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April 4, 1947

MEMORANDUM FOR THE PRESIDENT

FROM: The Council of Economic Advisers

SUBJECT: First Quarterly Review

In the three months which have passed since the preparation of your first Economic Report, business has continued at a high level.

Civilian employment has declined about 1 million from the fall high of 57 million attained last November. This decline is primarily a normal season fluctuation, and the 2.3 million unemployed in March is not cause for present concern.

As for production, business indexes which best measure economic activity have now passed the highest previous point in peacetime, and some of them are crowding the high point of wartime. This accomplishment is highlighted by the fact that, while the Nation was then supporting production by heavy deficit financing, the Government is now accumulating a modest surplus.

Profits shown in the considerable number of corporation annual reports which have not appeared corroborate the estimate in the first Economic Report that profits in the fourth quarter of 1946 reached a very high level. Difficulties of reconversion had evidently largely been surmounted, and, as a result, productivity and profits have continued to improve in the first quarter of 1947.

The combination of good business profits, a high level of employment, and a sound financial structure is the foundation of continued prosperity if no adverse development interferes. But a potential danger cited in the Economic Report of January 8 has persisted.

This adverse factor is the course of prices. The President's Economic Report laid emphasis on the marked decline in real purchasing power of great numbers of consumers during the latter part of 1946. It indicated that this decline flashed a danger signal. The best means of escaping that danger was to be found in prompt, orderly, and selective reduction in prices, and the avoidance of excessive wage increases.

Wage adjustments during the first quarter of 1947 have resulted in moderate wage increases in a number of cases, but in general they have been smaller in amount than those characteristic of 1946. Work stoppages have been held to a minimum and labor productivity has risen. Such wage increases as have been granted have mainly been of a size that employers felt they could absorb in existing prices or even might not preclude subsequent price reductions.

In the first Economic Report of the President, you urged business managers to adopt policies to bring about the moderate and orderly reduction of prices which is needed to stabilize our prosperity. You have recently repeated this view, as have other representatives of the Administration. Similar warnings have been given by leaders of business and labor.

This economic advice has not been altogether unheeded. A few price reductions have recently been made. But, after a period of six



weeks at the beginning of the quarter during which prices were fairly stable, the upward movement of wholesale prices was resumed. This upsurge of wholesale prices of many important goods during late February and March has been the most unfavorable development during the first quarter of 1947. If this upward swing should continue, and if it should be reflected fully in retail prices, the consumers' purchasing power situation would soon become acute. We would expect a great resistance to another round of retail price increases at this time, a drop in retail business, a piling up of inventories, a reduction in business investments and plans for construction, a drop in production, and an increase in unemployment.

The total price situation shows considerable difference between farm and food prices, on the one hand, and non-agricultural prices, on the other. Wholesale prices of other than farm and food products appeared to be levelling off in January and February but began to rise faster again in March. These advances included small adjustments to rising material costs in many commodities and steady advance in several important lines such as lumber, paint, non-ferrous metals, and cotton and wool goods, but also spectacular jumps in rayon, petroleum products, fats and oils, and cattle feed. The over-all trend in non-farm prices indicates a creeping upward movement rather than an inflationary sweep. There is some indication it may now be topping out in part as a result of rising industrial production and in part as a result of an increasingly intelligent attitude among business and labor executives.

Agricultural prices showed a slight downward trend at the beginning of the quarter, and it was our hope that this would ease the downward adjustment of other prices during 1947, but at the same time not



lead to a demoralizing break in farm incomes. Since the middle of February, wholesale farm and food prices have shown sharp advances. If these advances in wholesale prices should be fully reflected at the retail level and maintained during the months ahead, this would further impair the purchasing power of the mass of consumers and exert a pressure toward wage increases which might spiral upward in commodity prices. This is the most difficult phase of our adjustment problem because we are in the last stage of the old crop year, when total supplies cannot be increased and remaining stocks are susceptible to speculative hoarding. This situation has been further complicated by pressure to increase export shipments to war-devastated countries. There is therefore little prospect of materially easing this situation in the immediate future. It puts on us the responsibility, however, to use existing regulatory machinery to prevent market abuses and to follow taxation, banking, and other policies which will do the most possible toward checking inflationary tendencies.

Today's situation undeniably has inflationary elements, and the policies of Government should be pitched on that level and be designed to halt further price advances and if possible to induce price reductions by moderate degrees rather than to permit inflation to lead to a sharp and disastrous break.

Buyer and investor resistance can and may operate toward remedying the situation. Here and there it is appearing in the case of consumers' goods, and in significant scope in the case of business investment. Many firms have postponed their building plans on account of the high prices, and housing construction is clearly lagging. This, however, is not a basic solution of the problem. The "remedy may prove



worse than the disease^m if it results in blighting the normally expected spring and summer expansion of activity in the construction industry. It will be successful only if it brings construction costs down to the point where industrial, commercial, and residential building can go forward in volume sufficient to utilize our productive resources in the construction industry and the materials suppliers who depend upon it. A satisfactory level of construction activity this year requires voluntary adjustments of building material prices, high productivity of building trades labor, and wise action under the Government's housing program.

Since the general price situation, as we enter the second quarter of 1947, has not yet been brought into stable adjustment, government policy should be directed toward curbing inflation and promoting price adjustment. Besides the voluntary action of management on prices and of unions on wages already discussed, we repeat the recommendations made last January that income taxes should not now be lowered. Such lowering would add to the inflationary tendencies still present in the market.

If tax reductions were concentrated in the lowest income groups they would furnish relief for the family budget where it is desperately needed, but they would still have an inflationary effect and we believe that even such reductions should be deferred for a time. Tax reductions for higher income groups and for business would certainly add to the inflationary pressure and they are not now necessary to induce any desirable expansion of business investment. Such investment will proceed in most gratifying volume if prices can be reduced in a rational way without curtailment of production.



As a fiscal instrument to influence economic conditions, tax reductions should come when business is lagging. They should now be saved for such a period. In view of the international situation and our necessary commitments in that field, and considering our obligations in the matter of expenditures for interest on the debt and for veterans' assistance, the national budget cannot be reduced to such an extent that a second reduction in taxes could be made in a period of deflation without resorting to deficit financing.

Here it should be emphasized that business conditions can change very rapidly. If a sizable recession were to come in the latter part of this year, we would then probably recommend the reduction of personal income taxes. We would in that event expect to make recommendations as to the total amount of such cut and its distribution among income classes so as best to promote the purposes of the Employment Act.

A related policy which is important at this time because of its anti-inflationary effect is the further retirement of that part of the debt which is held by the commercial banks. This process reverses the inflationary process which takes place when the Government sells bonds to the banks, and new deposits are thereby created. By paying off bonds held by the banks, the Government brings about a reduction in deposits, which is anti-inflationary. Under present conditions it should be done to the fullest possible degree, and present tax rates should be maintained for that purpose.

Of similar import is the policy of credit control. In order to replace earnings lost by reduction in holdings of Government securities, banks might continue to expand other types of credit, which would be even more inflationary. Present powers of the Federal Reserve System,



particularly under wartime policies of maintaining a fixed pattern of interest rates, are inadequate to prevent such credit expansion. While the broad objective of maintaining a low general level of interest rates on Government securities should continue, some changes in policy may be desirable. But beyond this, additions to the Reserve System's powers are needed, if further credit expansion is to be restricted.

There now exists the power to limit the growth of installment credit which, even under the present restraints, has been expanding at a disturbing rate. This power now rests on wartime Executive Order, which may have to be rescinded in the absence of legislative authority for its continuation. If the curbs on the extension of instalment credit now being exercised under Regulation W were to be removed at this time, there would be a tendency of producers and distributors to try to sustain the absorptive power of the market by accepting lower down-payments and a longer time period rather than adjusting prices to the purchasing power of current incomes. This would postpone rather than promote the kind of stable adjustment that our economy requires.

It is in line with the philosophy of the Employment Act that there should be some effective means of opposing unwise credit expansion in boom times and of easing credit as a recovery measure. Hence we would recommend that the President lend his support to legislation designed to include the regulation of installment credit among the permanent powers of the Federal Reserve System.

In conclusion, the Council of Economic Advisers would express deep concern over the extent of prospective cuts in the work of various statistical agencies in connection with the necessary reduction of Federal

expenditures to a peacetime basis. A large amount of statistical fact-finding is necessary as the foundation of the work of this Council, and the employment Act instructs us to get such service from existing agencies. Our ability to perform our functions adequately would be greatly impaired if these statistical services are cut down to the extent contemplated in present appropriation bills or proposals. We trust therefore that the President will use his influence to halt sweeping reductions which have not been thoroughly investigated and fully justified.

Edwin G. Nourse, Chairman

Leon H. Keyserling, Vice-Chairman

John D. Clark