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ECONOMIC PROSPECTS

Statement by Woodlief Thomas,
Director, Division of Research and Statistics,
before Conference of Chairmen of Federal Reserve Banks,
December 6, 1946.

It may now be said that the American economy has passed through the stage of reconverting its productive facilities from war to peacetime uses. Expenditures on goods and services for military purposes have declined drastically and are close to the low level likely to be reached for a while. Output of civilian goods and services is the largest in the history of the country. The aftermath of war, however, continues to create serious problems. There remain many dislocations in the mechanism of production and distribution of goods and services, and a great many important readjustments must still be made. Of greater importance is the large volume of unsatisfied demands created by wartime restrictions on production of civilian goods and by the wartime growth in incomes. The pressure of these demands on available supplies of goods was so great that it finally resulted in a complete breakdown of all price controls and the development of sharp inflationary price rises.

A year ago in a public address ^{1/} I said the following:

"During the coming year of transition from war to peace, the outlook is for a heavy demand for peacetime goods and services at a time when supplies are still restricted. Total production and income will be below the high wartime levels because of the sharp reductions in expenditures for war purposes. Production of civilian goods needs to be increased as rapidly as possible to build up inventories and to supply current and deferred demands, both domestic and foreign. The buying power for making these demands effective already exists or can be readily obtained. And in the meantime, the pressure of demand on the limited supplies will result in rising or firm prices. Speculative buying movements may develop in commodities, real estate and securities."

Last March I said:

"I think we can safely count for the rest of this year on people buying everything they can possibly find to buy and then bidding for more. There are not going to be any surpluses of anything of great importance. Expenditures for consumer goods will increase as fast as production can expand and there will be more demand than supply."

About the same time, on another occasion, I expressed the view that in the coming year nearly everything that could be produced could be sold at any price the seller was willing or permitted to ask.

1/ Industrial and Business Outlook, Annual Outlook Issue of The Agricultural Situation, November 1945, Bureau of Agricultural Economics, United States Department of Agriculture.

These statements are reasonably close descriptions of what has actually occurred in the past year. The accompanying charts show that events have been in conformity with the views previously expressed. The first chart shows what has happened to the national product and its components up through the third quarter of 1946. The various charts also have some projections through the first half of 1948, indicating broad movements that now seem likely. These projections are not intended to be forecasts but are guide lines with which actual performance may be compared and which give some idea of inter-relationships between various parts of the economy.

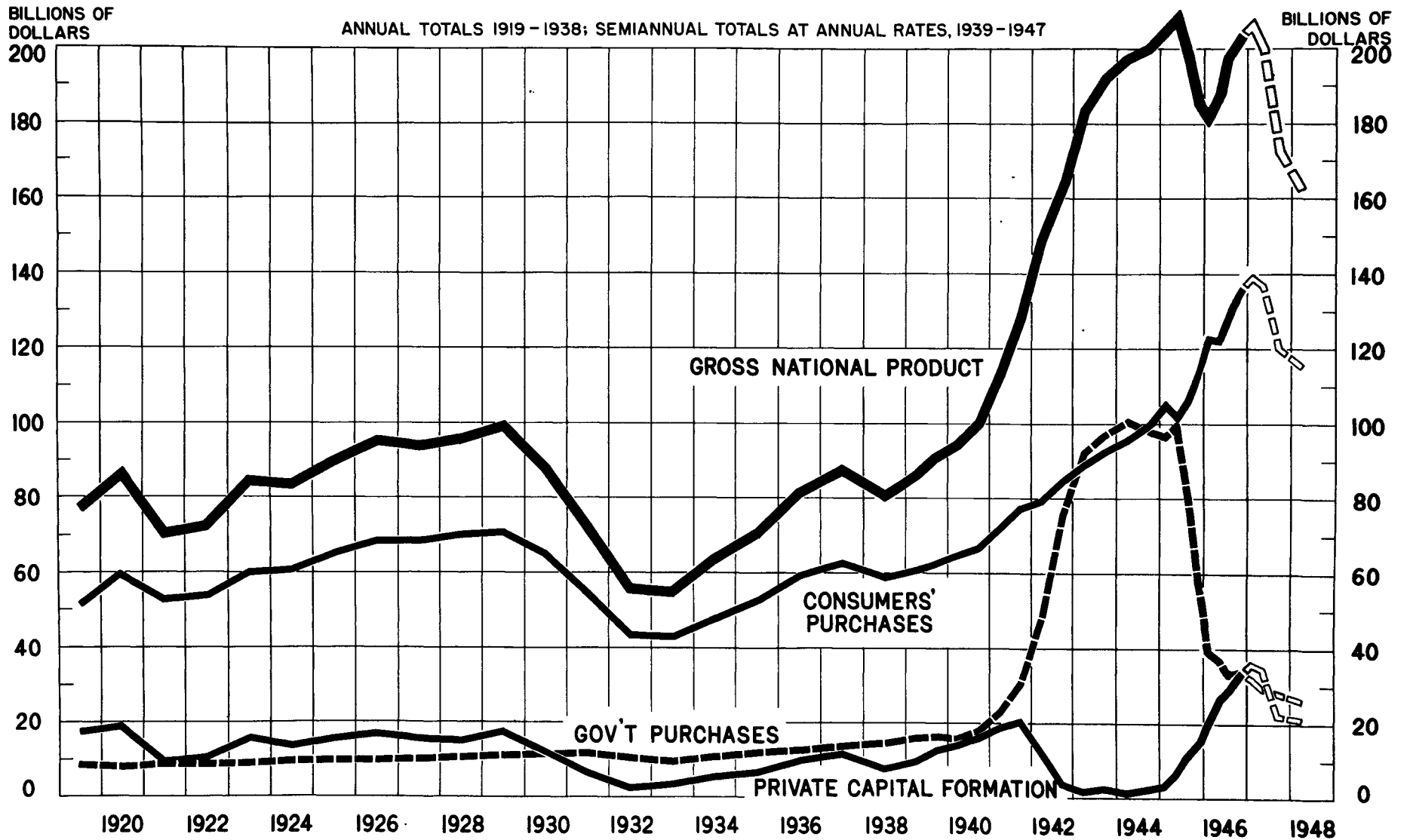
At this stage it is much more difficult than it was a year ago to be confident about future developments. Although there remain many unsatisfied demands and practically no surpluses of importance have appeared, it can no longer be predicted with confidence that pressures for rising prices will continue strong. There is a growing feeling that we have reached the top of demand as well as of output and that many of the shortages are about to be satisfied or their fulfillment deferred because of high prices. The projections allow for some work stoppages but not for prolonged and severe ones.

Rise in prices

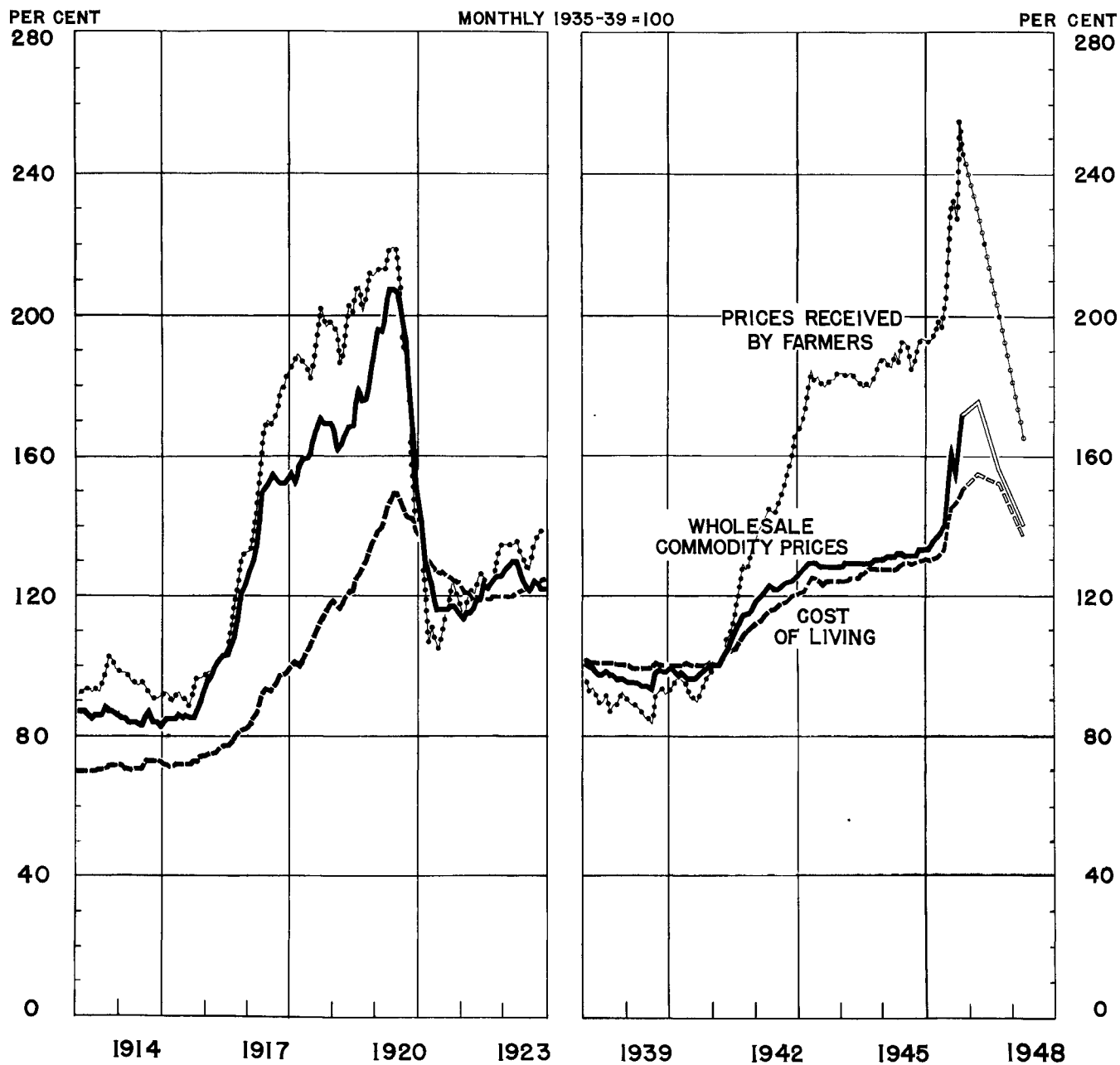
The most important recent development has been the sharp rise in commodity prices. The movement of prices during this war compared with those during and after the last war are shown on the chart. Prices were gradually rising during OPA controls, but with suspension of those controls last summer there was an immediate sharp upward spurt and another one followed the lifting of controls in October. Prices of agricultural products are about 250 per cent of the prewar level; they have risen more than during the last war and in fact have risen as much in the past six months as in three years from the middle of 1917 to the peak of 1920; and they are now higher than at the 1920 peak. Wholesale prices of industrial products have not risen during this war by anything like as much as they did in the last war--about 50 per cent compared with over 150 per cent--but further increases of these products are yet to be recorded. Retail prices of food, clothing, and many other nondurable goods have nearly doubled since 1939, and prices of durable goods have risen by about 50 per cent, while rents and many utility charges have shown little increase. The total cost of living index is up about 50 per cent.

During 1946 the country was faced with the alternative of further price inflation of a more serious nature than had occurred during the war or of rigid economic controls of a degree and character thought to be foreign to our nature. There was no other alternative because at the controlled level of prices demand was certain to be in excess of available supplies that could be provided in any short period of time. An attempt was made to maintain controls, but they were inadequate and in the end the course of inflation was chosen. We are now in the midst of the inflationary boom. The important question is when the pressures of large buying power will be more than balanced by increasing supplies and the retarding effect of high prices on demand.

GROSS NATIONAL PRODUCT AND COMPONENTS



PRICES



The price rise that has occurred may be justly called inflation. It seems more than likely that the present price structure is an untenable one; that the high prices may already be curtailing demand for some consumers' goods at least in physical volume terms; and that they will cause widespread postponement or abandonment of as yet unsatisfied demands for many durable goods, housing, and business plant and equipment. It is because of the recent sharp rise in prices that we have projected a decline in spending and incomes--a position that I was unwilling to take two months ago.

Further rises will occur in the prices of many commodities, but it seems probable that the upward movement will soon end. Agricultural prices will unquestionably decline from present levels and much, if not all of this decline, will probably occur in the next 18 months. A fall to or below wartime levels is likely. Prices of nonagricultural products have risen less and will decline less; they may continue above the controlled wartime levels unless and until higher wages are absorbed by reductions in other costs.

In our projections we are allowing for a decline in wholesale commodity prices during the next 18 months back close to the average level for the first half of 1946. This means a sharp decline but it is not a low level of prices. The basis for these estimates will be more fully explained in discussing other elements in the situation.

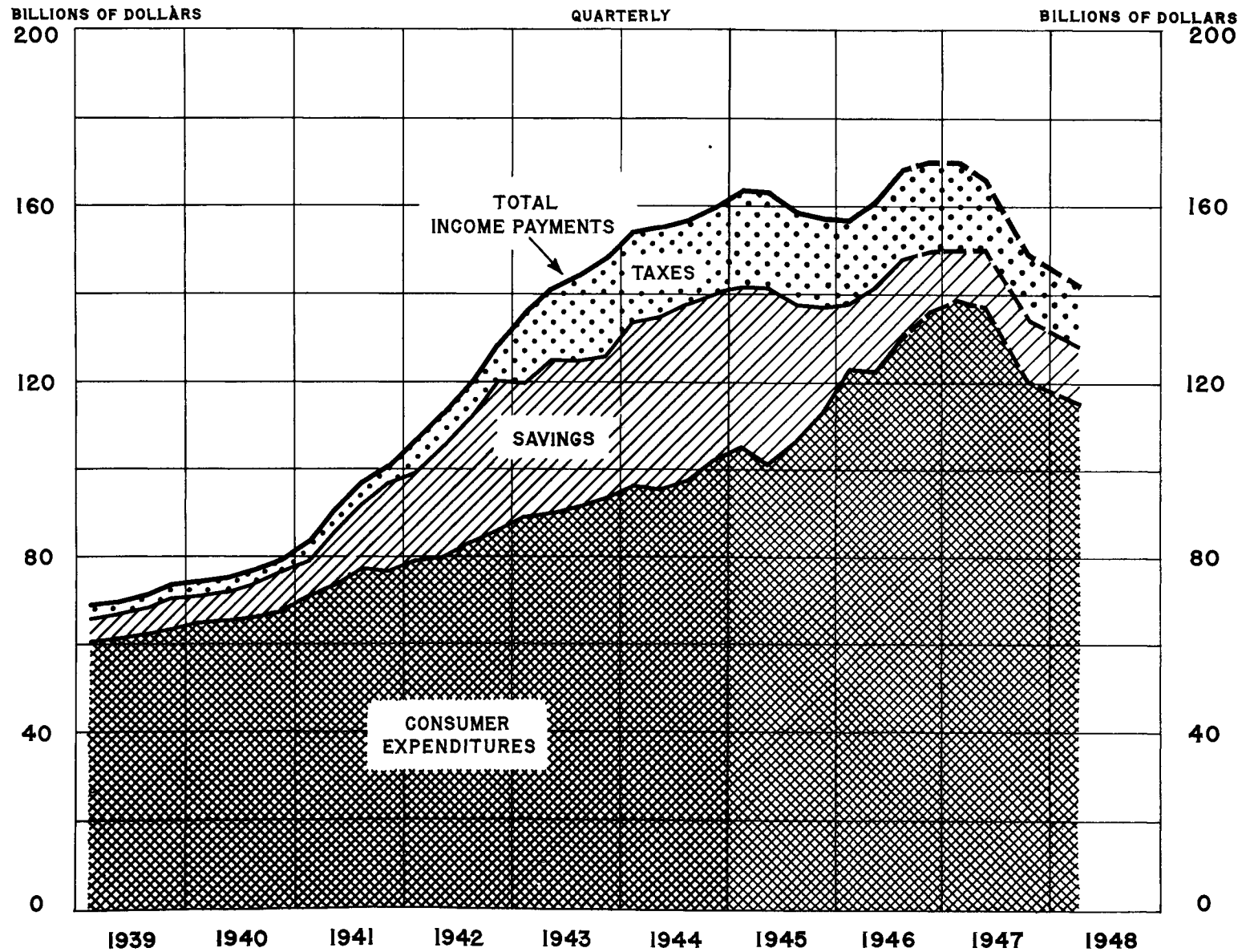
Expansion of consumer expenditures has been the outstanding development in the transition period. It has been far beyond previous expectations. As shown in Chart I, there were sharp increases in these expenditures in the last half of 1945 and in 1946. Expenditures on nondurable goods and services, which continued at a high level throughout the war, have expanded further, but the growth in recent months has probably not been as great as the rise in prices, indicating some decline in physical volume. The buying of durable goods has expanded rapidly with increased production of such goods, but is still below accumulated demands and potential capacity for production.

Total consumer expenditures are now abnormally large, not only in dollar amount and in volume of goods and services but also with reference to the level of individual incomes, which are also at a high level. This relationship is shown on the third chart. The net current savings of individuals, that is the excess of income after taxes over consumer expenditures, have been sharply reduced since the end of the war. Net savings are currently at an annual rate of about 15 billion dollars, compared with a peak wartime level of nearly 40 billion dollars. The ratio of current net savings to disposable income is now about 10 per cent, compared with the wartime peak of nearly 25 per cent and pre-war rates of less than 10 per cent.

Because the available supplies of consumers' goods, particularly durable products, will no doubt increase further, while incomes, for various reasons, will not increase correspondingly, the rate of net savings is expected to decline further. This reduction in net current savings will be one factor slackening or terminating the growth in total consumer expenditures. In this connection, however, it is significant and should be emphasized that these figures represent net current savings, that is, the difference between gross new savings by all individuals and current drafts on past savings. With the tremendous volume of liquid

INDIVIDUAL INCOMES, EXPENDITURES, AND TAXES

SEASONALLY ADJUSTED, ANNUAL BASIS
QUARTERLY



assets accumulated during the war, it is to be expected that withdrawals from past savings will be much larger than would normally be the case. This could be brought about by the use of savings to replenish reduced supplies of durable goods.

The willingness of people to draw upon their past savings to purchase durable goods will have an important bearing upon the volume of consumer demands during the next few months. Our liquid-asset surveys show that, although people planned at the beginning of this year to spend only relatively small percentages of their total holdings, the amounts that they expected to spend were substantial with reference to the supply of goods that are available. This was a better forecast than those made by some economists. The rise in prices that has occurred since that time, together with purchases that have been made, may give a different outlook for 1947. The next survey to be taken in January should indicate the extent to which the events of this year have altered intentions.

Another important factor maintaining consumer expenditures at a high level relative to income, particularly those for durable goods, is the rapid expansion in consumer credit. This expansion is likely to continue as more durable goods become available. Were it not for Regulation W the expansion, and subsequent contraction, would be more rapid.

It might be concluded that consumer spending need not be reduced because of the shortages of buying power. People have the money. It is more difficult, however, to know whether or not they will continue to spend it. The projections of consumer expenditures shown on the chart imply some continued drafts on past savings and expansion in consumer credit, since it is expected that gross current savings will continue relatively large.

Higher prices, however, will check some buying. It seems highly likely that the effect of higher prices, together with other factors to be mentioned later that will reduce incomes, will cause a marked decline in consumer buying beginning around the middle of 1947, if not earlier. Prices will also fall, accelerating the decline in the dollar value of incomes and expenditures, in addition to that reflected in a decrease in physical volume of goods and services supplied and in employment. The decline is likely to continue for about a year but, in view of large still-unsatisfied demands, will probably not be extremely severe or prolonged. The projections show a decline to a level in the first half of 1948 that is still slightly above that for the last quarter of 1945.

Government expenditures, which were the dominant factor in economic developments during the war period and which made forecasting much easier, have now become a much less important influence. Government expenditures for goods and services, as shown on the chart, are not declining as rapidly as they were several months ago but will be somewhat further reduced. This further decline in Government expenditures, which is of no small significance is due to a number of large items of a nonrecurrent nature in this year's Federal budget, as well as to other expected reductions.

The level of Government receipts will continue at a high level for a while, and the approximate balance between Government receipts and expenditures removes much of the stimulative effect of Government activity on the income flow. Possible reductions in tax rates may alter this relationship somewhat for the 1948 fiscal year and maybe even earlier. In fact if the decline in national income here projected should occur, Government receipts would be little or no more than expenditures, even on the basis of present tax rates, and if taxes were reduced, there would be a deficit. This perhaps would not be an undesirable development in case of business recession.

Private capital formation, indicated by the purple line on the first chart, comprises a hodge-podge of items which represent expenditures for the production of goods and services that generally are not available for purchase by consumers or are purchased out of savings or from the proceeds of borrowing. This figure includes expenditures for construction (residential and nonresidential), plant and equipment purchases by businesses, and accumulations of inventories. The net export balance is also included in the figure charted because it has the same effect, although it cannot logically be called capital formation.

Since these expenditures increase individual incomes but do not at the same time increase the supplies of consumer goods, they are likely to be an inflationary influence, except to the extent that they are financed out of current savings. If such expenditures are less than current savings, and there is no offsetting Government deficit or other credit expansion, then the result is likely to be of a deflationary character.

Expenditures for private capital formation were at a very low level during the war, but have subsequently expanded to an annual rate of about 30 billion dollars, compared with prewar figures of around 15 billion dollars or less a year. They are expected to increase further at least in the early part of next year, as increased supplies of materials and equipment become available.

Residential construction has expanded rapidly; expenditures for this purpose are now far above the maximum for any year in the 'thirties and new contracts awarded this year have been well above the peaks of the 'twenties. To some extent this increase reflects higher prices and the volume of building may be little above the level of the 'thirties. Practically all of the new housing construction now being started is under the Veterans Emergency Program.

It is in this field that price pressures are most acute. Shortages are tremendous and demands have been urgent. Because of the long-term nature of commitments, however, high prices are most likely to be a retarding factor. It is questionable whether at current levels of income people will continue to buy houses at the prices now asked, even with all the Government assistance that is being provided. As families make temporary living arrangements, even though unsatisfactory ones, they may decide to defer more permanent commitments until terms are more favorable. Already there has been a marked decline from earlier peaks in contracts let for residential construction, but current awards are still in excess of those for any previous period.

Expenditures on industrial and commercial buildings and equipment comprise the most important items in capital formation. Nonresidential construction rose much more sharply than residential building following the end of the war and the termination of allocations and of permit requirements by the war agencies. Controls have subsequently been reimposed and these activities are now being curtailed, but the actual expenditures on projects started or to be permitted are large and may expand further. Further removal of controls in these fields might stimulate renewed expansion.

Business is also buying new equipment in large amounts. Expenditures for producers' durable goods have been rising as fast as production could be expanded. Shortages are substantial in many lines and heavy expenditures are likely to continue for a few more months. There are reports, however, that many businesses are reviewing their programs for capital expenditures and if considerable uncertainty as to the future should develop, many planned expenditures may be deferred or abandoned. These plans, however, are far in excess of available capacity and can be considerably curtailed without seriously affecting current outlays for some time to come. There is as yet no evidence of a decrease in actual expenditures.

Business inventories, which were seriously reduced during the war in civilian goods lines, have been expanding at a rapid rate. Much of the large increase in recent months has reflected rising prices. It appears that over-all inventories are still not excessive in relation to the current volume of sales, particularly in view of the advantage under present conditions of being assured of adequate supplies. The situation is, no doubt, considerably varied; there are serious shortages in some materials or semifinished goods, which hold back production and make supplies of other items excessive in terms of current use, if not of actual demands. This unbalance in inventory positions is an important factor leading to further expansion.

If current trends continue, inventories can quickly become excessive. If demands should slacken because of satisfaction of past shortages or because of opposition to rising prices, many inventories now apparently inadequate would become too large. This point may be reached earlier in many of the nondurable goods lines where production has been in large volume and where the more urgent demands may be close to satiation. The increase in inventories will undoubtedly slacken or perhaps end during the next few months. This change will reduce or remove one of the most important stimulating factors in the recent expansion of incomes and will bring future incomes closer to the present level of consumer expenditures. The consequent decline in incomes would be another factor leading to a reduction in consumer buying.

Exports of goods from this country have continued large and could be much greater if current demands were met. The cessation of UNRRA may reduce somewhat our exports of foods, but in view of the demands for foods throughout the world it is likely that shipments will continue at a high level. Other products of this country are also in great demand and foreigners in general have or can obtain funds to buy all the goods that we will let them have.

In the aggregate the capital formation items are expected to continue large during the first half of 1947 but to decline sharply in the latter part of next year--from an annual rate of over 30 billion dollars to one of below 17 billion by the end of 1947. About two-thirds of this projected decrease represent a change from large inventory expansion to a slight reduction in inventories, but some relatively small curtailment in residential building and in expenditures for business plant and equipment is also indicated.

Stock market

The recent stock market decline has resulted in growing caution about the future. This decline could be readily explained on the basis of special market factors with little relevance to the general business outlook. These market factors include the development of a general movement for the taking of profits after the long rise which had occurred in the market since 1942; a surfeit of new issues floated at high prices; and a generally thin market, which is unable to absorb any sudden and large increase in purchases or sales.

Another possible explanation of the decline is that speculators and investors were looking beyond the immediate prospects for expanding volumes, rising prices, and higher corporate profits to the inevitable collapse to follow. The prospects for labor disturbances and for higher wages, which might result in reduced profits and retard adjustments in prices and costs during the recession, may also have contributed to the attitude of caution.

The existence of high margin requirements or rather the prohibition on margin trading has, no doubt, been helpful in reducing the repercussions of the decline in stock prices upon income flows and buying power. It may also have somewhat increased the difficulty of absorbing a large volume of new capital issues in the market. To this extent margin requirements served a useful purpose because many of these issues would be an inflationary influence at this time. In any event the decline of the stock market has at least temporarily removed one source of inflationary pressure.

Financial Situation

The financial picture has changed considerably since early this year. At that time, as a result of the playing of the pattern of rates by banks, expansion in bank holdings of Government securities was continuing and long-term interest rates were declining to new low levels. Recently bank holdings of Government securities have been declining sharply and interest rates have returned to their 1945 levels. Bank loans, however, are increasing rapidly.

There have been a number of reasons for these changes, the most important of which have grown out of the changes in Treasury financing. The discontinuance of war loan drives, which created excess reserves and encouraged bank buying of securities, has been one factor in the change. The Treasury debt retirement program has been the more important factor, in that it has exercised a drain on bank reserves through retirement of securities held by the Federal Reserve and it has also reduced commercial bank holdings of short-term securities. The third factor has been an increased demand for private credit--commercial,

industrial, real estate, and consumer loans. Expansion in loans of this type has been largely offset by an accompanying decline in loans on securities so that until recently total loans showed little change.

With the reduction in bank holdings of short-term Government securities, resulting from debt retirement and from sales necessary to maintain reserves, and with increased demands for private loans, banks have practically ceased their buying of longer-term securities. There have been some purchases of Treasury bonds by the banks, but the amount purchased has just about offset retirement of bonds from their holdings.

The net effect of all of these conflicting and offsetting developments has been some further expansion in deposits of businesses and individuals at banks to a new high level, although the amount of the growth has been less than in war years. Businesses and individuals have reduced somewhat their holdings of Government securities, and their total holdings of liquid assets have shown little further increase this year.

It may be said that fiscal developments and monetary policies are no longer contributing greatly to inflationary pressures as they were until a few months ago. Playing the pattern of rates is not now a problem of great and urgent moment.

There are, however, speculative and expansionary elements in the field of private credit. Bank loans to customers are expanding rapidly, reflecting inventory accumulation, real estate financing, and consumer credit. Banks are able to meet these needs by selling short-term securities to the Federal Reserve, thus creating reserves which can provide the basis for further credit expansion. Some of these credits are necessary and desirable, but many of them may be speculative in nature.

Little can be done to check expansion of this sort by raising interest rates on short-term Government securities. The yields on long-term Governments are now about as high as they probably should be permitted to go. It would be desirable if expansion in private credit could be offset by sales from the banks' holdings of Government securities to nonbank investors. There should be a steady investment demand for long-term Government securities and banks could sell some of their holdings. The question is whether they will do this as long as they can freely sell short-term issues to the Federal Reserve.

General Summary and Outlook

Production of goods and services in the United States is now close to the maximum that is possible or likely to be reached during the next year. Some further expansion might be accomplished through increased productivity of available manpower and the elimination of many dislocations, but in view of the limited supplies of many basic materials, any increase in over-all finished goods output likely during the next few months would probably not exceed 5 or 10 per cent. Work stoppages or other disturbances could prevent even this accomplishment.

Serious shortages relative to needs and demands still exist and very few have as yet been wholly satisfied, although some may be close to satiation. If greater productivity can be attained, many of the more pressing situations may be relieved within a few months. Some of the shortages for goods, however, will require two or three years to meet and those for housing and other construction will need many years.

Consumer expenditures are at an exceptionally high level relative to current income. Any further expansion and even the maintenance of this level depends in part on the willingness of consumers to draw on past savings or to reduce the rate of current savings. A great fund of past savings exists and in view of the accumulated shortages, particularly of durable goods, some drafts on these savings might have been expected were it not for the sharp price rise that has recently occurred. This price rise is the most important influence likely to bring about a decline in consumer buying and consequently in employment and incomes.

Accumulated shortages for capital goods are tremendous and expenditures might rise further as supplies of goods become available. Supplies are still the principal hindrance to expansion. These expenditures, however, are considerably influenced by anticipations. The needs exist for large capital expenditures, but many of them are postponable and their profitableness depends on the long-term outlook. The currently high level of prices and the difficulties of obtaining needed supplies of materials and labor are no doubt inducing many postponements likely to develop.

In looking to the future probably fully as important a factor as higher prices and related to them is the likelihood of an early cessation of the expansion of inventories. This will remove an important element maintaining incomes and absorbing goods. A further decline in Government expenditures and perhaps a budget surplus will also reduce disposable income.

It now seems highly likely that, notwithstanding continued unsatisfied demands, some recession in expenditures by consumers and business and a marked decline in prices will begin before the middle of 1947. By that time many consumer nondurable goods are likely to be in adequate supply, even at a very high level of demand, and larger supplies of durable goods will be available. If consumers should curtail purchase of nondurable goods in order to buy automobiles, household equipment, and the like, then there would be a decrease in demand for nondurable goods and in their production. At the same time higher prices are likely to induce some deferment of expenditures for plant and equipment purchases and for new housing. Buying for inventory expansion will slacken and with sales declining or no longer expanding, many inventories would be found to be excessive.

These developments will lead to falling prices, reduced production and employment, and declining incomes. This might be interpreted as "boom and bust". We have certainly had the boom, as measured by any past standards, but it seems unlikely that we will have a bust, judged historically. In view of the many

deferred demands and the accumulated savings and the relatively moderate speculative credit structure to be liquidated, it seems unlikely that a prolonged downward spiral will develop. There remain the tremendous wartime accumulations of liquid funds that are readily available for spending and investing. On the basis of past standards they are large relative to even the present very high level of gross national product. The projected decreases in output and prices are not likely to be accompanied by reductions in the volume of liquid assets.

When prices have reached a more tenable basis, then active buying is likely to be resumed. Should the boom continue longer than is here envisaged, with further price rises, and considerable credit expansion, then the recession might develop into a severe and prolonged depression. On the other hand, gradual adjustment of individual dislocations may lead to a new more tenable level of prices and production without any serious maladjustment or sharp decline. That has never happened before, but it may not be impossible.