[REVISED, October 1] Copy No. 24
Report - CEA-QR
3rd Qtr 1947

~~STRICTLY CONFIDENTIAL~~

September 30, 1947

MEMORANDUM FOR THE PRESIDENT

FROM: The Council of Economic Advisers

SUBJECT: Third Quarter Review

The third quarter of 1947 presents on the surface an economic picture which continues the favorable impression of the first half of this year and of the year 1946.

THE QUANTITATIVE VIEW

Civilian employment has continued close to the 60 million level attained in June (latest figure 59.9 million). Against a normal seasonal reduction in agricultural labor, we are seeing a marked increase in textile and apparel employment. The increase in number of housing starts during the third quarter also promises a longer-than-normal extension of building trades labor in the fourth quarter. The overall number of claims for unemployment benefits is now at the lowest level since shortly after the end of the war.

Production indexes have maintained a high level, though not fully up to marks set in the first quarter. Advances have recently been registered in such important industrial indicators as bituminous coal, petroleum, steel, electric power, motor vehicles, and freight-car loadings. Motor vehicle production and freight-car loadings registered highs for the year during September, and electric power production, by crossing the mark 5 billion kilowatt hours, registered an all-time high. On the other hand, agricultural conditions have been less favorable since late spring, so that the index of agricultural production is moderately down.

Purchasing power has reflected the high level of employment and production. With strikes or other work stoppages relatively few and brief, the substantial wage advances granted in important industrial areas during the first half of the year have been reflected in an increase of workers' spending money. The sharp advance in prices of many agricultural products has brought farm income to a record level, and the high rates of earnings over most of the industrial area have sustained liberal spending for plant and supplies and have permitted an increase in dividend disbursements. Cash income from current operations has been augmented by continued drafts on savings, the cashing of terminal leave bonds, and extension of credit at home, and by the inflow from foreign countries which have needed to draw down their dollar balances to meet pressing import needs. The free flow of monetary purchasing power in the face of shortage of some goods, particularly agricultural products, has been reflected in a marked advance in the general price index, especially during the last two months.

THE QUALITATIVE ANALYSIS

When we look below the surface manifestations of continuing prosperity during the third quarter, the picture is much less reassuring. While it is not a cause for immediate alarm or panicky action, it does demand sober consideration of the probable trends during the fourth quarter of 1947 and of what steps should be taken to adjust ourselves to these trends as they may be projected into 1948.

Employment and labor input. While the number of jobs has been satisfactory, these jobs have not been as regular as would have been necessary to attain full production. This has been due in part to labor-management friction resulting in work stoppages. But more seriously it has been due to shortages of material and, back of that, to shortages of equipment.

Production and its limiting factors. This brings us immediately to the disappointing conditions of national production which have developed in the third quarter. On the side of agriculture, this untoward development is due **primarily** to adverse weather conditions. The number of farmers and the time devoted to farm work has been ample, and materials and equipment have not shown any crippling shortage (though there has been some tightness in the fertilizer supply and farmers are still eagerly taking improved equipment as fast as it becomes available).

On the industrial side, however, we have encountered some unforeseen limitations in the process of converting from war production to full-scale peace production on a level of high efficiency. Industrial technology sets its own pace, and the new equipment provided to give men employment is of the most efficient kind. If that is not available, men are partially idle rather than used full time at lower efficiency. The first rush of reconversion was amazingly rapid. Where the same plant and equipment could in the main merely be rearranged to produce a different design or product, the change was largely a matter of organization and managerial skill. Likewise, procurement of the early instalments of new equipment encountered no great difficulty. But now we are finding that the problem is not limited to opening the last of the bottlenecks, but involves delay at least in providing an ample supply of basic materials and of crucial types of equipment, notably railway rolling stock and power units and steel-producing capacity.

Steel-using industries have not been able to keep up to full production schedules because of delays in getting needed steel. To some extent this shortage has furnished the opportunity to use more of our aluminum capacity, which had been overexpanded by war demands. Probably aluminum use will become established in part of this expanded area and thus permanently reduce the need for steel capacity in a stabilized high employment economy. But in the area where substitution of aluminum, plastics, plywood, or other materials is not possible, there is still a demand for steel which is not being currently met. This results in both lowered production in many dependent industries and higher prices at initial points, which contribute strongly to the general inflationary pressure.

It is quite possible that there will be production cutbacks in the steel industry during the winter months due to shortages of (a) coal, (b) scrap metal, and/or (c) pig iron. Any shortage of coal would be due to shortage of coal cars to bring it from the mines. Car-building has been lagging for lack of steel. Shortage of scrap would be due to the permanent loss of steel products as a result of the war and to the high rate of use in a full-scale peacetime economy. It raises the question whether pig iron capacity is now being provided in sufficient amount to meet clearly foreseeable needs of a stabilized economy. Whatever the answer to that question, it is evident that new blast furnaces cannot be brought into operation to combat possible shortages this winter, and also that withdrawal of steel now to build steel-making facilities would further aggravate the present scarcity.

The shortage of railway equipment affects the movement of grain and other farm products as well as coal and industrial materials. It reflects the high rate of wear on railroads entailed by the war effort and also raises the question of just what railway capacity is needed for a full production economy and how it can most economically and promptly be provided.

There is great difference of view as to what rate of capital formation would be needed for sustained high-level production and what would constitute boom-time overexpansion. The Council of Economic Advisers is studying the question of plant capacity intensively in cooperation with all government agencies and the appropriate management organizations. Meanwhile, we have to appraise the results of shortages in industrial facilities which cannot be immediately relieved. This brings us to brief comment on the Nation's purchasing power situation, which is characterized by the lagging of physical supply behind monetary demand.

<u>Purchasing power high but unstable</u>. The First Economic Report of the President addressed itself to the possibility that a deficiency of purchasing power in the hands of consumers might develop before the close of 1947. This analysis was based on the assumption

that crop conditions would be as favorable as those of 1946 and that industrial productivity would rise substantially in the course of the year. If, then, wages and prices were to continue at the level of January 1946, we foresaw a shortage of consumer purchasing power which, unless corrected, would lead to clogged markets and subsequent production cutbacks and a generally recessionary movement.

The type of correction suggested in that report was the bringing up of wages at the lower end of the wage structure while refraining from further advances in the higher brackets which would force price increases or prevent desirable price reductions. The major adjustment to be hoped for if we reached high-level production by the end of the year was, in general, downward reductions of prices to permit ready market absorption of this maximum product. We recognized that, even with good crops, farm products could not be expected to fall much in the competitive market during this year. On the industrial side, it appeared that, with low unit-cost derived from efficient equipment and high-capacity operation, profit margins could be narrowed and prices competitively lowered to a point which would put this maximum volume within reach of currently disbursed consumer incomes.

The Mid-Year Economic Report had to record the fact that this voluntary adjustment had not taken place except in small measure but that, meanwhile, purchasing power of wage earners had been strengthened by substantial increase in wage rates over a considerable industrial area, and business purchasing power had been buttressed by high rates of profit and ample credit. This profit situation in turn had sharpened wage demands. Agricultural prices had risen more than those of manufactured goods and cost of living had risen substantially.

While this was not the type of adjustment which had seemed to the Council most wholesome and effective in the long run, it was recognized that, in a free enterprise economy in a troubled transition period, we have to "feel our way towards a workable set of price relationships" and that it would not be impossible to keep going on the basis of these adjustments pending more satisfactory conditions. These adjustments would be reflected in a higher price level than would have developed from the types of adjustment proposed in the first Economic Report.

In the third quarter, disturbing price advances have been resumed. Marked price increases were registered in coal and steel. Other prices have also risen, particularly for food commodities. The real purchasing power of many groups of consumers has consequently dropped. Quite aside from the funds made available for purchase of goods for foreign shipment, a rapid expansion of credit to consumers and others and a large amount of dissaving have been drawn upon to support prices far out of line with domestic buying power based on current earnings. Hence, the economic tendencies which gave cause for attention earlier in the year give cause for increasing concern now.

The present price situation, particularly with respect to rising food prices, creates three dangers which can be characterized as immediate and serious. First, the increasing cost of living threatens to generate another series of wage demands in urban areas, leading either to industrial stoppages and curtailment of production (with a further harmful impact upon prices) or to a wage-price spiral that would introduce new instability and uncertainties throughout the economy. Second, the present high cost of living, even if it does not climb still higher, imposes such discomfort or privation upon millions of families in the lower parts of the income structure that it is a source of nationwide discontent which cannot fail to produce serious economic repercussions. Third, the price situation could jeopardize public acceptance of the foreign aid program and make each dollar of foreign aid worth less to the recipient in terms of buying power.

NEED OF POSITIVE ACTION

While reduction of the scale of foreign relief would undoubtedly ease the strain of our own economic adjustment, it would not solve any of its basic problems. Moreover, we must assume that this aid will, for controlling reasons of national policy, be continued at or about present levels. The effect of such a program will be quite as much that of a continued but temporary prop to the domestic market as that of an additional strain. In fact, the new program, in all likelihood, will be less of a strain on the general economy than the export program of the past. It will, however, impinge particularly on food, fuel, steel, and a few other commodities which happen to be in short domestic supply. Therefore, we believe that, in the interest of the domestic economy as well as the need of rendering essential aid to foreign countries, a positive program of action is required to deal particularly with these areas of acute shortage.

The crux of the whole matter is, of course, to be found in the agricultural situation. Here we think the only safe assumption is that crops in 1948 will be below the high level of the first half of 1947, when we were still on the plane of a 1.4 billion bushel wheat crop and a 3.3 billion bushel 1946 corn crop. Between now and the fall of 1948, we shall be rapidly depleting the stocks from those two record crops and shall be harvesting a new wheat crop that is going into the ground under seriously adverse conditions.

As these developments appear, there can be little doubt that the high level of food costs will cause many persons to curtail their consumption of high-priced livestock products such as dollar steaks, 90-cent butter, and 85-cents eggs. Thus the rise will to some extent top itself out through curtailment of demand rather than through stimulation of supply. Reduction of wasteful or less essential consumption cannot safely be left to the operation of the automatic forces of the market. We believe the evidence is clear that speculation, shortsightedness, and general lack of skill and foresight in the voluntary management of our free enterprise economy under conditions of full employment are all playing their part in worsening the situation. And they are by no means out of reach of administrative and legislative treatment. Much as we deplore the return to more government intervention, we believe that the ~~gravity of the prospect~~ situation may become so grave as to require~~s~~ it.

The recently announced program for voluntary food conservation, if rigorously adopted by the farmer, the distributor, the manufacturer, and the consumer, can achieve substantial results. This program should be pushed with all vigor and celerity, and nothing should be done to cast doubts upon its utility. But the uncertainties with respect to future crops and with respect to the volumes of foreign aid which may be required as developments unfold, when added to the certainty that the current price situation threatens disturbance of our whole economy, lead us to the conclusion that the voluntary program should at once be supplemented with studies and plans for more specific and drastic measures. These measures at best take time to formulate and time to apply.

We therefore recommend that the following proposals be developed as comprehensively and promptly as possible:

First, the extension of export control;

Second, further regulation of commodity exchanges;

Third, regulation of the sale of flour by millers;

Fourth, regulations of, or limitations upon, the amounts and kinds of feed manufactured;

Fifth, regulations of, or limitations upon, the use of grains for the production of alcoholic beverages;

Sixth, inducements or penalties to discourage the feeding of hogs to heavy weight and the feeding of grain to beef cattle;

Seventh, Government purchasing and sale of grain on a wide scale to affect pricing and types of use.

Eighth, continuation of ODT controls for making fullest and most effective use of scarce equipment;

If a worsening situation--to which delay in utilizing these moderate measures might contribute--makes even more drastic measures essential, we shall need forthrightly to consider allocations and price controls for selected commodities. This contingency should be covered within the area of immediate study.

We do not at this time certify our belief in the desirability of all these proposals, or of any number of them in combination. We do certify our belief that some of these proposals will become essential in the unfolding situation, and that their further development should not be delayed in the cheerful expectancy that the voluntary program will do the job. We are now in a period when our capacity to act before the crisis appears is surely being tested. The purpose underlying the Employment Act of 1946 is to produce action before the crisis appears in all its intensity.

While some of these proposals can be applied, in whole or in part, under existing powers of Government, additional legislation also will be required. Public knowledge that administrative powers are being utilized to the full, and that requests for additional powers through legislation are being readied, might well serve to abate some of the current speculative factors.

Finally, we would direct particular attention to the large part played by credit expansion and fiscal action in a situation like the present. Serious inflation is always accompanied by undue credit extension. If total buying is held in close relation to current income, there is a barrier beyond which the price level cannot advance, although there may be advances within particular commodity groups, as there is at the present time in food products. To avoid an undue credit expansion, it is necessary for the Government to take definite steps.

Congress should reinstate to the Board of Governors of the Federal Reserve System power to regulate consumer credit, which has been repealed effective November 1 by recently enacted legislation. Present powers of the Federal Reserve System are also inadequate to limit general credit expansion, which is now proceeding at a rapid rate.

To check the use of credit for speculative trading in grain, we urge full use of its administrative influence by the Commodity Exchange Authority. Unless the exchanges make prompt and satisfactory adjustments in margins for speculative trading, the Government should seek legislative authority to impose upon the exchanges such regulations as are deemed necessary to protect the public interest.

On the side of fiscal action during an inflationary period, the Federal budget should be at least balanced and a surplus should be the objective. This means keeping expenditures, including those for public works, at the lowest levels consistent with non-deferrable national needs. Bonds held by commercial banks should be retired and bond sales to the public should be encouraged. Whatever the usefulness of deficit financing in deflationary periods, such a course in the face of present inflationary dangers would be reckless and harmful. Hence we renew our emphasis on the need of maintaining the present total of tax revenue during the coming year.

While we must deal vigorously with the pressing problems growing out of the international emergency, we must not do so to the neglect or prejudice of our longer-run problems of national economic adjustment for sustained high-level production. That process is merely interrupted or modified while we meet and surmount an unexpected setback growing out of unfavorable crop conditions at home and abroad and the underestimated wartime attrition of industrial facilities. The fundamental conditions of the national economy are still strong and the long-run outlook reassuring. There is still a great unspent momentum of the postwar replacement boom, and the additional goods available to the domestic market as foreign aid programs taper off can be absorbed by domestic buyers without production cutbacks. But we must not abate attention to the factors of growth and the kind of internal adjustment that must support the economy when the temporary distortions disappear. These matters are being given careful attention by the Council and its staff and will be covered in the materials submitted for your use in connection with the preparation of the second annual Economic Report of the President.