By Chairman Eccles

MEMORANDUM ON ECONOMIC OUTLOOK

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Perspective

1. We have not yet found the key to maintaining economic stability. The economy has been operating under forced draft for a long time. The war and postwar situations and the inflation which already has occurred have created distortions and maladjustments. Sooner or later, they will have to be corrected.

2. The problem immediately ahead is still one of controlling inflation. Demands for many important products are still urgent and very large. Federal expenditures are high; foreign demand is extensive; and the volume of purchasing power in the hands of individuals and business is not only adequate but excessive. On balance inflation factors still outweigh deflation factors.

3. Yet, some of the speculative pressure is being reduced. Some pipe lines are being filled and some buying resistance to high prices is developing. This is wholesome and desirable. It will help to forestall further distortions and give us an opportunity to recover a balanced foundation for long-run prosperity without going through a drastic boom and bust. Any slowing down of inflationary pressures is cause for optimism rather than pessimism.

4. Underlying economic conditions are basically strong. Backlog demands along some major lines -- construction, automobile, etc. -- should prove sufficient to keep the economy going at a high level for quite some time <u>if</u> distortions in the price and wage structure are corrected and further distortions avoided.

Record Since V-J Day

1. The record since V-J Day has been satisfactory in some respects, unsatisfactory in others. On the whole, the nation has done well from the standpoint of absorbing people into peace-time production but has not done so well in maintaining a stable economy.

Favorable factors are:

(a) Nearly 11 million veterans have been demobilized and absorbed into employment at a rapid rate.

(b) A very high level of civilian employment has been reached. Civilian employment now stands at 58 million. The highest figure during the war was 56 million.

(c) The shift from war to peace production has been made rapidly, and output is close to capacity in most lines.

(d) Incomes of practically all groups in the economy are above record peacetime levels. The annual rate of income payments is now close to 170 billion dollars which is higher than any wartime quarter and more than twice the highest prewar peaks of 1929 and 1940.

(e) Federal expenditures have been cut from over 100 billion dollars to an annual rate of 40 billion; the budget is being brought into balance; and we have started on a program of debt reduction.

(f) Liquid asset holdings of individuals have continued to increase, but at a much slower rate than during the war. More savings bonds have been bought than sold by the public.

(g) Government security prices have shown great stability notwithstanding a sharp break in the stock market, and a reduction in bank holdings of such securities.

(h) The expansion of total deposits has come to a halt and has been reversed and interest rates, although no longer declining, have remained low.

Unfavorable factors are:

(a) Wartime controls of prices, wages, and production were prematurely abandoned or relaxed. The excess-profits tax was abolished at the time we needed it most to support economic stabilization.

(b) The working week was cut at a time when increased production was the basic solution to the inflation problem.

(c) The upward spiral of rising wages and prices has gone too far. An upward adjustment in basic wage rates was necessary after the war, but in many cases it came too soon and in some cases it went too far. The cost of living has gone up sharply. Real incomes for many groups have greatly declined. Since V-J Day, the price rise has amounted to more than 1/3 of that which occurred during the entire war. This advance in living costs has eaten into the buying power of fixed income groups, and others who have lagged behind in wage increases. The rising living cost has created unrest among workers and now there is again danger of a period of wide-spread industrial unrest. A second round of wage increases is threatened early next year unless there is a reduction or at least no further increase in the cost of living. Higher wages would call for higher prices in many cases and thus add to inflation. Where profits permit prices should be lowered rather than wages increased.

(d) Prices in some areas (construction in particular, but also for most farm products) have risen to a point where they are out of line with what people can or are willing to pay, even at present high levels of income.

(e) Prices of capital assets have in some cases advanced to untenable levels. This is true of prices of urban real estate, which are now in many areas over twice prewar figures. Farm real estate prices are also well ahead of what likely future farm incomes can sustain. Stock prices have also increased sharply but the recent decline in security markets provides a healthy correction to a speculative overextension.

(f) Production in vital areas has been held back by disruptions due to strikes last winter and spring. There has also been withholding of goods because of price uncertainties.

(g) These disruptions of production combined with the large shifts in jobs and the general spirit of relaxation after the war have held down productivity.

2. On balance, however, the record is fair. Most important, the returning veteran has been absorbed into a going economy. It would have been very much better had this been done without any inflation but it was better to have done it with some inflation than not at all.

Outlook

1. Now the need is to realize that we cannot sustain prosperity by keeping up the inflation process. Inflation can only end in collapse. To sustain prosperity, we must place it on a stable basis. The decline in the stock market and some levelling off in real estate prices encourages the hope that we may be able to squeeze out the speculative factors in the economy, correct the distortions that exist in some lines, and maintain production and employment at high levels.

We can succeed in the period ahead (1) if productivity per worker can be raised -- this is most important, (2) if large scale industrial disputes and further general wage increases can be avoided, and (3) if business groups are willing to refrain from further price increases, or even to lower prices and rely upon volume operations for profits.

High income and employment require demand sufficient to buy what the people can produce. During the 30's demand was woefully inadequate. This basic inadequacy may well develop again when the backlog demands have worn off, unless we have policies and programs to forestall it. But this is not our most immediate concern. We are still in a position -- and will be for some time -- where private demand is basically sufficient to sustain a high level of employment if maladjustments and speculative excesses are avoided. The immediate danger is that demand in most lines is in excess of supply.

What are the main favorable and unfavorable factors in this picture?

2. The basic reason for believing that employment and incomes may be maintained is that there still is an unprecedented demand for investment and consumption, domestic and foreign. To give a few illustrations:

(a) There is a huge backlog demand for housing, especially in the low-cost brackets. This demand has been accumulated because the volume of residential construction during the war and during the 1930's was exceptionally low and because the average income and number of families has increased greatly.

If building costs can be reduced from their present untenable levels, by improving the flow of materials, and by increasing the efficiency of workers, the volume of residential construction ought to continue very high for many years.

(b) Automobile production is just beginning on a large scale. The backlog demand for automobiles is huge, and at reasonable prices should permit a record level of automobile production for several years. A similar situation seems to prevail in the case of many other durable consumer goods.

(c) Demand is supported not only by high level of current income but also by the large volume of liquid assets accumulated during the war. Income payments after taxes are now nearly 150 billion dollars a year as compared with about 90 billion in 1941 or 140 billion during the wartime peak. Liquid assets held by individuals are at 180 billion dollars or almost three times the amount outstanding at the end of 1941.

(d) Replacement needs for plant and equipment, as well as expenditures for capital expansion are still large. How long this will continue will depend on the general economic outlook.

(e) Foreign demand for American goods is great, and is supported by an ample amount of funds. The net export balance is now at an annual rate of about 5 billion dollars and may be expected to continue high for some years. Dollar and gold resources of foreign countries are approximately 22 billion dollars. Still unused credit facilities of the Export-Import Bank (including unused portions of loans extended) amount to 2.5 billion dollars. In addition loans arranged over the next three years by the International Bank may amount to as much as 5 billion.

(f) The Federal budget will continue to be large for a long time -- possibly 30 to 35 billion or about four times the prewar level. Government demand will thus continue to be a sustaining force.

3. While these basic sustaining forces are still very strong, they are nevertheless fickle friends. Even though you are most anxious to buy a house or to add to your equipment, you may decide not to do so if you consider the price is exorbitant and the outlook unstable. Once inflationary maladjustments become excessive, a slump will result even though people have funds and many needs remain unsatisfied.

Fortunately, it appears that inflationary pressures are lessening in some areas. Pipe lines are getting filled and supplies are coming into the market in increasing volume. Buyers, wary of rising prices, have begun to show some restraint. These are desirable developments, but there are still acute needs for other adjustments.

(a) The stock market, after a four-year rise which increased values by 150 per cent, has now experienced a decline bringing prices down to the level at the end of the war, or about 20 per cent below their high points last spring. To the extent that this readjustment reflects more sober appraisal of prospects and a lessening of inflationary psychology, it contributes to balance in the economy. As the stock market has a tendency to exaggerate every movement both upward and downward, the magnitude of the price change cannot be considered alarming. In any event, credit for stock market purposes, which has been declining since early in the year following the raising of margin requirements, is at a relatively low level. Because of this prudent credit policy, forced selling has been practically non-existent.

The general level of profits, after taxes, is relatively high, although in many lines they may be kept below earlier expectations by rising costs.

(b) Inventory accumulation should be watched. Inventories have always risen sharply in any upswing and naturally did so in recent months when civilian production increased on a vast scale. When inventories rise sharply they are almost certain to become excessive. Total inventories lately have been rising at an annual rate of 5 billion dollars and are now close to a point where it is important to prevent excessive accumulation. The less we overshoot the mark, the smaller the readjustment that will later be necessary.

(c) In certain areas prices have gone too high and downward adjustments are needed. The levelling off in real estate prices is a healthy sign but construction costs also need to be reduced. Prices of farm real estate and of many farm products are also excessively high. As long as food and clothing prices are rising it is impossible to maintain stability in wages.

Credit Developments

In the field of credit, the inflationary forces that were operating earlier in the year have been moderated considerably.

(1) Budget expenditures dropped sharply and tax receipts stayed up. As a result the deficit has about disappeared.

(2) 17.5 billion dollars of public marketable securities have been retired from March 1 to October 1 by drawing on the Treasury's large cash balance. This has been a wholesome influence in the credit picture. It has:

(a) Moderated the tendency of banks to increase their holdings of long-term Government securities.

(b) Reduced total (Treasury and private) deposits from 151 billion at the end of February to 143 billion at the end of September.

(c) Brought to an end the decline in long-term security yields.

(3) Notwithstanding the debt retirement program, however, there has been a large increase in commercial and real estate loans and consumer credit amounting to about 2.5 billion dollars at weekly reporting member banks since March 1. This increase has been offset in considerable part by a decline of about 2 billion in security loans, largely on Government securities.

(4) As distinct from the decline in total deposits, deposits held by others than the U. S. Government continued to rise by 7.8 billion from the end of February

to the end of September. Of this 3.3 billion was in time deposits and 4.5 in demand deposits. This continued expansion in privately held deposits has remained a major inflation factor. It was due largely to private credit expansion, a continued Federal deficit and retirement of U. S. securities held by nonbank investors.

(5) It should be noted, however, that the period of drastic decline in the budget and in the size of the deficit is over. This decline has operated as a powerful deflationary force, although it was more than offset in the total economy by inflationary forces.

Conclusion

Some points stand out clearly form the foregoing considerations: The situation calls for a budgetary surplus and continued debt retirement. Continued efforts should be made to reduce public expenditures. Taxes should not be further reduced under present conditions. It is desirable to increase tax revenues, without increasing tax rates, by increasing the national income as a result of greater productivity. Such an increase in the national income, together with decreased Federal expenditures, will bring about a budgetary surplus which will make possible tax reductions later on.

Speaking of the general credit situation, there is no reason under present conditions for reducing margin requirements on stock market trading or for relaxing consumer credit restraints on durable consumer goods in short supply. Credit should be provided for productive purposes, but not for speculation. Nor is there justification for increasing interest rates which would greatly complicate the Government's problem of managing the public debt and increase the cost of carrying it, without the offsetting advantage of preventing inflation.

At best, Government price or credit controls can only be a stopgap, and fiscal policy can deal only with the money side of the inflation problem. The overwhelmingly vital need now is for more work and more goods -- for increased productivity. Whether we are to have a stable economic progress depends fundamentally now on the industrial front, on labor and management, on increasing output by increasing efficiency, eliminating bottlenecks and restrictive rules and practices, including those in the construction industry, and by avoiding strikes and shutdowns. We all know that in our interdependent economy a strike in one key industry paralyzes others -- strikes even by a comparatively few workers in plants that supply others can throw many thousands out of work.

More work and more goods are the basic cures for inflation. That is the only way in which labor can keep the gains from the pay increases it has received. It is the only way to safeguard the purchasing power of all wages and savings. Further wage increases for the same amount of work and output would serve only to intensify the upward pressure on prices. Increased wages that result in increased prices are self-defeating. It will be far better to hold prices down and increase productivity -- to increase real wages -- than to have further wage and price increases that would finally result in public resistance. For this, in turn, would upset business calculations, and all long-term commitments, thereby precipitating a recession, the severity of which would depend mainly on how long it would take to correct the distortions and maladjustments. Only by keeping prices down and maintaining the buying power of wages and savings can we have a higher standard of living.

We have all the tangible elements of sustained prosperity -- manpower, raw materials, money supply, coupled with a vast backlog of needs and wants. The intangibles, still needed, include self-restraint, enlightened self-interest, the will and wisdom to translate the tangibles into a lasting, higher standard of living.