October 12/39

TO: Miss Egbert

FROM: J. Eakin

Attached is the copy of Dr. Ezekiel's memorandum which has been made for the Chairman's files, as you requested this morning -

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October 3, 1939

Dr. Mordecai Ezekiel
Economic Adviser
Department of Agriculture
Washington, D. C.

Dear Dr. Ezekiel:

I find myself so largely in agreement with your analysis of the short term business outlook that it is difficult to make any comments of a general sort.

With respect to the net contribution, my remarks over the telephone the other day may have been slightly misleading. The estimated net contribution shown in the table on page 6 of your memorandum contains the figures which I gave you as representing our last estimates prior to the outbreak of war. (On this basis, the figure for the second quarter of 1940 should be 780, rather than 730.) Our latest estimates, which roughly take account of the effects of war during the remainder of the present fiscal year, are as follows: 910, 920, 830, 740. These estimates are highly tentative because we do not have much information upon which to guess the additional amount by which military and naval outlays will be stepped up as the result of war. It does seem probable, however, that the increase in such outlays will be at least counter-balanced by higher tax receipts, even if, as we both expect, the present inventory spurt is followed by some reaction in business volumes in the early months of 1940.

With respect to the partial reaction in business which we anticipate, I don't believe that such a reaction, if moderate and if followed later in 1940 by an expansion of activity based upon growing war demands, is in itself to be greatly deplored after a sharp inventory spurt. Rather, we should seek to avoid recession during the interval between the end of the inventory spurt and the beginning of heavy war demands, chiefly because such recession would indicate a failure to hasten needed capital outlays whose postponement may later on intensify congestion in heavy industries.

Viewing the longer term impacts of the war, and assuming it to be a long drawn out affair, it looks as if wartime demands

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September 30, 1939

MEMORANDUM TO:

The Secretary
Mr. Paul W. Appleby
Mr. W. R. Tolley
Dr. Lauchlin Currie
Dr. Richard Gilbert
Mr. Emile Despres
Mr. Nile Perkins

Gentlemen:

Enclosed is a copy of a memorandum which attempts to appraise the minimum business activity which is to be expected in the next few months, in view of the impact of the war on our domestic activity and the probable developments in the next few months. Obviously, much of the picture is still very unclear because of inadequate information.

I shall be much interested in any corrections, reactions or comments you might have on this memorandum.

Sincerely yours,

Mordecai Ezekiel
Economic Adviser
Office of the Secretary

Memorandum to the Secretary

MINIMUM ESTIMATE OF WAR INFLUENCE ON DOMESTIC DEMAND

Summary

1. The war, in the early stage, may prove less costly to the Allies, in men and materials, than the World War proved.

2. Exports to neutrals during the next few months may be dominated more by unfavorable developments than favorable.

3. The sharp pick-up in domestic production thus far may have been largely upon an inventory basis.

4. Large-scale increases in new capital goods purchases not yet in sight.

5. The Federal net contribution will slacken after the end of 1939.

6. The present upturn in activity may be followed by a recession, possibly during the winter, which will carry production and employment back toward August levels. This reduced level of activity might then continue for some months until export or rearmament orders finally got the true war expansion under way.

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MINIMUM ESTIMATE OF WAR INFLUENCE ON DOMESTIC DEMAND

In an earlier memorandum (September 13) an attempt was made to appraise the possible stimulating effect of the war on domestic demand over the next year. That memorandum stated certain upper limits which appeared to indicate the maximum effect possible.

Now, with nearly a month of wartime events to base observations on, a first shot can be made at estimating what the minimum effects may prove to be.

In September, now only prices, but also industrial production and employment, spurted sharply. The index of industrial production (1923-1925 = 100) rose from 102 for August to 110 for the September average. At the present time the production is probably running at a level of 115 or better. Will the rapid upturn continue through the months ahead, or will it be followed by a sharp recession, such as occurred in mid-1933?

1. The war in its early stages may prove less costly to the Allies, in men and materials, than the World War proved.

To date, the campaign on the Western Front has apparently consisted largely of preliminary skirmishes, without large-scale engagements, and without large-scale expenditure either of munitions or aircraft. Assuming (1) that Russia does not enter as an active participant, and (2) that neither Germany nor the Allies attempt to outflank the fortified lines by a drive through neutral territory, the Allies would probably continue to follow the strategy of restricting the conflict to the economic and resource fronts so far as possible, with only enough pressure in the West to steadily deplete Germany's economic power. If such a strategy is followed, the demands on us for exports, both for munitions and for raw materials, may show much less increase than the speculative markets have generally assumed. This lack of immediate pick-up in exports to England and France may be especially marked over the fall and winter months ahead.

2. Exports to neutrals during the next few months may be dominated more by unfavorable developments than favorable. In the absence of definite information, we can only examine the 1914 experience, and conjecture as to how far it may be repeated. In the first World War, our exports to North America, South America, and Asia showed no upturn until six or seven months after the outbreak of war, and made no exceptional gains until a year to a year and a half later. Exports to Europe increased promptly in two or three months, largely because of heavy shipments of wheat, horses, meats, and similar war supplies either direct to the Allies or to adjacent neutral countries.

Where the war interrupts commodity movements, the effect may be almost instantaneous. Where it creates new potential outlets for our products, it may take some time for the new business contacts to be established, new lines of production to be developed here, and new export movement to get under way. At the same time, the uncertainty as to the probable extent and duration of the war make business men hesitate for a time to enter upon such new commitments. Again this time, the net effect may be a decline in exports to neutrals for several months or even longer.

3. <u>The sharp pick-up in domestic production thus far may have been largely upon an inventory basis.</u> The rapid rise in prices stimulated many distributors and manufacturers to order ahead to cover subsequent needs. For example, it is reported that the Chrysler Corporation ordered all its suppliers to buy steel to cover their production for six months ahead. Similarly, the large volume of cotton textile sales was the normal response to an upward movement in raw cotton prices. Corporate inventories on August 30 were generally still high, so the subsequent purchases may carry them up even beyond the 1937 levels. Employment and production were already strengthening in July and August. Income payments, corrected for seasonal, increased from 83.7 in July to 85.4 in August (1929 = 100). The subsequent increase in domestic consumer buying power cannot have been enough to support the recent sharp increase in industrial production. On the contrary, the increase in the cost of living since September 1 will cancel out a good part of the September increase in incomes, and leave little or no net gain in commodity buying power. From August 15 to September 15 factory employment, seasonally adjusted, increased only 2.7%.

It seems unlikely that consumer buying power will increase rapidly enough in the next few months to validate the recent upsurge in production. Only if investment or exports increase rapidly above recent levels can the present level of production be sustained.

4. Large-scale new investment not yet definitely assured. The expansion in production will undoubtedly itself stimulate freer use of depreciation reserves for actual expenditure. Railway equipment and steel-mill equipment are also reported to have been ordered recently. Even with the recent addition of $70,000,000 of railway equipment (as estimated by RFC), railroad equipment expenditures will still be well under the 1937 level. It is doubtful if such orders are as yet sufficient to sustain the recent increases in production, and certainly not in consumers' goods lines, such as textiles and clothing.

Construction, although still running above a year ago, seems more likely to slacken than to increase further. F.H.A. mortgages selected for appraisal have been running behind last year's figures ever since July. They closed part of the gap in August, but for the first half of September still lagged definitely below last year's levels.

5. Public expenditures will slacken. The net federal contribution is expected to reach a peak in the 4th quarter of the year, and to decline gradually thereafter, though the decline will not be as sharp as was

feared earlier. The present anticipated contribution is about as follows:

Net federal contribution to purchasing power:

Quarter		Expected (millions of dollars)	Corresponding figure, a year earlier (millions of dollars)
3rd quarter,	1939	870	756
4th "	"	930	864
1st "	1940	870	864
2nd "	"	730	1010

Conclusion: It seems quite possible that the increase in production to date has been in large part an inventory boom, but the scanty specific data on inventories and on new capital commitments are not adequate for a definite judgment. Unless tremendously increased export orders are forthcoming in the very near future, this boom in production will probably be followed by a recession in activity which may carry the indexes of production and employment down toward what they were before the upturns started.

While all the gain may not be lost, it seems unlikely we can long continue the recent upward spurt, and a subsequent sharp downward movement, beginning perhaps during the winter, is more to be expected. If the present boom psychology should lead to any marked reduction below the level of relief or other public expenditures now planned, the possibility and extent of the downturn would be intensified. After the reaction from the inventory boom, production might remain somewhat horizontal until the actual realization of large export orders or new preparedness expenditures finally began the true war upturn in production.

Over the past six years, our industry seems to have become increasingly unstable, so that when movements start either upwards or downwards they go to extreme levels. The drop in production in early 1939 was much sharper than forecasters generally expected, and the upturn in September exceeded all expectations. If this upturn should culminate in a downward smash in production, prices, and stock quotations, the downward movement might again be more extreme than the conditions warrant or than anyone would now anticipate.