

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

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To Chairman Eccles

Subject: The War Boom and Some

From Emile Despres

Implications for Policy

I. "THE WAR BOOM"

The influence of the European war upon the American economy will be exerted through its effects (1) upon our exports to foreign countries, both belligerent and neutral, and (2) upon our own armament outlays, and other public expenditures and receipts. What happens to domestic capital expenditures, consumer outlays, total employment, and national income, depends largely upon the behavior of these two factors. Appraisal of these two basic factors indicates that:

1. The stimulus of wartime demands will develop much more slowly than the business community now expects. The premature boomlet which we are now experiencing will probably be followed by a sharp reaction early in 1940.
2. Total activity and employment, even when wartime demands have reached their peak, will remain far below prosperity levels. Unemployment may be reduced from 10 million workers to 6 or 7 million, but not to 2 or 3 million.
3. Owing to the abnormal character of war demands, the war will leave behind some redundant capital equipment (e.g., steel) and a large body of workers firmly entrenched in communities where they will have little chance of finding jobs in the future. The postwar problem of unemployment will be more intractable than our present unemployment problem.

These points will be briefly discussed in the subsequent paragraphs:

1. Slowness of War Boom

- a. Foreign buying of American goods will show only a slow increase. Our exports of heavy industrial products will increase, but for a considerable time this expansion will be nearly offset by a decline in our exports of farm products (wheat, cotton, tobacco) and light consumer goods.

- (1) Trade with countries affected by British naval blockade will be promptly and sharply curtailed.

Our trade with these countries produced an export surplus of \$305 millions in 1938, or over one-quarter of our total export surplus.

(2) Great Britain and France are determined to draw only sparingly on their gold and exchange reserves, in order to conserve this important element in their economic staying power. To avoid drawing heavily on these reserves, they will obtain food-stuffs and raw materials largely from their own political and economic empire, whose productive power has greatly increased since 1914-18. As a further means of conserving reserves, Great Britain and France have imposed thoroughgoing systems of direct economic control; through such controls their imports of many types of goods related to civilian requirements are being considerably curtailed, while imports of goods related to war needs will be expanded only slowly, as a widening of the scale of hostilities, consumption of materiel, loss of life, and impairment of industrial facilities through enemy bombing make such expansion essential.

(3) Our exports to Latin America and to other non-European neutrals can expand significantly only after these countries have replenished their depleted gold and exchange reserves through increased sales of food-stuffs and raw materials to Great Britain and France. Only then will they be in a financial position to increase their purchases from the United States.

b. Despite growing expenditure for armaments, the Federal Government's net outlays which contribute to community income will decline somewhat during the second half of the present fiscal year, owing chiefly to reduced W.P.A. expenditures and increased tax receipts. Net outlays by quarters for the fiscal year ending June 30, 1940 are estimated as follows:

first quarter	910 millions,
second quarter	930 millions,
third quarter	820 millions,
fourth quarter	740 millions.

c. The present sharp spurt in business volumes, though it reflects increased buying of certain types of capital goods, is based predominantly upon inventory accumulation. This inventory accumulation is the result of the feverish rush to place orders which immediately followed the outbreak of war, owing to the exaggerated optimism of American

business men concerning war demands. It seems inevitable that there will be a sharp decline in business volumes early in 1940, when the bulk of these orders have been filled and inventory accumulation has ceased.

2. Inadequacy of War Boom

Even when wartime demands are at their peak, our economy will probably be operating at far below capacity levels and the number of unemployed will probably be only 3 or 4 millions under recent levels. It is estimated that with our present working force, a volume of industrial production about 60 per cent above immediate prewar levels would be required to reduce unemployment to normal proportions.

- a. It seems unlikely that our annual export surplus, at its peak, will exceed $2\frac{1}{2}$ or 3 billion dollars. This is equivalent to a monthly average of 250 or 300 million dollars as compared with an average of about 100 millions in 1938 and about 55 millions in the first eight months of this year.
- b. Our armament program will doubtless be greatly expanded, but this will be accompanied by important, automatic offsets in the form of increased tax revenues, even if existing tax rates are left unaltered, and by reduced W.P.A. expenditures and unemployment insurance benefits. Moreover, it may be assumed that enlargement of armament outlays will be further offset by raising taxes, or reducing public works, housing, and A.A.A. expenditures, or both.
- c. The direct impacts of war demands will be chiefly concentrated in a few heavy industrial lines, such as munitions, chemicals, petroleum products, airplanes, ships, machinery, and steel. It is usually held that a given volume of primary, stimulating expenditure will, if concentrated in a few fields, have a larger cumulative effect on total activity and employment than if the same amount of spending had been thinly spread over many fields. The concentration of expenditure may induce extensive plant expansion programs in the industries specifically affected; diffusion of the initial expenditure makes plant expansion in particular lines less necessary. The concentration of the spending stimulus should induce capital outlays not only in fields which would be stimulated by ordinary, peacetime recovery, such

as housing, railroad equipment, and electric power equipment, but also in the armament, chemical, machinery, and iron and steel industries, which would be much less stimulated in a balanced peacetime recovery.

- d. If this were the whole story, one would be obliged to conclude that concentrated war demands will have a more powerful stimulating effect on total activity than an equivalent amount of diffused peacetime spending. The fact that war demands are regarded as temporary and of abnormal character produces, however, deterrents to the expansion of total activity and employment which greatly outweigh the stimulus due to the concentrated character of the initial expenditure.

(1) In a number of industries, adaptation to the production of war goods can be readily brought about through relatively inexpensive conversion of existing equipment.

(2) Output can be expanded in many war-affected industries through more intensive use of existing plant and equipment, for example by extending full time working hours for present working forces or by adding new workers and transferring from a one shift to a two or three shift basis. Industries in this group include airplanes, armaments, machinery, and shipbuilding.

(3) In the armament, chemical, airplane, and shipbuilding industries, where new capital outlays will be required despite more intensive utilization of existing plant, products will be priced to include provision for rapid writing off of the new equipment and for abnormally high profits, owing to the transitory and distorted character of war demands. Thus, these capital outlays, instead of providing a means of injecting into the income stream the idle funds of the economy as a whole, will be financed in large part from the swollen profits and generous depreciation allowances of the war industries.

For all these reasons, the cumulative stimulus to total activity and employment provided by temporary and abnormal war demands will be much smaller than the stimulus which an equivalent volume of diffused, peacetime expenditure would furnish.

3. Postwar Dislocations

- a. As mentioned above, capital expenditure not subject to quick write-off is likely to be undertaken in railroads, electric power, iron and steel, and housing. In the first two industries expansion and modernization of capital equipment is highly desirable to meet the requirements of peacetime prosperity. In the iron and steel industry, the case is much more doubtful, and in housing, there is serious danger that construction, instead of occurring in localities where it can be useful in the future, will be undertaken in the localities experiencing a temporary boom.
- b. The present degree of mobility of the unemployed working force is quite high, both geographically and occupationally. About three-quarters are under 45 years of age and more than half are under 35, the proportion of young workers being much higher than for the working population as a whole. With a few exceptions, such as New England textile workers, most of the unemployed are so situated that they can readily move from their present localities to the places where jobs are available and are sufficiently adaptable to be quickly taught semi-skilled trades. As a desperate means of making ends meet after a fashion, many of the industrial unemployed have moved to rural areas where the need for cash income is small, or to localities where odd jobs and part time jobs are most frequently available; these workers could and would move quickly from these localities if good jobs were open elsewhere. It will be extremely difficult, however, to shift workers from war industries after the wartime demands have disappeared. Many of the newly-employed workers, following a brief period of apparently stable employment and income, will marry, raise families, and buy houses, and become firmly rooted in the localities to which they have moved. From a long-run standpoint, the problem of getting these workers into peacetime jobs is far more difficult than that of drawing the workers into the war industries.
- c. The last war produced a marked expansion of both our agricultural and industrial output. The agricultural expansion created grave postwar difficulties. The industrial expansion was welcome on the whole, even though the desire to keep some of our war-stimulated industries actively employed may have been partly responsible for our unfortunate policy of high tariffs and

encouragement to foreign lending. Under present conditions the character of war demands will scarcely be such as to create a new, postwar agricultural problem, but the war expansion of the heavy industries is likely to become a major source of postwar dislocation. In this respect, our postwar economic problem may be comparable to that of England's distressed area problem after the last war.

II. POLICIES TO MITIGATE THE EARLY 1940 DECLINE

1. Discourage increases in administered prices.
2. Check any renewed tendency towards higher interest rates.
3. Urge upon railroads and electric power companies, by whatever means available, the need for anticipating their requirements for new equipment and avoiding congestion and delays later on.
4. Defer to the spring months the scheduled winter increase in W.P.A. activities.
5. Postpone to the spring all postponable Government procurement.
6. Try to activate low^w cost housing projects under F.H.A. financing.

III. THE BUDGET FOR FISCAL YEAR 1941

1. Don't cut public works outlays or A.A.A. benefits, and don't curtail W.P.A. sharply.
2. Cover increased arms outlays by additional taxes on profits, such as:
 - a. more adequate capital gains taxes.
 - b. tax individual stockholder on basis of his share in total accrued earnings instead of cash dividends received. (The present Supreme Court probably would not declare such taxation unconstitutional)
 - c. excess profit tax
3. The policy of maintaining non-military outlays and taxing profits will divert to other sectors of the economy the sterile profits accruing from war industries. It will both mitigate

the worst features of the localized boom in war industries, and allow a part of the profits of these industries to stimulate the rest of the economy. An opposite fiscal policy would retard general recovery while allowing the war profits boom to become accentuated.