

Reports
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3rd Quarter 1948

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MEMORANDUM TO THE PRESIDENT

From: The Council of Economic Advisers

Subject: Third Quarter (1948) Review

The third quarter of this year has not seen the introduction of any striking new factors into the economic situation. There has simply been some partial clarification of the ultimate impact of influences which had already entered the picture at the time of our midyear analysis. The outstanding ones were: (1) the favorable crop prospects, (2) wage advances in coal, steel, and automobile production, which were promptly reflected in price rises, (3) the rising scale of expenditures under foreign aid and defense programs, and (4) the effects of income tax reduction.

We indicated that these developments had more inflationary implications than possibilities of deflation. We called attention, however, to prospects of supplies catching up with demand in additional areas with the passing months. We reported also a note of caution among industrialists, merchants, and bankers and of moderation on the part of some wage negotiators and price makers.

Since that time the favorable domestic crop prospects have been confirmed by yields even larger than those forecast in the July crop reports. European output of cereals and foreign output of oils and

fats has improved to an extent that tends to lessen the demand on us for exports. Defense and foreign aid expenditures are moving at approximately the scheduled rate. The very mild restraint introduced in the credit field through the restoration of consumer credit regulations, the slight advance of interest rates, the small increase of reserve requirements, and mounting concern over the mortgage situation appear to be having some cautionary effect. Total volume of credit continues to expand but not to be entering a runaway phase.

We do not believe it is possible at the present time to arrive at a firm conclusion with reference to the course of the economy beyond the period of the next few weeks or months. During this near-time period, there is every assurance that employment and production will be maintained at very high rates and that the course of the general price level will be upward to a greater or less extent. But underneath these overall conditions there will be the greatest variety between industries that are moving into a condition of easy supply or even surplus and those that are feeling increasing scarcities. There will be a wide range between areas of strongly advancing prices, relatively stable prices, and prices that are declining.

As noted in the Midyear Report, there is a strong upward thrust on industrial costs resulting from higher freight rates (complicated by the basing point decision), substantial wage advances in basic industries, and higher costs for many materials still in scarce supply. These higher costs are in the process of being digested in a market situation which, overall,

is still strong, but in which there are many indications of greater difficulty in passing price increases on to the buyer. And in such an important item as bituminous coal, record-breaking production and lessened export demand (due to recovered production in Britain and Poland) have satisfied ~~the~~ market to the point where high-cost and low-quality producers are dropping out.

Under the impact of these varied influences, the all-commodity index of wholesale prices rose 1.2 percent from the end of June to September 25 and is now 1.9 percent above the peak of last January. Farm products dropped 3.8 percent from June to September 25. Other-than-farm-and-food prices rose 2.3 percent, as compared with a rise of 2.4 percent in the first half of this year and a 10.9 percent rise during the latter half of 1947.

Behind these averages, movements for various product groups have been very different.

Hides and leather products have declined 6.7 percent since mid-January, but are practically unchanged since June. Chemicals and allied products have declined by 5.2 percent since January and 1.5 percent since June. Textile products have risen slightly since January, but declined 1.6 percent since June.

At the opposite extreme, metals and metal products ~~have~~ risen 12.1 percent since January and 8.2 percent since June, even the latter figure being in excess of the whole rise during the second half of 1947.

Other product groups - fuel and lighting materials, building materials, and house furnishings - have risen by 6.0, 6.2, and 8.0 percent, respectively, since January and all show rise since June.

Foods have increased by 3.6 percent since January and by 2.6 percent since June, but have declined slightly since July. There are also reports of declining or flattening tendencies in clothing and shoe prices.

Lowering the prices of processed materials in proportion to the decline in farm prices is impeded by the fact that wage and other operating costs of processors have increased substantially. On the other hand, profit margins in some cases are quite wide, and it is possible that these cost-of-living items will show greater or less declines in price during the next few months. Apparently, knowledge of the fact of large crops is having the psychological effect of stiffening consumer resistance to high food and clothing prices. Developments of the next two or three months should shed a great deal of light on how the conflicting forces we have discussed will work themselves out.

The most significant factor in this developing situation means clearly to be the size of the military effort on which we embark. These expenditures, along with ECA, are rising at a time when there are some tendencies for activity to decline in the domestic lines which have been highly active during the reconversion period. As we have emphasized on several previous occasions, the absolute amount of the increase involved in present programs is not so large as to disrupt civilian production and consumption or to accelerate sharply the rate of price inflation. Even at this level, however, it impinges so strongly on critical factors in our industrial process, notably metals, fuels, and electric power, that it already exerts a definite pinch on the operation of the domestic civilian economy.

There is clearly evident danger that the outlays being made for rearmament of Europe and for domestic stockpiling and equipment even under the projected scale of expenditures would within a period of six or nine months create such a situation as to wage adjustments and materials prices as might accelerate a new inflationary spiral. If the scale of military expenditures should be raised by any substantial amount above its present level, we believe that this inflationary result would inevitably follow. This appears to be the consensus of informed business thinking. There seems also to be more and more acceptance of the view that any substantial increase of rearmament pressure would necessitate reimposition of controls on a considerable scale.