortage of scrap would be due to the permanent loss of steel products as a result of the war and to the high rate of use in a full-scale peacetime economy. It raises the question whether pig iron capacity is now being provided in sufficient amount to meet clearly foreseeable needs of a stabilized economy. Whatever the answer to that question, it is evident that new blast furnaces cannot be brought into operation to combat possible shortages this winter, and also that withdrawal of steel now to build steel-making facilities would further aggravate the present scarcity.

The shortage of railway equipment affects the movement of grain and other farm products as well as coal and industrial materials. It reflects the high rate of wear on railroads entailed by the war effort and also raises the question of just what railway capacity is needed for a full production economy and how it can most economically and promptly be provided.

There is great difference of view as to what rate of capital formation would be needed for sustained high-level production and what would constitute boom-time overexpansion. The Council of Economic Advisers proposes to study the question of plant capacity intensively in cooperation with all government agencies and the appropriate management organizations. Meanwhile, we have to appraise the results of shortages in industrial facilities which cannot be immediately relieved. This brings us to brief comment on the Nation's purchasing power situation, which is characterized by the lagging of physical supply behind monetary demand.

Purchasing power high but unstable. The First Economic Report of the President addressed itself to the possibility that a deficiency of purchasing power in the hands of consumers might develop before the close of 1947. This analysis was based on the assumption that crop conditions would be as favorable as those of 1946 and that industrial productivity would rise substantially in the course of the year. If, then, wages and prices were to continue at the level of January 1946, we foresaw a shortage of consumer purchasing power which, unless corrected, would lead to clogged markets and subsequent production cutbacks and a generally recessionary movement.

The type of correction suggested in that report was the bringing up of wages at the lower end of the wage structure while refraining from further advances in the higher brackets which would force price increases or prevent desirable price reductions. The major adjustment to be hoped for if we reached high-level production by the end of the year was, in general, downward reductions of prices to permit ready market absorption of this maximum product. We recognized that, even with good crops, farm products could not be expected to fall much in the competitive market during this year. On the industrial side, it appeared that, with low unit-cost derived from efficient equipment and high-capacity operation, profit margins could be narrowed and prices competitively lowered to a point which would put this maximum volume within reach of currently disbursed consumer incomes.

The Mid-Year Economic Report had to record the fact that this voluntary adjustment had not taken place except in small measure but that, meanwhile, purchasing power of wage earners had been strengthened by substantial increase in wage rates over a considerable industrial area, and business purchasing power had been buttressed by high rates of profit. This profit situation in turn had sharpened wage demands. Agricultural prices had risen more than those of manufactured goods and cost of living had risen substantially.

While this was not the type of adjustment which had seemed to the Council most wholesome and effective in the long run, it was recognized that, in a free enterprise economy in a troubled transition period, we have to "feel our way towards a workable set of price relationships" and that it would not be impossible to keep going on the basis of these adjustments pending more satisfactory conditions. These adjustments would be reflected in a higher price level than would have developed from the types of adjustment proposed in the first Economic Report. It was also noted at mid-year that inflationary types of adjustment had gained a new impetus from the unexpectedly high level of agricultural and industrial exports during the second quarter and from the poorer crop prospects growing out of bad weather in the Corn Belt.

Third quarter developments have in the main continued and accentuated the tendencies noted at mid-year. Prices have continued to rise, particularly for food commodities. The real purchasing power of consumers has consequently dropped. Quite aside from the funds made available for purchase of goods for foreign shipment, a rapid expansion of credit to consumers and others and a large amount of dissaving have been drawn upon to support prices far out of line with current domestic buying power. Hence, the economic tendencies which gave cause for attention earlier in the year give cause for increasing concern now.

The present price situation, particularly with respect to rising food prices, creates three dangers which can be characterized as immediately and serious. First, the increasing cost of living threatens to generate another series of wage demands in urban areas, leading either to industrial stoppages and curtailment of production (with a further harmful impact upon prices) or to another wage-price spiral that would introduce new instability and uncertainties throughout the economy. Second, the present high cost of living, even if it does not climb still higher, imposes such discomfort or privation upon millions of families in the lower parts of the income structure that it is a source of nation-wide discontent which cannot fail to produce serious economic repercussions. Third, discontent with the price situation, accompanied by some improper interpretations of its causes and effects, could rapidly jeopardize the whole foreign aid program through reducing the prospects for foreign aid and through making each dollar of foreign aid worth less to the recipient in terms of buying power.

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If the national economic situation could be dealt with merely on the basis of production and marketing mechanics, we would anticipate a rolling or staggered type of adjustment such as has been going on and still is in process. We would expect that this would see us through 1948 and probably longer without such strain on voluntary business relations as would produce business demoralization of the magnitude of a depression or serious recession. There is still a great unspent momentum of replacement boom, and there is no inherent reason why we should not complete this catching-up phase and extend it into a period of sustained high production. But for the present we must meet and surmount an unexpected setback growing out of political and even military necessity. And we must deal with it in the face of a substantial loss of productive power due to widespread crop losses and the underestimated attrition of industrial power during the war.

NEED OF POSITIVE ACTION

While reduction of the scale of foreign relief would undoubtedly ease the strain of our own economic adjustment, we assume that this aid will be continued at or about present levels. If so, vigorous and prompt measures must be taken to prevent inflation from getting out of hand, with inevitable demoralization of the national economy.

The crux of the whole matter is, of course, to be found in the agricultural situation. Here we think the only safe assumption is that crops in 1948 will be at the reduced level of the second half of 1947 rather than the high level of the first half, when we were still on the plane of a 1.4 billion bushel wheat crop and a 3.2 billion bushel 1946 corn crop. Between now and the fall of 1948, we shall be rapidly depleting the carry-over from those two record crops and shall be harvesting a new wheat crop that is going into the ground under seriously adverse conditions. Unless present depleted soil moisture is made up, we shall also face the prospect of a corn crop no better than this year and of a lowered yield of forage.

As these developments appear, there can be little doubt that the high level of food costs will cause large numbers of persons to curtail their consumption of high-priced livestock products such as dollar steaks, 90-cent butter, and 85-cent eggs. Thus the rise will to some extent top itself out through curtailment of demand rather than through stimulation of supply. This, however, cannot safely be left to the operation of the automatic forces of the market. We believe the evidence is clear that speculation, profiteering, over-reaching, short-sightedness, and general lack of skill and foresight in the voluntary management of our free enterprise economy under conditions of full employment are all playing their part in worsening the situation. And they are by no means out of reach of administrative and legislative treatment. Much as we deplore the return to more government intervention, we believe that the gravity of the prospect requires it.

The recently announced program for voluntary food conservation, if rigorously adopted by the farmer, the distributor, the manufacturer, and the consumer, can achieve substantial results. This program should be pushed with all vigor and clerity, and nothing should be done to cast doubts upon its utility. But the uncertainties with respect to future crops and with respect to the volumes of foreign aid which may be required as developments unfold, when added to the clear certainties that the current price situation threatens our whole economy, lead us to the conclusion that the voluntary program should at once be supplemented with studies and plans for more specific and drastic measures. These measures at best take time to formulate and time to enact.

Whether the Congress is returning in November or in January, the intervening time should be utilized to prepare these additional measures in full comprehensiveness and precision, so that, depending upon the economic situation when the Congress returns, concrete proposals can be made on a selective basis with respect to such of these measures as may then seem urgently desirable. Public knowledge to the effect that these measures are being readied might well serve to abate some of the speculative factors.

We therefore recommend that the following proposals be developed as comprehensively and succinctly as possible within the next few weeks: extension of export control beyond its current expiration date, increased appropriations for these controls, and their vigorous application; regulation of the commodity exchanges; regulations or limitations upon the sale of flour by millers, upon the amounts and kinds of feeds manufactured, and upon the use of grains for the production of alcoholic beverages; regulation of retail trade practices to avoid waste; taxes, premiums and bounties to effectuate changes in the types of livestock produced for market; government purchasing and sale of grain on a wide scale to affect or determine pricing; and rationing and price control applied to certain key products. Each of these proposals would require enabling legislation.

We do not at this time certify our belief in the desirability of all of these proposals, or of any number of them in combination. We do certify our belief that some of these proposals will become essential in the unfolding situation, and that their further development should not be delayed in the cheerful expectancy that the voluntary program will do the job. We are now in a period when our capacity to act before the crisis appears is surely being tested. The purpose underlying the Employment Act of 1946 is to produce action before the crisis appears in all its intensity.

Finally, we would direct particular attention to the large part played by credit expansion and fiscal action in a situation like the present. Disastrous inflation is always accompanied by unwise credit extension. The extent of the danger that a price advance may lead to an economic collapse is measured by the extent to which the buying which creates the price level is based upon supplementation of the current income of consumers, including business buyers. If the buying is within current income, there is a barrier beyond which total prices cannot advance, although there may be advances within particular commodity groups, as there is at the present time in food products. To avoid the catastrophe of an economic collapse, it is necessary to adopt policies which will hold buying as nearly as possible within current income. There are definite steps which the government can take for this purpose.

In view of the accelerating growth of both consumer and business credit by commercial banks, we reiterate our belief in the need of selective control over credit by the Federal Reserve System. We urge also the full use of its administrative influence by the Commodity Exchange Authority to secure the sharp reduction in margin trading in grain.

On the fiscal side we must urge the great importance of keeping surplus within a balanced budget by Federal, state and local authorities and refraining from sale of bonds to commercial banks. Whatever the usefulness of deficit financing in deflationary periods, such a course in the face of present inflationary dangers would be reckless and harmful. Hence we renew our emphasis on the need of maintaining tax revenue during the coming year.

BOARD OF GOVERNORS
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Office Correspondence

Date September 30, 1947

To Mr. Thomas

From Frank R. Garfield & Kenneth B. Williams

Subject: Third Quarter Review by Council of Economic Advisers

The policy recommendations in this report are based on the belief that inflationary forces will continue dominant for a considerable period. Concerning foreign demand it is said that "while reduction of the scale of foreign relief would undoubtedly ease the strain of our own economic adjustment, we assume that this item will be continued at or above present levels. If so, vigorous and prompt measures must be taken to prevent inflation from getting out of hand with inevitable demoralization of the national economy." In discussion of the total demand situation emphasis is placed on shortages of agricultural products, especially grains. There is also some comment on shortages of industrial products such as steel and railway equipment.

The recommendations call for:

1) Vigorous promotion of voluntary food conservation

2) Preparation of plans for "more specific and drastic measures," with public announcement that these plans are being made." The following proposals are to be developed within the next few weeks:

   a) Extension of export control

   b) Regulation of the commodity exchanges

   c) Limitations upon the sale of flour by millers, the amounts and kinds of feed manufactured, and the use of grains for production of alcoholic beverages

   d) Regulation of retail trade practices to avoid waste

   e) Taxes and premiums and bounties to effect changes in the types of livestock produced for market

   f) Government purchasing and sale of grain on a wide scale to affect or determine prices

   g) Rationing or price control applied to certain key products

Concerning these proposals the Council says: "We do not at this time certify our belief in the desirability of all of these proposals, or of any number of them in combination. We do certify our belief that some of these proposals will become essential in the unfolding situation, and that their further development should not be delayed in the cheerful expectancy that the voluntary program will do the job."

3) Restrictive fiscal and credit measures

   a) "On the fiscal side we must urge the great importance of keeping within a balanced budget by Federal, state and local authorities and refraining from sale of bonds to commercial banks."

   b) "In view of the accelerating growth of both consumer and business credit by commercial banks, we reiterate our belief in the need of selective control over credit by the Federal Reserve System."

4) A comprehensive study of plant capacity by the Council.

Third Quarter Review of Council of Economic Advisers

Insert, page 12, second full paragraph after first sentence.

Congress should reinstate to the Board of Governors of the Federal Reserve System power to regulate consumer credit, which has been repealed effective November 1 by recently enacted legislation. Present powers of the Federal Reserve System are also inadequate to limit general credit expansion, which is now proceeding at a rapid rate. In order to restore the Reserve System's power to limit credit expansion, without upsetting the vast new war-created public debt structure, Congress should pass legislation along the lines recommended by the Board of Governors of the Federal Reserve System in its Annual Reports for 1945 and 1946.