CONFIDENTIAL October 24, 1939

MEMORANDUM FOR: Mr. Despres

FROM: Alfred Sherrard

RE: CRITERIA OF PRICE CONTROL

Summary

In certain quarters, voluntary cooperation between industry and Government, centering around the trade association, has been suggested as an appropriate method of regulating prices.

Price control should be designed with several ends in view. The most important of these are:

1. To control speculative accumulation of inventory. This requires mere stabilization of prices, regardless of their level. It might therefore be achieved by the voluntary cooperation of industry, since the advantages of predictability are perhaps sufficient to induce compliance with a stabilized price--especially if it were relatively high.

2. To encourage long-run investment and employment. The revenue resulting from price rises must be absorbed to some extent in unproductive balances--such as depreciation or amortization accounts, corporate surpluses, or private savings. Thus from this point of view the purpose of control would be to keep prices as low as possible without discouraging desirable capital expenditures. The trade association is an inadequate instrument for achieving this end, since the members of any industry are likely to profit by high prices for their own products. The representatives of any particular industry cannot be expected to submerge its interest in those of the economy as a whole.

3. To prevent distortion of the industrial structure. Many industries may be extremely prosperous during wartime even though their prospects for the longer future are far less sanguine. If they are allowed to expand now, the result will be unwanted capacity and stranded workers after the war. Furthermore, desirable activity in housing and other consumer goods fields may well be checked by the very forces that cause undesirable expansion in other directions. Price control alone cannot cope with this problem, since some price advances should probably be encouraged in the war-goods industries as a means of rationing. Excess profits taxation and perhaps even export control should supplement price policy in this connection.

Indirect pressure through such agencies as the FTC, the Anti-Trust Division, and perhaps even the TNEC is probably the most effective immediate approach to the price control problem. If a real war boom should develop, direct Government price regulation might be necessary, but it should be avoided as long as possible because of the administrative difficulties involved. Meanwhile the Government should avoid establishing any mechanism that it cannot control. In particular, it should avoid even the appearance of sanctioning prices established by producers in their own interest. Far better, in the absence of direct regulation, to allow business men to bear the onus before consumers and the general public for the price advances that they announce.

CONFIDENTIAL

October 23, 1939
(Revised October 24)

MEMORANDUM FOR: Mr. Despres

FROM: Alfred Sherrard

RE: CRITERIA OF PRICE CONTROL

Since the outbreak of war in Europe, suggestions for the voluntary cooperation of industry and Government for the control of prices have again become prevalent. Most of these schemes, as in NRA days, give a central place to the trade associations, relying upon them largely for enforcement as well as for the formulation of standards. Such a method of regulation, entered into without clearly understood objectives, might well have highly dangerous consequences.

Price control under present conditions should be designed to serve several purposes. The most obvious aims are discussed below, but others could no doubt be added.

1. To control speculative accumulation of inventory. Inventory accumulation is a form of capital expenditure and, as such, a stimulant to business. The incentive to amass stocks of commodities is not high prices, however, but the expectation of rising prices. When this expectation no longer exists, speculators will sell in order to realize their paper profits. Such sales may even reverse the trend, creating an anticipation of falling prices and thus leading to further sales. Business activity based upon inventory accumulation is necessarily precarious, since an upward trend of prices cannot continue forever. Employment, being dependent upon production, therefore fluctuates violently during an inventory boom and collapse.

This aspect of the price control problem might be rather successfully handled through the voluntary cooperation of industry, since a mere stabilization of prices--at any level--would be sufficient. The advantages of predictability might be sufficient to insure compliance with a stabilized price--especially if it were relatively high.

Furthermore, if prices are to advance, a single sharp rise, with no further movement anticipated, is preferable, from the point of view of inventory speculation, to a series of minor advances. This condition might also be achieved through trade association activity encouraged by the Government, and should be welcome to most business men.

2. To encourage long-run investment and employment. As prices in general rise, the volume of goods and services, and therefore the volume of employment, represented by any given rate of consumer spending and capital goods purchases decreases. Thus if employment is to be maintained, the rate of expenditure--by consumers and producers together--must be increased.

To the extent that price advances represent increased direct costs--in particular, higher wages or lower productivity per worker--they probably lead to some expansion of consumer expenditure. To the extent, however, that they are absorbed by increased depreciation or amortization charges or retained earnings, there is no such offsetting contribution to incomes. If increased earnings are distributed as dividends, the effects will be intermediate; there will be some stimulus to consumption, but a large part of the increased earnings will remain unspent. (Higher prices may also, of course, be explained by increased raw material costs. Raw material costs, however, may in turn be analyzed into wages, charges to various depreciation and amortization accounts, interest payments, and profit. In other words, the revenue derived from higher prices must--viewing the economy as a whole--find its way into one of these categories and thus produce some combination of the results discussed above.)

In any case, consumer expenditure cannot expand sufficiently to maintain employment as prices rise. Thus increased capital outlays--either private or public--become necessary. Until the capacity of existing equipment is strained, a sufficient volume of private expenditure on capital goods is unlikely. The obstacles to large-scale public investment are formidable enough to suggest, therefore, the desirability of vigorous price control.

The purpose of control, from this point of view, would be to keep prices as low as possible without discouraging desirable private investment. (The criterion of desirable investment will be discussed in the next section.) For such a purpose, the trade association is clearly an inadequate instrument. To be sure, the members of any industry may benefit by low prices in all other industries, but they benefit even more by high prices for their own product. Nobody whose responsibility is primarily to one industry can in justice be expected to submerge its interest in that of the economy as a whole. Price regulation for the national welfare can be achieved only by an agency with national responsibility and with no obligations--pecuniary or emotional--to any particular firm or industry.

3. <u>To prevent distortion of the industrial structure.</u> In the present wartime situation, many industries may be extremely prosperous even though their prospects for the longer future are far from sanguine. Should these industries be allowed to expand in response to an ephemeral demand, grave problems of postwar readjustment will be created. Not only will excess capacity exist--in itself a waste of resources--but labor will be transferred to regions and occupations in which there will later be no jobs.

Under present circumstances this difficulty is accentuated because the very industries most likely to profit from an expansion of exports would profit further from their own capital expenditures. Steel, for example, is used for constructing steel mills; to the extent, therefore, that projects for increasing mill capacity are undertaken, the existing capacity is further strained and the impetus to expand is reinforced.

The negative aspect of undue development in some fields is the inhibition of desirable activity in others. As the prices of building materials rise, for example, in response to orders for plant expansion in the heavy industries, private housing activity will be retarded. This would be unfortunate not only because better living quarters are urgently wanted; it would also cause the unemployment of many building workers, especially in the smaller towns and in agricultural areas, who would be unable to transfer to industrial construction. A similar situation might be expected in most consumer goods fields.

This problem is rather more complex than those previously examined, and its remedy cannot be stated so simply. The most obvious suggestion is that prices of heavy industrial products should be kept down, so that the profits that would stimulate and partially finance plant expansion might be curtailed. If, however, demand at present prices is more than sufficient to absorb the maximum output of existing equipment, some rationing device must be found unless capacity is to be increased. Price advances are by far the simplest method of rationing, especially under conditions in which there is no desire to discriminate among customers. (Rationing of exports might be defended as a desirable discrimination in favor of domestic purchasers. Similarly, price increases on products largely exported--implements of war, for example, if the present embargo is repealed--might well be encouraged.)

This apparent contradiction in aims suggests that price regulation must not be considered in isolation, but as part of a larger policy designed to minimize the ill effects of the European war upon our economy. In cases where price advances are allowed or encouraged, some other device--such as an excess profits tax--should be used to prevent industrial distortion and the absorption of income into unproductive balances. Conversely, if prices are to be kept low in the face of rising demand, another method of allocating output among customers--possibly some form of export control--might be needed. Equity and expediency are sure to conflict at times if control is applied at only one level of the business structure, but they may usually be reconciled by a flexible policy applied simultaneously at several levels.

Direct governmental price regulation is probably too cumbersome to be worth introducing except at a time of actual economic crisis. Perhaps the most effective technique for handling the present situation would be an intensification of effort by already existing agencies. The heavy industries, which are the area of most immediate concern, are sufficiently replete with skeletal anomolies in their bank vaults to be fairly susceptible, perhaps, to a pressure-by-insinuation applied through the Anti-Trust Division, the FTC, and conceivably the TNEC. The position of the Federal Government as an important purchaser of many industrial products might provide leverage for similar indirect influence.

If coordination among the agencies concerned with price control seems necessary, it could be achieved more effectively through an interdepartmental committee than through a grandiose new Authority unfamiliar with the work that has already been done.

It must be emphasized, however, that no form of indirect pressure would be sufficient to combat price inflation if a real boom in the war industries should occur. Furthermore, no close approach to an ideal price pattern with respect to the desirable long-run allocation of resources can be expected to result from such a policy of mere opportunism. Direct price regulation, nonetheless, presents such major administrative difficulties, that it should be introduced only when less cumbersome methods appear completely inadequate. Meanwhile, however, the Government should avoid establishing any mechanism that it cannot control. In particular, it should avoid even the appearance of sanctioning prices established by producers in their own interest. Far better, in the absence of direct regulation, to allow business men to bear the onus before consumers and the general public for the price advances that they announce. The illusion of self-regulation is simply another form of the fallacy that a man is the best judge in his own case.

Confidential

FOREIGN HOLDINGS OF GOLD, DOLLAR BALANCES, AND AMERICAN INVESTMENTS - END OF AUGUST, 1939

(In millions of dollars)

	World (outside U.S.)	United Kingdom, France, and British Empire	Germany, Italy, and U.S.S.R.	Smaller European Countries	Non-European Neutrals	United Kingdom, France, and British Empire: United Kingdom	France	Canada	British India	British Africa	Australia & New Zealand	Germany, Italy, & U.S.S.R.: Germany	Italy	U.S.S.R.	Smaller European Countries: Belgium	Netherlands	Switzerland	Sweden	Other	Non-European Neutrals: Latin America	All Others
Gold Reserves																					
Under earmark at New York	1,131	252	-	831	48	-	252	-	-	-	-	-	-	-	220	314	185	88	25	43	5
Other	10,608	5,488	1,372	2,765	983	2,000	2,748	218	274	222	26	29	193	1,150	411	455	400	267	1,231	609	374
Total	11,739	5,740	1,372	3,596	1,031	2,000	3,000	218	274	222	26	29	193	1,150	631	769	585	355	1,256	652	379
Dollar Balances																					
Official	445	132	5	265	43	54	28	50	-	-	-	1	-	4	4	4	80	153	24	25	18
Private	2,460	1,137	21	605	697	540	288	306	3	#	#	10	11	-	100	155	204	7	139	365	332
Total	2,905	1,269	26	870	740	594	316	356	3	#	#	11	11	4	104	159	284	160	163	390	350
American Investments																					
Securities readily negotiable																					
Common stocks (market value)	2,055	1,060	#	630	365	530	135	395	#	#	#	#	#	#	#	275	290	#	65	30	335
Preferred stocks (market value)	310	200	#	85	25	120	15	65	#	#	#	#	#	#	#	25	30	#	30	5	20
Bonds (market value)	455	160	#	265	30	80	40	40	#	#	#	#	#	#	#	175	55	#	35	5	25
Total (market value)	2,820	1,420	#	980	420	730	190	500	#	#	#	#	#	#	#	475	375	#	130	40	380
Investments not readily negotiable (various bases of value)																					
Direct investments (book value)	1,680	1,185	#	425	70	755	25	405	#	#	#	#	#	#	#	250	100	#	75	5	65
Other investments (various bases of value)	760	390	#	245	125	165	55	170	#	#	#	#	#	#	#	130	70	#	45	10	115
Total (various bases of value)	2,440	1,575	#	670	195	920	80	575	#	#	#	#	#	#	#	380	170	#	120	15	180
Grand Total (various bases of value)	5,260	2,995	#	1,650	615	1,650	270	1,075	#	#	#	#	#	#	#	855	545	#	250	55	560
GOLD, DOLLAR BALANCES, AND AMERICAN SECURITIES (readily negotiable)	17,464	8,429	1,398	5,446	2,191	3,324	3,506	1,074	277	222	26	40	204	1,154	735	1,403	1,244	515	1,549	1,082	1,109
GOLD, DOLLAR BALANCES, AND AMERICAN INVESTMENTS (includes investments not readily negotiable)	19,904	10,004	1,398	6,116	2,386	4,244	3,586	1,649	277	222	26	40	204	1,154	735	1,783	1,414	515	1,669	1,097	1,289
Annual Gold Production - 1938	1,145	747*	176	17	205	-	3	165	11	487	61	-	1	175	-	-	-	6	11	89	116

Small amounts not shown separately in available sources.

* Includes $20 millions of British Empire production outside regions shown separately.

Statistical Note
Gold reserves: Figures are for various report dates near the end of August except that in certain instances where complete reports were not available for a recent date figures were estimated, notably in case of United Kingdom, France, and U.S.S.R. Dollar balances: Figures reported for August 30 except that holdings by countries were partly estimated in certain cases, notably Sweden, Belgium, and Other Europe. Foreign investments: Based upon Department of Commerce estimates, with adjustment for recent changes. Gold production: 1938 figures partly estimated in certain cases, notably U.S.S.R.

Form F. R. 131

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date November 6, 1939

To Chairman Eccles

From Emile Despres

Subject:

Referring to my memorandum of October 24 regarding Ben Cohen's request, communicated through David Ginzburg, I have been meaning to tell you that shortly thereafter Cohen spoke to me directly about this proposal. It turned out that the thought in his mind coincided with your views in the matter. His suggestion was that a few of us who knew each other might find it helpful to get together on occasional evenings in order to discuss general questions of current interest. He made it clear that this was merely an informal suggestion which we might follow or not as we liked, and that it was in no sense an instruction or even a request from him. It appears that our original doubts about this were due to the fact that Cohen's suggestion was somewhat garbled in transmission.

ED