Form F. R. 131

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

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To Mr. Goldenweiser

Subject: How things stand

From Frank R. Garfield

Critical problems before the Nation aside from those of a strictly military nature relate to overseas transport and materials for war production. Then there is the problem of organization, and that is one that seems to defy solution. There are problems of labor supply, too, in particular localities, but notwithstanding a rapid rate of inductions this problem seems much less urgent than the others mentioned. Fortunately enough action has been taken to prevent price increases so that the problems of transport, production, and labor supply are not complicated by runaway prices as they might have been.

At times it may seem as though the problems of organization were complicated by having one set of managers pressing for the maintenance of stability in prices, wage rates, and the like and it is certainly true that a good many of the most competent people are devoting their energies to that problem. It seems to me clear, however, that the alternative problems would be more serious and that failure to take a vigorous stand continuously on the inflation problem would lead to the imposition of more regimentation than is necessary if the campaign against inflation and the disorder that would accompany it is waged in an orderly fashion. In passing it may be noted that the central problem for the Government in handling inflation problems in the coming months will be to secure conditions which will insure the further increase in savings by the people of the country either on a voluntary or a compulsory basis. I am assuming that the tax bill will not be much larger than the one passed by the House and that any tax bill that will be passed will be wholly insufficient of itself to prevent consumers from having enough income after taxes so that if they chose to take it into the markets they could push prices sky high in a very short time. Another problem will be to prevent increases in costs that would furnish a good argument, and perhaps a real reason, for price increases.

Overseas transport

The situation in this respect is even worse than I indicated in my discussion with the Board. Sinkings of merchant

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ships of the United Nations have continued to exceed deliveries of new ships and the merchant fleet of the United Nations is now substantially smaller than it was when the United States entered the war. It will not be back to that level until sometime in 1943, assuming further increase in building and no further rise in sinkings. In a period when the requirements for shipping are increasing rapidly that constitutes a very serious problem. I doubt that the use of cargo planes now under construction or proposed will afford much of a solution to this problem for a long time. If a second front is opened up in Europe that will require shipment of great amounts of war materials and will thereby further complicate the shipping situation.

There are problems of domestic transport, too, but it is my impression that most of these can be solved through curtailment of civilian travel and trade. Currently there are shortages of flat cars, open top cars, and tank cars on the railroads but the supply of box cars seems to be sufficient owing to heavier loading brought about by the Office of Defense Transportation. It seems entirely possible that freight could be shifted in such a way as to work out most car shortage problems except those on tank cars. That won't answer questions with regard to motive power but that problem can probably be handled one way or another. Whether most civilians, including salesmen, have tires to drive their automobiles in customary fashion seems to me, from a national standpoint, of relatively minor concern. I believe that eventually necessary restrictive measures will be taken to eliminate nonessential driving and thus to maintain essential services and the principal problem here is to get action taken soon enough.

Production -- materials

At the outset of the defense program people were perfectly willing to meet the obvious requirement for a large volume of new plant specialized for the production of finished war products, such as guns and tanks, but they were not so willing to produce more raw materials. They said that most of the materials could be obtained by curtailing civilian consumption and besides it would be disastrous at the end of the war to have on hand greatly enlarged capacity for production; and they pointed to the idle capacity of the 30's. Primarily as a result of this attitude the country now is coming into a position where it has more capacity to produce finished war products than it has to produce the materials required for this production and maintenance

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~~enough~~ of essential civilian services. Right at the moment it is still true that some additional materials could be obtained for war purposes by reducing output of civilian goods, such as farm equipment. It is also true that some additional materials can be obtained by transferring excessive stocks held by some people to others who are short. Nevertheless the basic production problem, and one that will be with us from here out, will be that of relatively short capacity for production of materials. That is, it will be unless somebody exercises real ingenuity in the rewriting of specifications for finished products. Somehow Germany gets along on very much smaller amounts of material than we have available and current efforts by the WPB and some people in the armed forces to reduce requirements for metals in short supply should be encouraged. This whole problem of materials will be serious over the coming months and would be even more so if the facilities were available to transport overseas a larger share of the production than now can be carried.

Of course there has been some increase in capacity to produce materials and in lines such as aluminum and magnesium this increase has been and continues to be spectacular. Pig iron capacity is being increased by 10 per cent this year and steel ingot capacity by 5 per cent (from 88.6 million tons to 93.7); and further substantial increases are planned for early 1943. Such capacity increases as these help to make possible a continuing rise in industrial output as a whole, but this rise for some time has been less rapid than had been anticipated or than would seem to be required to utilize fully the facilities available for the production of finished war products.

Last November the Board's index of industrial production was at 166 per cent of the 1935-39 average. In the eight months from that time until July, when the index reached 179 or 180, the rise was about 8 per cent. To some extent the rise in this period was limited by conversion operations. The prospect seems to be that during the remainder of this calendar year the index will advance only slowly owing to material shortages and that it will not reach the 200 level. Primary production of most materials is increasing only slowly and stocks can be drawn upon in important amount over an extended period only for items such as rubber, supplies of which were accumulated earlier. Scrap collection will be increased but the record so far on that is not too encouraging. This slow increase in industrial production will reflect marked increases in output of aircraft and other munitions, offset in part by further declines in output of civilian goods. Some types of military production may not be expanded as much as had been planned. It should be noted, however, that failure of some of the new plants to operate at full capacity may not represent failure of those plants to turn out as much as had been anticipated; capacity of war plants was in many cases greatly underestimated.

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The following table shows the volume of industrial production for war and for civilians in June 1940 and in July 1942 as near as we can estimate it.

INDUSTRIAL PRODUCTION

(Points in total index, 1935-39 = 100)

	For all purposes		For war		For civilians	
	June 1941	July 1942	June 1941	July 1942	June 1941	July 1942
Total	159	180	32	89	127	91
Durable manufactures	74	95	23	68	51	27
Nondurable manufactures	65	64	6	15	59	49
Minerals	20	21	3	6	17	15

Another table shows a comparison between November 1941 and July 1942.

INDUSTRIAL PRODUCTION

(Points in total index, 1935-39 = 100)

	For all purposes		For war		For civilians	
	Nov. 1941	July 1942	Nov. 1941	July 1942	Nov. 1941	July 1942
Total	166	180	47	89	119	91
Durable manufactures	79	95	34	68	45	27
Nondurable manufactures	67	64	9	15	58	49
Minerals	20	21	4	6	16	15

It is our estimate that output of durable industrial products for war practically doubled between November and July; that war production of nondurable goods rose by two-thirds; and that war production of minerals increased by half in this interval.

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For industrial production as a whole the rise in war output from November to July was probably between 85 and 90 per cent. An index of munitions production recently published by the WPB showed an increase of nearly 190 per cent from November to June and will show a further increase for July. It should be noted, however, that the deliveries of war products, which is for the most part what the WPB index measures, were still at a very low level last November. We have included in the war component of the Board's index the production for war purposes all the way back to the materials that go into the production of machinery to be used in the manufacture of munitions. Also, food and clothing for soldiers.

Increases in industrial production and in agricultural output, together with heavy shipments of military equipment and with heavy troop movements, have required increased domestic transportation. Also activity in some service industries has been stimulated by high consumer demand. In part, these increases have been achieved at the expense of activity in distributive lines and in some other forms of services; the total of production, however, has been increased and this is evident in national income figures, which reflect the volume of production together with the changes in rates of pay and the like. Income payments to individuals reached an annual rate of $111 billion in June and probably $112 in July as compared with $97 billion last November. Increases in the coming months may be less rapid than they were from November to June if efforts to stabilize prices, wages, and the like are successful. There will be, however, some further increase in income as capacity and output continue to expand. In that connection I am assuming that a sufficient number of workers will be available notwithstanding the fact that probably 4¼ million men are already in the armed forces and inductions are continuing at a rapid rate. It is my notion that occupational deferment will be extended as may be required, particularly in view of the shortage of overseas transport to carry troops and supplies.

Organization

There was a time when all moving of Washington offices was after working hours; now people are often moved in the middle of the day and their functions are changed almost as often as their offices. As yet no one has been able to bring enough order into the process of directing the flow and utilization of materials for war and civilian purposes. Of course it is easy to set up an unreasonable standard of perfection as to results, ~~then~~ paying scant attention to the real complexities of the problem; Walter Lippman talks as though it would be simple for a production man

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to do this job when actually the matter is vastly more complicated than any production man ever faced. Nevertheless the requirements are urgent and it does seem essential that action be substituted for endless conferences in more than one quarter. Probably as time goes on and as pressures become greater, there will be more direct action and less negotiation and concern for property rights - at least of some of the people - but this is a process which is not easily carried forward in a democratic community distant from the scene of actual combat. There has already been some increase in army control with respect to materials, and it is likely that there will be further moves in this direction, but I am by no means sure that this would solve the problems.

Labor supply problems I am skipping on the theory that Ken Williams can give you information you may desire.

Problems of inflation

The facts with respect to inflation can be considered in terms of cost-price relationships and cumulative market developments; also from the point of view of consumer demand in relation to the supply of consumer goods. From the latter (gap) point of view the central facts are:

1. The volume of income payments being received by individuals is at an exceptionally high level and is continuing to increase.

2. The amount of such income which is available to consumers for their own use after payment of personal taxes is also large and continuing to increase. It also seems clear that, notwithstanding any tax program that may be adopted in the near future, disposable income in the hands of consumers will continue at or above current high levels. For some basic figures, temporarily confidential, see attached table.

3. Output of consumers' goods has already declined sharply and many commodities, particularly automobiles and some other durable goods, are already unavailable to most civilians. The volume of goods available currently for distribution, however, continues substantially above current output as large stocks of many commodities had been accumulated in various stages of distribution. At department stores stocks amounted to 4.6 months' supply on June 30. This was substantially above the 2.8 months' supply on hand a year earlier and for many departments the

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CONSUMER POSITION

(Billions of dollars)

	Annual rates Adjusted for seasonal variation			Quarterly totals, unadjusted		
	Disposable income	Expend-itures	Savings	Disposable income	Expend-itures	Savings
1941						
1st quarter	81.0	72.8	8.2	19.2	16.8	2.4
2nd quarter	86.0	75.6	10.4	21.5	19.3	2.2
1942						
1st quarter	99.9	80.6	19.3	22.6	18.9	3.7
2nd quarter	103.0	78.8	24.2	25.4	19.7	5.7

Note:--Disposable income is income payments to individuals less direct personal taxes. Expenditures include outlays for durable goods as well as for other goods and services. Savings is the indicated difference between disposable income and expenditures. For the second quarter of 1942 the indicated savings are lower than the $6.5 billion estimated by Goldsmith.

Source:--R. B. Bangs, Department of Commerce.

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increase was much larger than this. During the remainder of this year stocks in distributive channels may very well be sharply reduced, especially if prospective shortages lead to renewed buying by consumers.

4. Notwithstanding the very high level of incomes, the physical volume of goods and services purchased by consumers recently has been smaller than that a year ago when incomes -- both before and after personal taxes -- were nowhere near as high as in recent months. Dollar expenditures in the second quarter were only 4 or 5 per cent higher than a year ago, although prices were 10 to 15 per cent higher.

5. In the second quarter the annual rate of savings, as estimated by Milton Gilbert and Robert Bangs,[1] was 24 billion dollars as compared with 10 billion dollars a year ago. Goldsmith[2] shows a still higher rate of savings in the second quarter. This very high level of savings has taken many forms: the purchase of savings bonds; the repayment of consumer debt without the incurring of corresponding obligations; the accumulation of currency, demand deposits, etc. In the near future presumably all these savings may continue and in addition there may be a reduction in mortgage debt as the number of new mortgages declines (as a result of reduced private residential construction) and as amortization of old mortgages continues.

6. In considering anti-inflation policy for the future, it is essential to inquire under what conditions consumers will continue to increase their rate of savings; also to consider cost-price relationships. The anti-inflation program of the Administration, announced informally by the middle of April, has certainly had considerable influence in the recent period in preventing increased incomes from being reflected in anticipatory buying and price increases. Another important influence, however, has been the availability of many types of goods which had been ordered by merchants long ago. In this period some retailers have even been worried about the possibility of disposing of their stocks of textiles and the like. As commodities that have been in plentiful supply become scarce and as consumers begin to wear out some of the things on which they stocked up last January and last summer, there may be renewal of active buying in retail markets. With limited new supplies becoming available, this could go quite a ways and bring very important pressure to bear on prices, especially if in the meantime costs of manufacturers and distributors have been rising. Already in many uncontrolled food markets prices had been rising and this will contribute, along with many other factors, to continued demand for higher rates of pay, even though the cost of living generally is being held fairly stable by the price control authorities.

[1] Department of Commerce
[2] Securities and Exchange Commission

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In any event, it seems clear that under the conditions and prospect with regard to income payments, taxes, and supplies of goods, the possibility of avoiding tremendous upward pressure on prices will hinge very directly on voluntary saving by consumers, on the course of production costs, and on the price policies of manufacturers and distributors. No compulsory savings program on a scale large enough to insure only a reasonable amount of purchasing power in the markets is in immediate prospect. Over the next few months the upward pressure on prices may become very great -- will unless consumers go on increasing their savings -- especially if costs rise. The Price Administration will probably be forced to raise ceilings on prices of many commodities, or at least to arrange subsidies. If with the particular combination of voluntary and compulsory action that exists now the situation seems to be getting out of hand, then comprehensive measures for reducing the volume of disposable income by increasing taxes or providing for large compulsory savings -- will probably be given a much more serious hearing than at present.

Wage policy

The wage policy established in the Little Steel case has been praised as a stabilization move and damned as an inflationary move. Ken Williams will no doubt give you a comprehensive memorandum on the subject presently. In the meantime we have satisfied ourselves by special study of the average hourly earnings figures to adjust for overtime that the increase permitted under the 15 per cent provision would be small, at least in terms of the previous anticipations of workers. The amount of the increase yet to be made available in all manufacturing would be ~~considerably~~ less than half a billion dollars and for all lines of activity would be less than a billion dollars a year -- unless the increases due to change in classification within firms is larger than we think. This is much less than the 3 billion dollars or more that the OPA estimated as the amount of increase. There is a real possibility that substantial increases will be granted to those now receiving substandard wages (in the case of cotton textiles, where the average hourly earnings adjusted for overtime had been 51 cents in May, the Board allowed an increase of $7\frac{1}{2}$ cents an hour) and that the Board will grant minor increases on the grounds of existing inequities. But, allowing for these factors, the OPA estimates still seem high. The increases included in these grand totals will not all come at once and many of them will not come at all simply because workers will not be sufficiently organized to press their claims.

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As long as wage increases are kept within the general range indicated in the Little Steel and other recent cases it can be argued that they need not necessarily be inflationary in any great degree. The additions to income payments will not be large and some of those increased payments will ~~probably~~ be saved. Manufacturers may be able to avoid increasing prices by reducing their outlays in other directions. Taxes may be reduced and under pressure it is usually possible to work out operating economies. On the other hand, the economies of capacity operations have already been achieved and it is clear that higher wage rates would provide an excellent argument for demanding higher prices. In general any policy which permits one group in the community to get a higher rate of return, whether for farm products, for labor, for managerial services, or for the use of property, tends to encourage other groups to increase their demands and to contribute thereby to the general upward movement of prices so difficult to avoid in a period of the sort that lies ahead.

The discussion of wage rates and of prices generally has run pretty much in terms of commodities and services and nothing has been said about capital values. It is entirely possible that people will decide to invest their funds in farm land, urban real estate, etc., thereby inflating values; plans should be laid for handling any problems that may arise in this connection, as well as for maintaining orderly conditions in the markets for commodities and services.

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