

MEMORANDUM

October 18, 1939

TO: Mr. Currie
FROM: Emile Despres

THE BUSINESS OUTLOOK

I. The Present Situation

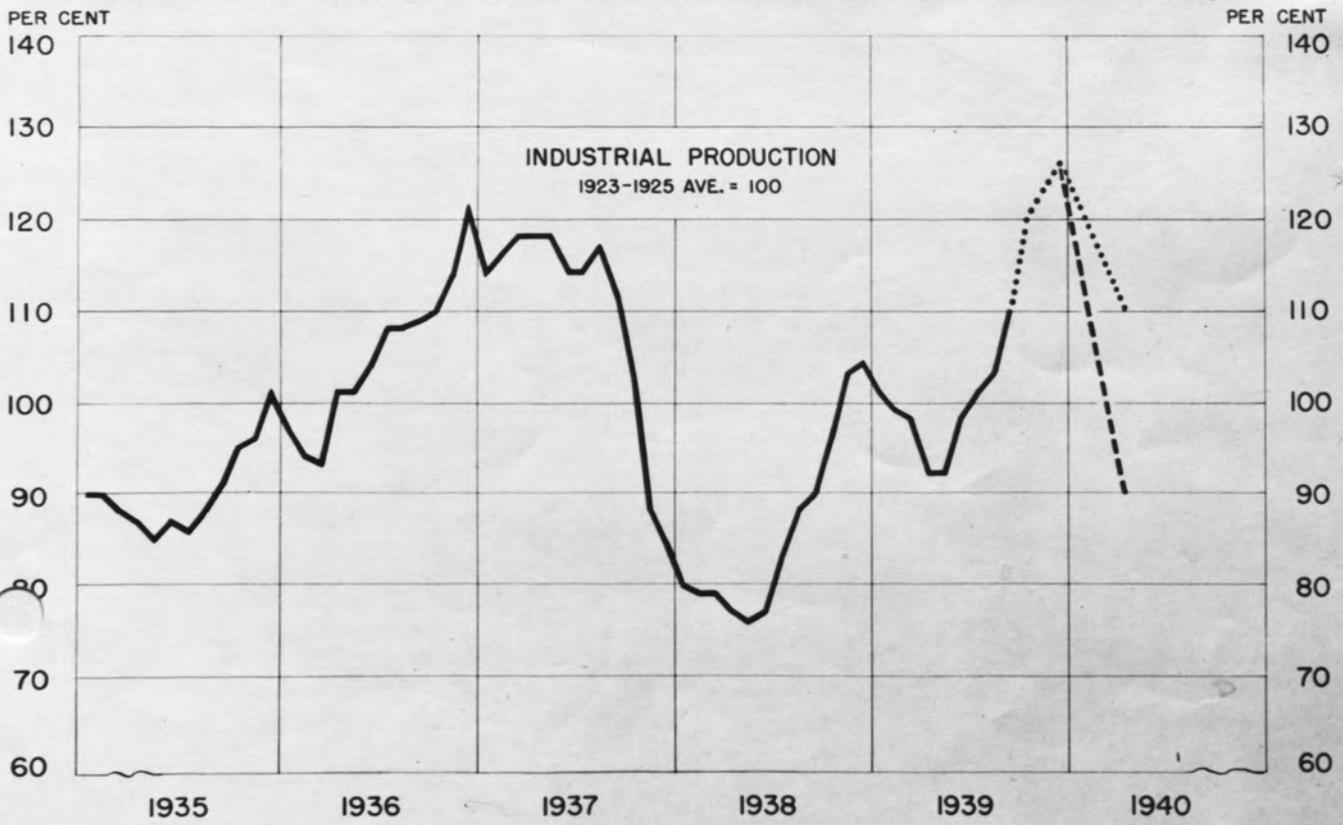
Prior to the outbreak of war, inventories of a number of highly fabricated goods appeared, on the basis of trade reports, to be somewhat low in relation to prevailing and prospective rates of activity, while supplies of foodstuffs and industrial raw materials were excessive. Stocking of finished goods by retailers and jobbers, and of semi-fabricated goods by some manufacturers of final products, was expected to contribute to a continued, gradual expansion of business volumes during the autumn. The feverish buying which immediately followed the outbreak of war greatly exceeded, however, anything which might have been expected on these grounds. This buying movement, based upon memories of the powerful inflationary stimulus exerted by the last war, reflected an anticipation both of price increases and of possible difficulties in obtaining deliveries.

The extraordinary volume of speculative and precautionary orders which were placed immediately following the outbreak of war has provided the principal stimulus to the present, sharp spurt in industrial activity; the process of inventory accumulation may be expected to promote expansion of industrial volumes during the remainder of 1939. As is shown in the accompanying diagram, it is now estimated that the Federal Reserve index of industrial production will reach 125 to 130 in December as compared with 102 in August, and that this expansion in industrial output will raise the volume of stocks in the hands of manufacturers, dealers, and retailers by from 1 to 1.4 billion dollars, after allowance for customary seasonal changes. The increase in consumer incomes associated with higher industrial activity should induce a moderate rise in the volume of retail buying.

II. Outlook for Early Months of 1940

Business expectations at the outbreak of war in 1939 were directly based upon memories of the powerful inflationary stimulus exerted by the war of 1914-18. In forming business judgments, little weight was given to the possible effects upon our economy of the disrup-

VOLUME OF INVENTORIES, RETAIL SALES, AND INDUSTRIAL PRODUCTION



tion of peacetime trade in European countries, and the retrospective view of the war of 1914-18 seemed to be one in which the developments of those years were telescoped into a single episode. It was apparently forgotten that the increase in our exports which got under way late in 1914 was at first based in considerable part on the combination of high crop yields in this country and rather poor yields elsewhere, that industrial activity in the United States did not turn up until well into 1915, and that the upward sweep of commodity prices did not begin until late in that year. Moreover, little thought was given to the difference between conditions now and conditions during the last war. This was most spectacularly illustrated in the sugar market, where memories of wartime shortages and high prices led, despite existing large supplies, to a brief rush of buying by both professional traders and consumers.

The avoidance of a substantial decline in business volumes after production of goods for inventory has come to an end requires the swift emergence of less transitory factors of demand. The possible sources of increased demand may be grouped under three main classes: exports, expenditures of the Federal Government, and private capital outlays.

1. Exports. - It is probable that our total exports will show only a moderate expansion over the next nine months; that the increase in imports associated with inventory accumulation in this country may cause a temporary contraction in our export surplus over, say, the next three months; and that thereafter our excess of exports will increase only gradually. Our trade with European countries other than Great Britain and France, which produced an export surplus of \$305 millions in 1938, will probably be substantially curtailed, owing to the British-French naval blockade. This direct loss in trade will be only partly compensated by such indirect offsets as Latin American purchases from the United States of machinery formerly imported from Germany. In view of the British and French determination to draw sparingly upon their gold and exchange reserves, which constitute an important element in economic staying power, their net imports from the United States will increase only moderately during the early months of the war as increased importation of goods related directly to war needs will be offset by forced curtailment of imports for civilian consumption. Increased British and French demand for our goods will be largely concentrated in heavy industrial products, foodstuffs and raw materials being obtained chiefly from Empire sources and from Latin America. Substantial expansion in our net exports to non-European countries will await an enlargement of British and French imports of foodstuffs and raw materials from such countries; when their sales to Great Britain and France begin to increase, Latin American and other

non-European countries will for a time refrain from spending the additional proceeds in order to replenish their depleted gold and exchange reserves. Non-European demand for United States products, though likely to be somewhat more diversified than that of Great Britain and France, will also be largely concentrated in heavy industrial products.

2. Federal Government expenditures. - It appears probable that during the first half of 1940 the Federal Government's net outlays which contribute to community income and business activity will be somewhat below present and recent past levels. Our estimates of adjusted receipts, adjusted expenditures and net outlays for the present fiscal year are shown in the following table, together with actual figures for the 1939 fiscal year.

(In millions of dollars)

	Adjusted Receipts	Adjusted Expenditures	Net Outlay
Quarter ending:			
Sept. 30, 1938	1,580	2,340	760
Dec. 31, 1938	1,570	2,410	840
Mar. 31, 1939	1,560	2,410	850
June 30, 1939	1,490	2,480	990
Fiscal year 1939	6,200	9,640	3,440
Quarter ending:			
Sept. 30, 1939	1,450	2,360	910
Dec. 31, 1939	1,470	2,400	930
March 31, 1940	1,670	2,490	820
June 30, 1940	1,680	2,420	740
Fiscal year 1940	6,270	9,670	3,400

Enlargement of military and naval outlays during the remainder of this fiscal year will be more than offset by a reduction in non-military disbursements, notably work relief, and by increased revenues.

3. Private capital outlays. - The present spurt in industrial volumes, although based predominantly upon the filling of speculative orders for inventory, also reflects an increased domestic buying of certain types of capital goods. Orders for industrial machinery have been placed in relatively large volume, railroad buying of freight cars has been substantial, and indications of some increase in demand for electrical generating equipment have been reported. Industrial operations in connection with the filling of orders for these types of capital goods will give some support to total activity and incomes in the early months of 1940, after inventory accumulation has ceased.

Appraisal of the three possible sources of increased demand indicates that (1) over the next nine months the contribution to income made by export sales will rise only moderately; (2) that this rise will be nearly offset by a small decline in the Federal Government's contribution to income; and (3) even though private capital outlays in a few lines are likely to increase considerably, this will serve merely to cushion the decline in activity.

Business activity may therefore be expected to drop back towards earlier levels in the early months of 1940, after inventory accumulation has run its course. The view that the present increase in activity will generate a sufficient expansion of incomes to take the additional output off the market, and that the higher levels of activity can therefore be maintained after expansion of inventories has ceased, is supported neither by the experience of earlier inventory boomlets, such as those of 1933 and 1937, nor by economic considerations of a more general nature. A volume of purchasing power larger than the total of direct production outlays is needed for the sale of current production, because the price of the product must include not only direct costs, but also depreciation, accumulating earnings, interest charges, and the like, which go into reserves that do not appear in the market as current income available for individual consumer purchases. Moreover, although some individuals may for a time incur debts in order to spend in excess of their current incomes, individuals as a group do not ordinarily consume all of their income. It follows that unless private capital outlays, exports, or Government net disbursements increase sufficiently to fill the gap, a considerable decline in activity and incomes, after a period of heavy inventory accumulation, must result from the mere cessation of such accumulation.

The size of the decline in business volumes after the present growth in inventories has ended depends upon (1) the willingness or disinclination of business men to continue holding larger inventories, and (2) the extent of the increase in domestic capital outlays. If

it appears likely that the war will be long drawn out and that increased war demands will later be forthcoming, business men may be disposed to maintain inventories at a high level through the interval of declining business volumes. If, on the other hand, there are good prospects of an early termination of the war, or if the initial mood of buoyant optimism concerning prospective war demands gives way to undue skepticism concerning the eventual emergence of such demands, a concerted effort may be made by business to liquidate its swollen inventories. If business concerns are willing to continue holding larger inventories, the growth in certain types of domestic capital outlays should prevent business volumes from declining all the way to prewar levels. If a concerted effort is made to reduce inventories, the resulting decline in business volumes probably will more than cancel the August-December advance. These alternative possibilities are illustrated, respectively, by the dotted and dashed lines in the preceding diagram; these lines are designed merely to indicate graphically the conclusions of the above analysis, and should not be regarded as precise forecasts.

The anticipated decline in industrial activity and incomes may retard the growth in new domestic orders for capital equipment. This retarding influence will be accentuated if interest rates should rise considerably, or if price increases are put into effect for products of strategic importance in capital goods activity. The rising tendency of interest rates now appears to have been definitely checked, but the possibility of increases in administered prices cannot yet be ruled out. Such increases, if made, would considerably intensify the decline in business volumes, both by somewhat prolonging the inventory boomlet, and by discouraging needed capital outlays in such fields as railroad equipment, electric power equipment, industrial machinery, and residential construction.