"Reports CEA - QR 1st Quarter, 1948"

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EXECUTIVE OFFICE OF THE PRESIDENT

COUNCIL OF ECONOMIC ADVISERS

WASHINGTON 25, D.C.

EDWIN G. NOURSE, CHAIRMAN
LEON H. KEYSERLING, VICE CHAIRMAN
JOHN D CLARK

April 7, 1948

Dear Mr. President:

We respectfully submit herewith our report covering the first quarter of 1948. We have undertaken to appraise the impact of the new preparedness program on the domestic economy and to set this in the perspective of economic trends that had been developing before the plan was announced.

We have limited our analysis quite carefully to prospects within the calendar year 1948 and within the limits of the preparedness effort already announced. On this basis, we find the prospect by no means alarming and yet definitely requiring the prompt enactment of several control measures, most of which you have already recommended to the Congress.

Sincerely,

Chairman

Vice-Chairman (LHK)

The President
The White House

STRICTLY CONFIDENTIAL

April 6, 1948

MEMORANDUM

To: The President

From: The Council of Economic Advisers

Subject: First Quarter Report, 1948

The President's Economic Report of January 14, 1948 stressed continued inflationary tendencies as the prime danger to be combatted in early 1948. It recommended maintenance of the existing level of taxation and the tightening of credit controls as restraints upon the general price level, and extension of rent control and initiation of allocation of materials as specific devices for meeting the inflationary dangers. It recommended stand-by controls of prices and wages, to be invoked if crop conditions during ~~1948,~~ the actual impact of the European Recovery Program as authorized by the Congress, or other economic developments should bring particular inflationary situations to a critical level.

These recommendations were made in contemplation of a foreign aid program approximating the $6 billion program enacted by the Congress for the fiscal year 1949.

After the passage of three months, we should now examine and evaluate certain important new factors that have entered or old factors that have changed since January and, on this basis, consider what new or modified policies are now called for.

The Commodity Price Break and Other Anti-Inflationary Factors

One important new factor developed early in the quarter in the form of a sharp break in prices of agricultural products, particularly grains and livestock. The strong inflationary push given to the general price and wage situation during 1947 had, among other things, reflected a condition of poor crop yields in much of the world. In the first half of December 1947, reports of crop conditions both at home and abroad became more favorable, and the January report of the grain carryover was larger than had been expected. This betterment of the food outlook was reflected in considerable flucutation in agricultural prices, which culminated in a sharp break in late January. From a low about the middle of February there have been several short periods of recovery, but with these prices in the main making a plateau formation somewhat above the bottom point of the dip.

In many quarters, the agricultural price break was hailed as the end of inflation. Some even thought it was the beginning of a recessionary movement which would spread throughout the economy. As the Council then reported, however, there were clearly discernible factors which would make such a general movement extremely unlikely. Agricultural prices were not being forced down by any surplus of farm products either at home or abroad and they were not falling into a vacuum. They were declining toward the support levels provided by existing agricultural legislation. Cereals and meats were unlikely to test those levels in the face of the fact that at least moderate scarcity of food would exist in the markets of the world during the closing months of this crop year even if conditions for the

1948 crop should develop very favorably.

It was most fortunate for our people that this first open break in the inflationary movement occurred at the one place where it would induce no chain reaction in the shape of reduced production and of loss of employment throughout industry. The decline in agricultural prices did not have any direct effect upon production and employment, and when the grain markets had become fairly well stabilized before the end of February, we could feel confident that the economy as a whole had been distinctly benefitted. While the break had not created any specific recessionary developments, it had induced a desirable degree of caution in the business world.

In contrast to the break in agricultural prices, there was no important reduction of industrial prices during the first quarter. The weekly wholesale price index of goods other than farm and food products, which had been rising at a steady rate for full six months, dropped only one-half of 1 per cent in February to a level which it has since maintained without appreciable variation.

During the first quarter, reports of consumer resistance became increasingly prevalent and indications that competitive conditions were returning, or would return over wider areas as the year progressed, carried an intimation that the economy was approaching a "topping out" area in which the forces of inflation would be abating. This was reflected in a growing sentiment in commercial and industrial circles that the "honeymoon is over," the "bloom is off the peach," "it's time to put our house in order," "we've got really to sell the public, not just book orders," and the like. Of course, this trend of thought and action has been most marked in soft goods and light manufacturing. It did not hit automobiles, heavy industry, or basic materials, such as coal, petroleum, and steel. Even these industries, however, showed a sobering sense that their turn would come in a future which was constantly drawing nearer.

The Steel Price Rise and "Third-Round" Spiral

In contrast to the favorable economic factors which characterized the opening months of 1948, the last few weeks have witnessed developments which have given new impetus to the price-wage spiral of inflation and threaten seriously to retard production and to impair the real purchasing power of consumers.

The first of these developments was the mark-up of prices of semi-finished steel on February 13 as the climax of a creeping advance in various steel prices that had been going on during January and early February. This advance in prices of a commodity so basic as steel threatened compensating price advances in a wide range of steel-using industries. This would aggravate the general inflationary tendency or, encountering the consumer resistance which we have already mentioned, might lead to an impasse and curtailment of production. The furore of public criticism of this move, the prompt investigation by the Joint Committee on the Economic Report, and reports on the subject by the Departments of Justice and Commerce and the Council of Economic Advisers served to check the spread of price increases to finished steel. But the steel wage settlement was yet to be made, and the whole situation was thrown into confusion by the stoppage of coal production on March 15.

Up to this time, the so-called third round of wage adjustments had progressed without extensive work stoppages and with advances of wage rates mostly limited to a range of 5 to 15 cents an hour. They did not conform to a "pattern" but rather to the peculiar situations of the various companies and in the main were not at once reflected in proportional or larger price advances. There seemed to be some ground for hoping that labor and management would compose their differences without strikes and that wage adjustments would in the main be held within limits that would not require further price increases. Such an outcome would demonstrate our ability to use voluntary bargaining methods toward the containment of inflationary forces.

The high cost of living still exerts an upward pressure on wages. Thus far the consumers' price index has failed to reflect the commodities break which occurred in February. This may represent only the customary time lag. But in view of the recent stabilization of commodity prices, and the additional buoyancy which has been injected by the Preparedness Plan, there is certainly no assurance that the consumer price index will go down, and for such important items as meat and rent, there is strong reason why it may go up. In the case of meat, it is estimated that the supply this fall may be 10 percent below the supply last year. In the case of rent, the housing shortage is still acute and rent control has been loosened by a succession of legislative steps. The high cost of living still persists as an important element in the wage negotiations that are ahead. And significant industrial leaders have expressed in no uncertain terms their prediction or determination that any substantial wage increases would be followed immediately by further price increases.

Stoppage of work in the bituminous coal mines on March 15 did not grow out of a demand for higher wages, but it had the effect of immediately aggravating shortage of material at a point basic to our whole industrial system. Even if settled at an early date, it will result in the loss of many thousands of tons of steel and postpone the time when the supply of automobiles and other items fabricated from steel will catch up with demand.

The Preparedness Plan

Against this reminder of the continuing narrow margin of supply at the very basis of our industrial system, the President on March 17 addressed the Congress on the seriousness of the international situation and launched what has come to be known as the Preparedness Plan. On April 2, the Congress completed passage of the European Recovery Plan and on the same day removed approximately $5 billion from government revenues through its tax reduction act and added this amount to civilian spending power.

These developments must be evaluated against the background of an economy of relatively little slack in employment or productive capacity, of high prices still strongly colored by inflationary forces, and of a precarious balance between prospective federal revenues and projected scale of expenditures. In such circumstances the inflationary threat might easily be aggravated, and substantial increases in the demand for certain goods might quickly initiate new price advances.

In our analysis of this inflationary problem, we shall assume that the coal strike will be settled within a relatively short time. The loss of coal production in a strike of even a month would entail the serious disruption of railroad transportation, steel production, and other industrial output. Therefore, the restoration of fuel production constitutes our foremost domestic problem since indefinite continuation of the coal strike would bring industrial paralysis.

On this assumption of an early settlement of the coal strike, it is our belief that the European Pecovery Plan and the Preparedness Plan as now proposed should not generate inflationary pressures which at this time require resort to overall controls of the war economy type. We believe that the safeguarding measures included in the President's 10-point program in November and reiterated in January should be promptly enacted and somewhat extended but that this will leave free competitive enterprise to operate through most of the business world.

We are aware of course that the international situation with which the President must deal is most uncertain and that the Preparedness Plan now proposed may soon prove to be inadequate. We feel, however, that our analysis and recommendations should be limited strictly to the program as announced and as evaluated by the business community. This involves something of a psychological factor but, as already stated, does not as yet, as we read the signs, involve general speculative anticipation of future expansion of the program. Everywhere in the business world, there are heard words of caution, but we recognize that that condition might change suddenly.

The European Recovery Plan and the Preparedness Plan need to be considered together because they entail similar economic consequences. Both will entail withdrawal of goods from American consumers without a corresponding curtailment of purchasing power in their hands.

Appraisal of the combined impact of these two plans may be undertaken by an examination, first, of their general impact upon the economy, and, second, of their impact upon specific situations of shortage.

Viewing first the general impact, we concluded in our October foreign aid report that the export surplus in 1948 under an aid program of the size then contemplated would not inject a new inflationary influence because it would not exceed the export surplus already felt in 1947. As finally adopted, the European Recovery Plan will involve an export surplus in 1948 at least $2 billion below the level that the October report contemplated and found to be safe. This leaves room for the safe absorption of a preparedness program of considerable magnitude. The preparedness program, as now formulated, implies a $3 to $4 billion commitment for the fiscal year 1949. In the President's letter of April 1, transmitting an additional budget request, there was outlined a program involving additional expenditures for the armed services of only $1.7 billion in fiscal 1949. Of this amount, not more than half will represent actual payments to the public in 1948, and only a part of this will represent a demand for additional goods. Thus, in terms of its general impact upon the economy, the Preparedness Plan would seem to be something the country could readily take in its stride.

With increasing appreciation of these facts, the tendency for business to react to the preparedness program in terms of an incipient new boom has abated, and there has been an increasing disposition to assess the plan as an offset to softening tendencies which might be developing during 1948 rather then as a further stimulus to an already strongly inflationary situation.

But while a $3 to $4 billion program may not seem disturbing to a $240 billion economy when viewed generally, the conclusion is different when we turn to its specific impact upon particular production and market situations. Just as in the case of the European Recovery Program, to which it is now added, the real issues as to whether additional economic controls are needed grows out of the concentration of both programs on certain classes of goods and areas of production where shortages have been most severe and persistent. These areas include products of farm origin, particularly livestock products and textiles, steel and other metals, and the sources of power and heat, including coal, petroleum, gas and electricity.

While we do not yet have specific information as to the size and timing of these particular demands, we have already, in evaluating the impact of ERP, urged the adoption of allocation policies which, if carried out, will help to hold the prices of these goods from unduly rising and prevent demoralization of productive operations. The same prudent measures will help to offset the inflationary effect of the expedited stockpiling program for which the President has requested $375 million.

One factor which has entered the picture since the time of our foreign aid report is the addition of about $5 billion to the purchasing power of consumers through the reduction in taxes. This adds to inflationary pressures an important force and virtually eliminates the one important weapon controlled by the government with which to combat inflation—a substantial government surplus. Yet we believe that this untoward development can also be neutralized if the other features of the President's anti-inflation policy are adopted.

Recommendations

Of the policies and programs of the government which we believe will fairly well restrain inflation if labor peace is maintained and the preparedness program is not greatly expanded, the first three will operate through influencing the entire economy, the others are directed atpoints of specific pressure.

Fiscal controls. The imprudent reduction in taxes increases the need and by no ~~means~~ ends the opportunity for helpful fiscal policies. New taxes should be demanded in proportion to (or even in anticipation of) all subsequent increases of preparedness expenditures which are not clearly offset by practicable reductions of government expenditures in other directions. Reduction of public expenditures should be made wherever possible.

Credit controls. So long as inflationary danger continues, the central banking system should use its powers to restrain the creation of buying power through bank loans. The imperative need to protect the government bond market prevents the use of the traditional method of limiting the expansion of bank credit by raising discount rates, but something can be accomplished by increasing reserve requirements, and authority should be granted to take this action. If we avoid a government deficit and prevent the expansion of bank credit, we can still avoid a destructive general or monetary inflation, even though there might be a considerable rise in particular prices.

Consumer credit, also, should be restricted. The President's warning that there would be imprudent, competitive easing of credit terms when control was dropped has been fully vindicated.

Savings bond campaign. The completion of the extensive preparations for the nation-wide campaign to sell savings bonds fortunately comes at the most appropriate time to give maximum effect to the anti-inflationary value of consumers' savings. Saving by consumers is the only anti-inflationary measure which is pleasant. It is also one of the most effective of such measures. No effort should be spared in pressing to the fullest advantage the fine enthusiasm which has been built up in the great army assembled for this campaign.

Materials controls. Since we start the preparedness effort not from a position of industrial and commercial slack as in 1939 but from one of activity so high that significant material shortages already exist, we believe that ordinary prudence requires that increased attention be given to perfecting a system of allocations, priorities, and export and domestic use limitations which would build up adequate stockpiles and safeguard production under the Preparedness Plan against bottlenecks and breakdowns. Present and prospective shortages in food, textile, metal, and fuel or power items already referred to make it necessary that allocation and related control measures be promptly enacted and selectively applied.

Some controls have already been found necessary during the formative stages of the European Recovery Program. These should be articulated with or merged into the preparedness control system. We believe also that voluntary effort in the formulation of the materials control plan and in its enforcement should be utilized to the fullest extent possible. The authority to impose controls should not be limited to establishing priority of use. That simply makes the competition all the warmer for the balance of the supply. There must be power to make it unlawful to use controlled materials in unnecessary projects, or to use controlled materials beyond the permitted quantity in authorized but limited projects.

Price-wage control and rationing. There has not yet appeared need to impose either price control or rationing, other than in the case of a few materials, as discussed above. The prospect for an adequate meat supply are so poor, however, and there is so much uncertainty about the general food situation, that the President should have authority to make ready a price and rationing system and to put it into effect selectively as conditions require. Where price controls are imposed there should be a prohibition of such wage increases as would break through the price ceiling, except for certain necessary equitable adjustments and except for such wage increases as might be necessary to recruit people for the preparedness program in the absence of manpower controls.

Distribution of labor. The number of men involved in the contemplated increase in the armed forces and in the expanded industrial operations incident thereto will not exceed the expected increase in the labor force in 1948. The labor market is tight, however, and the frictional difficulties in the way of any accurate distribution of labor will lead to many local shortages. These can be minimized by making better use of the United States Employment Service.

To this end, we believe that the national office of the United States Employment Service would have to be enlarged and strengthened. The Employment Service should undertake to develop a smoothly functioning program of (a) priority referral in local offices, and (b) comprehensive interarea recruitment. We should make sure that the Selective Service Act and regulations are so drafted and administered as to give suitable deferment to individuals and groups who are especially needed in the preparedness program. Procurement agencies likewise should exercise care to see that contracts are placed in looser labor market areas and, so far as possible, withheld from tight labor markets. Efforts should also be made to prevent labor piracy or unrestrained intra-industry hiring.

In general our position is that manpower control should be of an indirect rather than direct sort.

In Conclusion

At this early stage of the Preparedness Plan, two points should be clearly recognized and made plain to the public:

1. We are still in a peace economy, not a war economy. The maintenance of an armed force is as much a part of the peacetime system as is the maintenance of a police force by states, counties, and cities, or the employment of railroad detectives and factory guards. The last two years have given us a fuller measure of the productivity of our resources when aggressively used. We were not staggering under the load of $11 billion for our protective forces, and the rise in this item to $14 or $15 billion will not swamp our economy nor require us to pass from free enterprise to regimentation. Some rather systematic and vigorous discipline, however, must be exercised to redirect our economic effort so as to meet the new goal in an orderly and economical manner.

2. Every citizen must recognize that further diversions of productive effort to military uses inevitably involves some sacrifice of civilian types of consumption. It is our particular application of the old alternative of "guns or butter."

Our people had—and we believe quite properly—looked forward to a postwar period in which larger numbers of people would achieve higher standards of living than had ever been realized before. Those hopes are not nullified by the preparedness program. But they must be in some measure postponed or for the present revised downward. During this period if any group insists that its income shall be advanced in proportion to every advance in prices or that it shall be in a position to pay up to whatever level is needed to bid its accustomed amount of goods away from other users, it is in effect demanding that it be exempted from sharing in the common burden of protecting our country. These economic facts of life should be proclaimed along with every step in working out the practical details of the preparedness program.