III. Price and Income Trends and the Course of Inflation

BACK of the income and expenditure totals whose trends have just been traced lies a whole network of price, wage, and profit relationships which determine whether or not we move toward economic stability. The changes in these relationships during 1947 have not accomplished that end, nor have they assured the maintenance of high production and employment in 1948. It becomes necessary, therefore, to examine the underlying facts more carefully and to uncover the dangerous tendencies which they include.

PRICE TRENDS

A review of price movements during 1947 cannot ignore the events of the last half of 1946. The abolition of OPA raised the question how the economy would adjust itself to freedom from price controls. The answer was soon read in the sharp rise of wholesale prices between June and December 1946. This was at an annual rate of almost 50 percent, one of the steepest rises ever recorded. Consumers' prices rose at an annual rate of 30 percent during the same period.

The dangers of this situation were emphasized in the first Economic Report and, when prices continued to rise during the first quarter of 1947, it was found necessary to repeat the warnings about high prices late in March and in April, urging businessmen to exert every effort to "hold the line" and help check the spiraling forces of inflation.

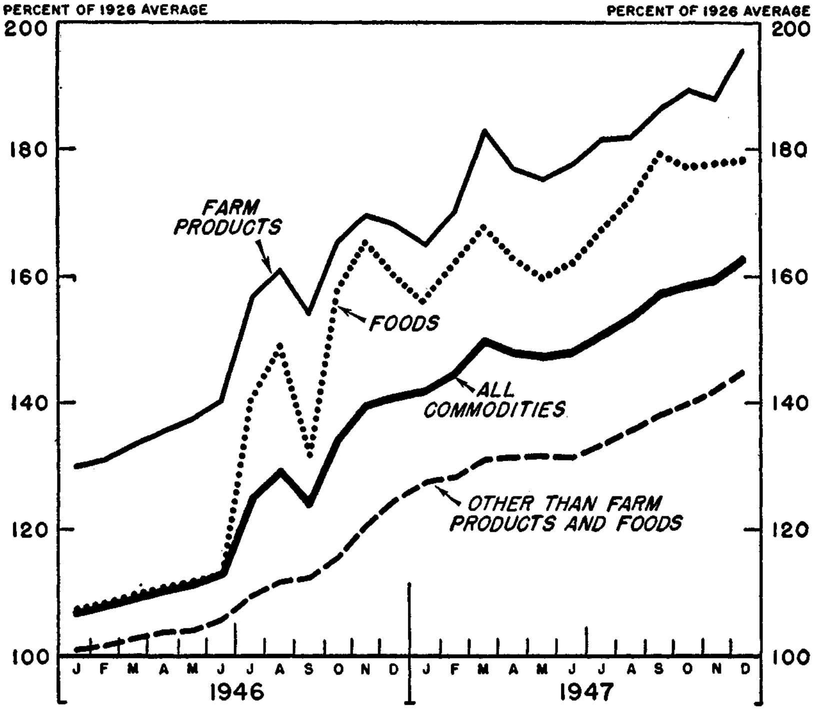
Prices leveled off in the second quarter of 1947. Business was pursuing a much more cautious inventory policy. Sellers of a number of commodities found that backlogs of demand had dwindled. There was evidence that many sellers were seeking to hold prices below the maximum that the traffic would bear. However, the pressure which many distributors put on manufacturers to lower their prices had little effect.

In the early summer of 1947 substantial price increases in coal, steel, and steel products took place, following the increase in freight rates and after the new wage contracts negotiated in the coal industry. There also com-

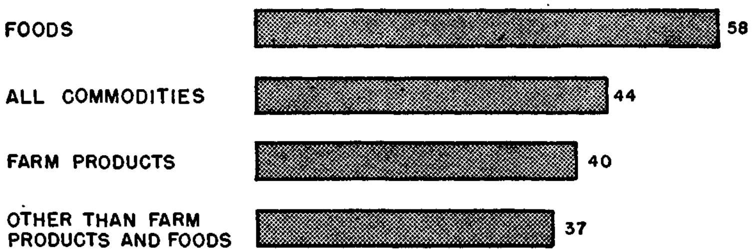
CHART 9

WHOLESALE PRICES

Wholesale prices, after leveling off in the second quarter of 1947, resumed their sharp rise in the second half of the year.



PERCENTAGE INCREASE SINCE JUNE 1946



SOURCE: DEPARTMENT OF LABOR.

menced a sharp rise in the prices of meats, dairy products, eggs and poultry, due to a normal seasonal downturn in the marketings of these products, and to a rise in the level of consumer demand growing out of increasing incomes and the larger number of people at work. And in the middle of August, grain prices began to move up rapidly. Although our wheat crop was of record-breaking size, our corn crop was poor. This put additional pressure on our domestic supply of wheat to supplement the deficiency in corn for animal-feeding purposes. It also became clear that foreign requirements for wheat would be large because of the poor crop in Europe. The large rise in wheat and corn prices caused increases in the prices of flour and cereal products. Led by these specific price increases, there developed during the third quarter a general upward movement of prices which continued through the rest of the year.

Since June 1947, wholesale prices have risen at an annual rate of 20 percent and consumers' prices at a rate of 12 percent.

The behavior of wholesale prices is shown in table 9 by commodity groups and by periods:

TABLE 9.—*Percentage changes in wholesale prices since June 1946*

Commodity group	June to December 1946	December 1946 to March 1947	March to June 1947	June to December 1947	June 1946 to December 1947
All commodities	24.8	6.1	−1.3	10.2	44.1
Farm products	20.0	8.6	−2.6	10.2	39.9
Foods	41.8	4.7	−3.5	10.4	58.3
All other than farm products and foods	18.1	5.1	.2	10.1	37.0
Hides and leather products	44.4	−1.2	−.8	18.9	68.3
Textile products	23.4	3.6	−.5	6.1	35.0
Fuel and lighting materials	9.5	4.8	3.2	18.2	39.9
Metals and metal products	20.1	3.9	1.9	6.5	35.3
Building materials	21.5	12.5	−1.7	9.0	46.3
Chemicals and allied products	30.4	5.2	−9.1	14.0	42.1
Housefurnishings	8.9	4.7	2.7	3.7	21.4
Miscellaneous	10.6	5.9	−2.3	7.5	22.9
Special groups:					
Raw materials	21.3	6.5	−1.8	12.9	43.2
Semimanufactured articles	28.9	7.1	------------	8.1	49.2
Manufactured products	26.5	5.6	−1.1	8.8	43.7

Source: Department of Labor (see appendix B, table XIII).

Wholesale prices during the second half of 1947 advanced at a slower rate than during the first quarter of the year. The character of the two movements differed fundamentally. During the first quarter, the price rise represented a tapering off of the broad upward thrust of prices following the removal of price controls. It was followed by a period of relative stability, when it appeared possible that the inflationary pressures had spent themselves. But the recent sustained rise in prices represents a renewal of inflationary pressures.

In response to the factors described above, consumer prices, too, have been rising rapidly on a broad front. This is shown in the following table:

TABLE 10.—*Percentage changes in consumers' prices since June 1946*

Item	June to December 1946	December 1946 to March 1947	March to June 1947	June to November 1947	June 1946 to November 1947
All items	15.0	2.0	0.5	5.0	23.7
Foods	27.7	1.9	.5	6.4	39.2
Apparel	12.3	4.4	.8	2.4	21.0
Rent	.3	.2	.2	5.5	6.2
Fuel, electricity, and ice	4.5	1.8	.1	7.8	14.8
Housefurnishings	13.5	2.9	.2	3.5	21.0
Miscellaneous	6.4	1.5	.7	2.8	11.8

Source: Department of Labor (see appendix B, table XII).

One notable aspect of the rise in consumer prices since June 1947 is that, unlike the movement of wholesale prices, they have been rising at a faster rate than during the first quarter of the year. In the first quarter, consumer prices rose at an annual rate of 8 percent. Since June, they have been rising at the rate of 12 percent per annum. Two factors contributed to this acceleration. In the first place, foods, which represent 43 percent of the total consumers' price index, have risen much more since June than they did during the first quarter of 1947. In the second place, rents rose from June to November at an annual rate of about 13 percent. Since June, they have risen more than they had over the previous eight years.

Although November is the latest month for which complete data are available, preliminary reports indicate that consumers' prices rose over 1 percent between November and December.

WAGE TRENDS

Efforts of labor unions in 1947 were concentrated on wages rather than on security issues because the employment situation was good and because of the over-riding importance of the rise in the cost of living.

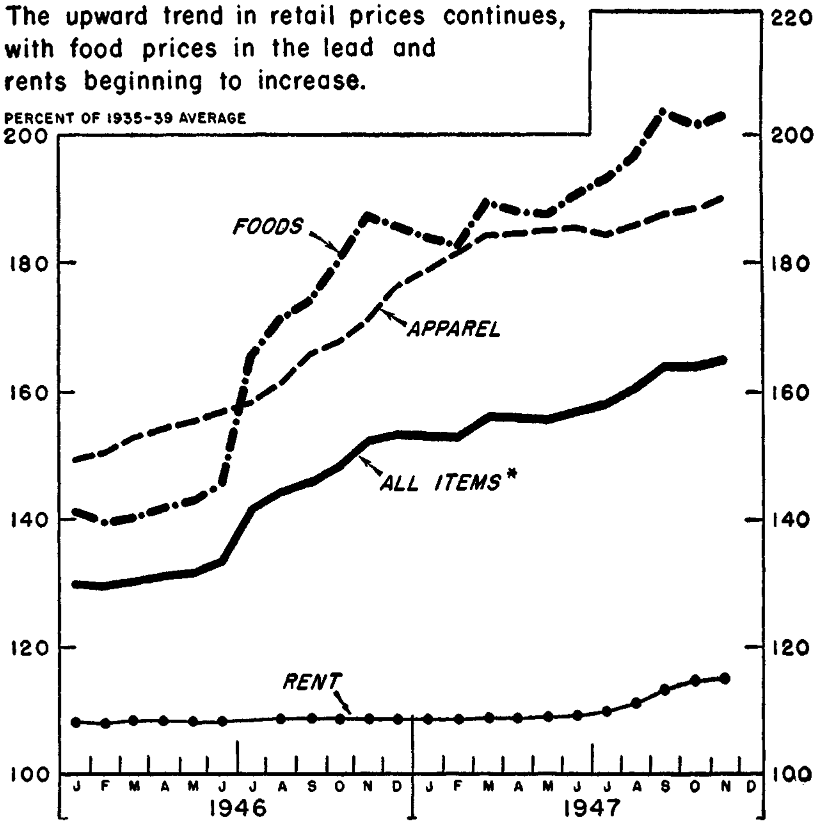
Wage adjustments in early 1946, largely to compensate for reduced hours, had brought about a reasonably stabilized wage situation by the middle of that year. But this stability was shortly disrupted by the rapid rise in the cost of living. By late 1946 and early 1947, industry in general seemed willing to offer, and unions to accept, wage increases approximating the advance in consumer prices which had taken place following the lifting of price controls in June. Some of these wage contracts contained escalator clauses to compensate automatically for further rises in the cost of living.

An examination of the early "second round" contracts of late 1946 shows relatively few wage increases above 15 cents per hour, most of them falling

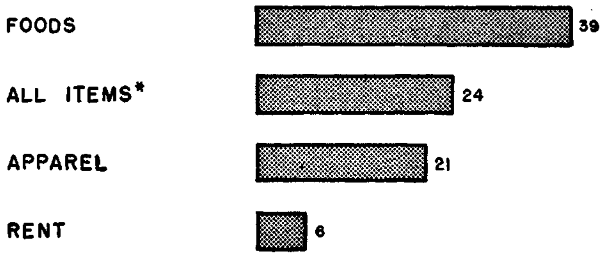
CHART 10

CONSUMERS' PRICES

The upward trend in retail prices continues, with food prices in the lead and rents beginning to increase.



PERCENTAGE INCREASE SINCE JUNE 1946



SOURCE: DEPARTMENT OF LABOR.

**ALSO INCLUDES HOUSEFURNISHINGS, FUEL, ELECTRICITY, ICE, AND MISCELLANEOUS GOODS AND SERVICES NOT SHOWN ON CHART.*

within the range of 10 to 15 cents. Contracts negotiated later, mainly in April and May 1947, in rubber, steel, automobiles, electrical equipment, and other metal products were similar to the fall contracts. These settlements were dubbed the "15-cent package," which included an evaluation of fringe benefits such as paid holidays and occasional retirement or insurance plans. Wage earners during this period, however, generally preferred wage increases, and pressure was concentrated on these rather than on fringe issues.

The 1947 wage "pattern" was less widely adopted than the 18½ cents of the "first round." Numerous contracts were negotiated at a figure below the pattern, while many wage and particularly salary workers received no increases. On the other hand, some other groups of workers, notably in the bituminous coal, construction, and printing industries, won wage increases in excess of the pattern. An examination of the second round contracts indicates that workers in the lower paid industries made smaller gains, both absolutely and on a percentage basis, than did higher paid workers.

The effect of the wage settlements in late 1946 and 1947 was to raise wages—both rates and earnings—to an all-time high. For the first time, average weekly earnings in manufacturing have exceeded $50, and throughout most of the wage sector of the economy average weekly earnings have become twice what they were in 1939. The wage increases which took place in 1947 expanded consumers' money income by approximately 3.5 to 4 billion dollars during the year.

The 1947 rise in prices left wage earners in no better position at the end of the year than they were at the beginning. The real income of many groups, such as government workers, teachers, and the white-collar class generally, was substantially less.

From June 1946, following the "first round" of wage increases, to October 1947, the cost of living rose 23 percent compared with an increase of 18 percent in weekly earnings in manufacturing. Earnings in nonmanufacturing industries during the same period registered diverse gains: 12 percent in bituminous coal mining, 20 percent in private construction, 8 percent in telephones, 10 percent in wholesale trade, 14 percent in retail trade, and 14 percent in hotel services. In general, earnings lagged behind living costs.

Though labor as a whole through wage gains was as well off at the end of 1947 as at the beginning, workers had lost ground steadily in terms of real income during the last half of 1946. This, primarily, explains the "second round" of wage increases. It also helps to account for the present movement for further wage advances unless an effective anti-inflation program is adopted. (See appendix B, tables X, XI, and XII.)

Several other 1947 wage developments should be noted. There was an extension of the practice of providing paid vacations and holidays to wage earners. One of the results of these practices was to cause a sizable reduction in the number of man-hours worked during the summer, particularly in July and August. Increasingly, it is becoming industry practice to shut down operations for one week during that period.

Efforts to standardize job classifications and to develop an equitable wage-payment program have been carried on by industry for a good many years. One of the most notable developments in this area took place last January when, following two years of joint effort, a wage rationalization agreement was concluded in the steel industry. This was the culmination of a major job-reclassification program designed to eliminate wage inequities both within and among the plants. This scientific approach to a complicated wage problem is a commendable development that could well be adopted more widely.

PROFITS

Profits during 1947 reached a new peak. They also maintained remarkable stability throughout the year despite considerable increases in wages and raw material costs. Compared with 1946, corporate profits rose from 21.1 billion dollars to 28 billion dollars before taxes and from 12.5 billion dollars to 17 billion dollars after taxes. In 1947 they averaged, after taxes, about 9.5 percent on net worth and 5.5 percent on sales. The income of unincorporated nonfarm enterprises rose during the same period from 21 billion dollars to 23.5 billion before taxes. Total business income before taxes in 1947 exceeded the 1946 total by 9.4 billion dollars, or 22 percent. Net farm income before taxes rose from 15.2 billion dollars to 18.3 billion dollars.

Not only profits for industry as a whole, but also profits for most industry subgroups were exceptionally high. There were, however, some divergencies in trend. Some industries, such as food, beverages, tobacco, and iron and steel, showed a downward trend, although profits continued high, while other industries, such as oil-producing and refining, and automobiles, showed an upward trend as well as a high rate. For profit data, see Appendix B, tables XXII to XXVI. Individual firms within each industry also showed divergent trends.

This stability of profits throughout the year indicates that business generally reacted to increases in costs by increasing prices rather than by absorbing them in whole or in part by reducing profits. It is also noteworthy that high and stable profits continued even where there was no appreciable expansion in production. In some categories where exceptionally high profits persisted, we were very close to a temporary ceiling on production due to physical limitations of capacity and shortages of raw materials and certain classes of skilled labor. While industrial production reached a postwar peak in March, receded to a low point in July, and has since recovered to approximately the March level, profits in manufacturing continued at approximately peak levels throughout the year.

In appraising profit trends, allowance should be made for the fact that business, like every other group, finds that the purchasing power of money has declined considerably. To maintain the same physical volume of inventories requires large additional amounts of capital funds. Furthermore, replacement costs have risen substantially, while profits are usually calculated by basing depreciation allowances on original costs rather than replacement costs. Although a portion of the large profits earned during 1947 merely compensated for changes in prices, profits on the whole were above the levels necessary to furnish incentives and funds for the expansion of business and to promote the sustained health of the economy.

THE NATURE OF INFLATIONARY PRESSURES

The movements of prices and incomes during 1947 constituted a strong inflationary trend. Increasingly through the second half of the year the total demand for goods was in excess of the amount of goods and services available at current prices to satisfy the combined requirements for final consumption, private capital formation, Government services, and exports.

The question has been raised as to whether we had inflationary pressure because of large exports, because of the very high rate of business investment, because of the large amount of residential and commercial construction, or because of the high level of consumer spending. The answer is that we had inflationary pressure because the sum total of these combined factors exerted too great a demand on available supplies. No one factor can be singled out as the principal cause.

Moreover, these factors could not have become fully operative without funds to make them effective. In addition to funds growing out of current incomes, there were several large special sources of funds in 1947. The major ones were: (1) the liquidation of dollar balances and sales of gold by foreign countries and spending by foreign countries of loans and grants provided by the United States; (2) the spending of liquid funds accumulated by business firms during the war; (3) the liquidation of private savings; (4) the increase of bank credit to finance inventory accumulation, capital expansion, and construction; (5) the increase of consumer credit; and (6) the cashing of veterans' terminal-leave bonds. Some of these sources of liquid funds are being exhausted and are nonrecurring, so that further expansion must increasingly be financed out of current income credit.

The inflationary impact of spending was strong in all fields—capital expansion, exports, and consumption. The high level of domestic business investment and construction aided in unfolding a total demand which increased prices, individual incomes, business profits, and Government receipts. The supply of consumer goods was limited by the large amount of resources devoted to capital goods and exports. Consumer demand, swelled by wage increases, by high farm earnings, by the use of consumer credit, and by the cashing of terminal leave bonds, was in excess of the supply at current prices.

The general excess of demand does not fully explain the resumption of the price rise in the second half of the year. In an important degree, the rise stemmed from actual and anticipated shortages of specific commodities, which caused price rises at particular points and from there spiraled into higher costs and prices all through the economy.

The most important specific shortage developed in the grains. This led to higher prices of many food products. New wage demands resulted from the increased cost of living. These in turn presented the prospect of higher costs transmitted into higher prices. The specific shortage was thus generalized into a broad increase of prices at many points, and often these increases were greater than were necessary to meet increased costs.

The spiraling of prices from a specific point of shortage was not confined to the case of food products. It also existed in the case of key industrial products, particularly steel.

The inflationary forces arising out of generally excessive demand and those arising at points of specific shortages are interacting. If general demand were not so great, the upward pressure on the prices of specific commodities in short supply would be less and could not so easily spread to other commodities. Moreover, the mere prospect of higher prices at particular points gives rise to strengthened general demand. Expectation of higher prices, for instance, stimulates the demand of business for inventories and of consumers for goods. Expectation that higher wages will follow higher costs of living may cause the increase in prices to take place even before wages have been adjusted upward.

In the face of the special and general factors outlined above, the precarious basis of the restraint and stability which had developed in the second quarter became evident. The fears of a recession subsided, the spiral effect of wage and other cost increases got under way, the increased cost of living gave rise to expectations of further wage demands, and the impact of expected foreign aid programs received wide attention. Such influences induced an upsurge of speculative activity superimposed upon the already great strength in most markets. In addition, there occurred a collateral development which had great significance. The high business demand in the earlier part of 1947 was financed almost wholly out of current revenues and liquid assets, with only moderate use of bank credit. After the middle of the year, when business expectations ran in the direction of higher prices, and as higher prices actually emerged, business borrowing underwent a rapid increase.

The year's end brought no evidence of an early weakening of inflationary forces. Unless anti-inflationary steps are taken, the prospect is that, in view of the grain shortage, prices of food, especially meat, will go still higher. Business sentiment now appears to entertain the expectation of strong markets for as far ahead as it can see. There is added to the forward outlook the possibility that, even though other sources of excessive demand diminish and a substantial budget surplus is continued, the inflationary spiral will be supported by funds from credit sources.

While the export surplus, even with our foreign-aid program, may be smaller than in 1947, exports are heavily concentrated on commodities that are subject to especially strong domestic demand. This makes it desirable that foreign aid funds be used as far as possible to finance purchases from other countries. The fact that foreign aid presents problems provides no reason to doubt the wisdom of a foreign-aid program which meets essential requirements of other nations within the limits of our own resources. The effects upon other countries directly, and upon us indirectly, of not providing this aid would be calamitous. Upon broad grounds of national policy, it is essential that the program go forward. But it must be recognized that carrying it out will make it all the more important that we invoke the measures required to stop the inflation.

WHY INFLATION IS DANGEROUS

During the course of an inflationary movement there are many who find it difficult to think that anything is wrong. There is a ready market, everyone is employed, wages are good, production is high, profits are good, and industrial capacity is being expanded.

There are some, indeed, who find real merit in the situation. They say that the cure for specific shortages is still higher prices. They expect that these will stimulate larger output and restore balance. But this is a vain hope. The stubborn and intractable fact about an economy already operating at peak levels is that output cannot be expanded except by slow degrees.

Nor are the immediate consequences of inflation as favorable as superficially appears. Some people are gaining at the expense of others. The heavy weight of higher costs of living bears down upon the millions of families who are unable to keep up with advancing prices. Economic relations degenerate into a hectic struggle to catch up or keep ahead. No firm basis can be established for orderly and stable progress.

But what most fully justifies every effort to halt an inflation is the certainty that, if it runs its course unimpeded, it will spread in its wake the

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disaster of falling markets, unemployment, and business losses. A rapid general rise in prices has the effect of unduly bunching investment in inventories and equipment at early dates and according to distorted calculations of possible profit. It induces investments, many of which will not pay out.

Rising prices breed upon easy access to credit, which supports the trend. They introduce speculative activities which also support the trend. They produce a price structure which is increasingly sensitive and precarious and vulnerable to changes in business and consumer expectations, spending, and investment.

At whatever point these developments induce a reversal of business sentiment or a withholding of consumer demand, some markets weaken, with a spreading impact. Caution dictates the withholding of demand. Buying for inventory, capital expansion, and consumption declines. A decline of production necessarily follows, spreading unemployment and loss of income from point to point in a widening and deepening downward spiral.

These developments are not inescapable. A well-designed program of measures to combat the inflationary trend will permit us to reach a state of economic stability without an interlude of severe depression. Such a program is presented in Section IV.