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MEMORANDUM

To: The President
From: The Council of Economic Advisers
Subject: Third Quarter (1949) Review

In the Council's review of the economic situation at midyear, we suggested two developments as possible in the second half year: (a) "reversal of the downward trend of production and employment" or (b) "a further spiral of unemployment, loss of consumer income, and decline of consumer demand." We felt that the more favorable prospect was sufficiently strong to justify our advice against extensive or drastic counter-depressionary measures at that time. The more optimistic trend has in fact developed during the third quarter. Both business sentiment and business performances improved markedly, although near the end of the quarter the business prospect was obscured by work stoppages and by new international developments.

While we said at midyear that the situation of mixed inflationary forces and deflationary forces had definitely yielded to one of a general weakening of markets for most goods, we found the favorable prospect in the fact that underlying economic elements had great strength. These had been fortified by government anti-depression policies. Buying by consumers and investment by business had declined but little, and there had been no spiraling of recessionary forces. We found reason to

hope for "early stability followed by renewed growth."

Our principal concern, nonetheless, was that the further decline in production and the increase in unemployment which we believed would occur in July might induce so much pessimism that consumers and businessmen might restrict their expenditures greatly enough to set up a spiraling deflation. This did not happen. Even while the expected unfavorable changes were occurring in July, business sentiment shifted from the pessimistic mood which colored all business journals in May and June. When August brought a few positive, although mild, changes for the better in some business indexes, business and consumer sentiment clearly became more optimistic. This mood was strengthened by the more emphatic business changes in September to a degree which has thus far enabled it to persist notwithstanding the adverse effects of the steel and coal strikes and the unsettling effect of the general devaluation of world currencies.

Production. The index of industrial production, which in January had fallen but little from the high point reached in the autumn of 1948, declined from 191 in January to 169 in June. It dropped temporarily to 162 in July, when vacations interrupted production. The prompt recovery to 170 in August was reassuring, particularly because it occurred both in durable goods and in nondurable goods manufacturing, and the favorable interpretation of the trend of business was confirmed by the continued advance, small though it was, in the indexes of production of these two classes in September. The coal strike in September caused the index of mineral production to drop substantially, but the increase in the production of manufactured goods was sufficient to lift the index of total

industrial production by one point.

The continued high level of operations of the automobile and construction industries has been an important factor in supporting the economy. It is especially noteworthy that new housing starts have remained close to the high level of the year; in contrast, they began to fall off in June last year.

Employment. Problems of employment and unemployment have been serious in many localities, but for the country as a whole they have been kept within manageable limits. The average number employed in the first half year was within one percent of the number employed in the first half of 1948, but while the number employed in nonagricultural jobs in the first half of 1948 was increasing, there was a slow decline from January to June in 1949.

Workers on scheduled vacations are not dropped from the list of those employed, and for this reason the figures for employment in nonagricultural jobs in July did not reflect the sharp drop in industrial production. However, the increase in employed workers in July was very slight, and was much less than enough to balance the seasonal increase in the labor force. Unemployment therefore rose to 4,095,000, which was 1,868,000 above that of July, 1948. The unsatisfactory trend in unemployment was amplified by the increase in the number of those with part-time employment.

In August there came the first real break in the downward trend of industrial employment, when jobs in manufacturing increased 330,000. Unemployment figures dropped in August and again in September, but an unusually large decrease in agricultural jobs has limited the decline

in unemployment. By September, the number employed in nonagricultural industries was 1,181,000 larger than in July. Total civilian employment was 59,411,000, and the number of unemployed was 3,351,000.

Consumer income and expenditures. An important point in an analysis leading to a judgment about the probable course of business is consumer expenditure. When the inevitable end of an inflationary movement brings a break in prices, the expansion of the economy will not be resumed so long as consumers restrict their buying, either because they lack income or because they are waiting for more price reductions.

There has been no substantial impairment of consumer income, and there has been no sustained withholding from the market. The expenditures by consumers in the third quarter, it is estimated, have represented the same proportion of personal disposable income as they did in each of the last two quarters of 1948. The anomaly of sustained consumer income for a full year after postwar inflationary forces began to subside has marked one of the important differences between this and other periods of recession. Except for farm income, which is protected against further serious decline by the farm price support policy, personal disposable income has dropped very little.

Business profits and investment. Business profits are high, when viewed from the standpoint of the effect of the businessman's profit margin upon his purpose with respect to new investment in plant and equipment. Profits are high in dollar terms, both before and after taxes, compared with those of any prewar year, although they do not represent so large a proportion of the national income as they have in some earlier years of great prosperity. Compared with 1948, when business profit

statements were expanded by the inflationary increase in the dollar value of inventories, business profits in 1949, when the opposite adjustment has had to be made, have been declining.

The important effect upon the economy of changes in business profits is found in the influence they have upon the ability and purpose of businessmen to make new capital investments. In the first half of 1949, notwithstanding pessimistic utterances, businessmen made larger new capital investments than in the first half of 1948. These investments far exceeded those in the first half of 1947, when business investment was great enough to contribute much weight to the inflationary forces which were then appearing.

At this stage, there are no adequate data of business investment in the third quarter, but the survey of investment plans indicate that new investment for plant and equipment in the second half will be about 14 percent below the all-time record level of the second half of 1948. That would be a high rate, measured by experience. It remains to be seen whether actual expenditures exceed those reported as planned, as has been the case since the war, or are less, as they may turn out to be if business sentiment should become uneasy.

Prices. During the third quarter the downtrend in wholesale prices of manufactured goods was arrested. The volatile farm and food prices fluctuated over a considerable range, and in the final week, in which a substantial decline occurred, the wholesale farm price index of the Bureau of Labor Statistics was 4 percent below that of the last week in June. The wholesale price index of foods was then slightly below the

midyear figure. The index of wholesale prices of other goods was very steady throughout the quarter. The consumers' price index, reflecting changes in retail prices, declined from 169.6 in June to 168.5 in July, and rose to 168.8 in August. This index has moved very little since February, when it was 169.

Satisfaction with the cessation of price reductions because it indicates that deflationary forces are slackening must be tempered by doubt whether the slight reduction in the price level which has thus far taken place represents a sufficient readjustment to establish a basis for stabilization. In the past, postwar inflations have been followed by severe price declines. The question now is whether the price adjustments already made are sufficient in the light of relative stability of incomes, or whether a more extended readjustment must still be made and if, until it has been made, we can enjoy more than temporary periods of business recovery.

This question is not really different from that of the ability of the economy to liquidate the postwar inflation without being driven into a serious depression. That this may be done is possible, we have said, because new policies--fiscal, monetary, unemployment benefits and other social security, and farm price support--are supporting the strong underlying economic forces and are preventing crises from arising while commercial inventories are being reduced and prices are being dropped in the more vulnerable commodity groups.

There is no standard, other than that of the willingness of consumers and of businessmen to buy, by which one may determine whether prices

have been brought into workable relationship with income, wages, and profits. Notwithstanding the moderate depth and the limited scope of the price reductions, the indications are that they have been sufficient to restore market demand at many of the spots where volume had dropped. In the case of such important goods as textiles and building materials, prices have been reduced enough not only to reestablish market demand, but also in some instances sufficiently to permit some price recovery, although it may be questioned whether it has been wise for businessmen to raise prices before the situation has been clarified. Some prices have been but little reduced, as in the case of automobiles, petroleum products, and some other commodities in the administered-price class, where the great postwar demand has thus far continued to be strong. But, in all probability, we shall not be safely through the readjustment period until the economy has faced price reductions in these important areas.

Two new factors. Following the expected slump in July, business changes during the third quarter of the year were definitely encouraging. The favorable prospect for increasing production and employment during the fourth quarter was, however, clouded at the end of the quarter by labor warfare and by the general devaluation of world currencies.

Balance in our international trade has been impeded ever since the war by the fictitious value at which other governments attempted to hold their currencies. In a sense, the official revaluation of these currencies at lower rates with respect to the dollar only publishes and officially accepts the fact already established in foreign exchange markets

There are other important results, however. To the extent that foreign governments are able to prevent offsetting wage increases and advances in other prices, prices we pay for goods exported by those countries will be decreased by the official devaluation and prices they pay for imports will be increased. This prepares the way for devaluing countries to make larger exports to and to reduce imports from countries in the dollar area, which have not (except for Canada) devalued their currencies. The United States is the country which would suffer most of the short-term disadvantage from this process, but it is not at all clear how far or how soon our foreign trade will be affected. Many factors, especially the inability of other governments to freeze their internal prices, will probably limit the ability of foreign nations to increase their shipments to this country and will thereby limit the pressure upon our recovering markets. Our foreign aid program will furnish important, though diminishing, support to our own exports.

The work stoppages in coal and steel thus far appear not to have dampened basic business sentiment. General buying and forward commitments are being maintained, and even the stock market has risen since the strikes commenced. This is partly because of realization that strikes of short duration, with large supplies on hand, are unlikely to affect the general economy very much, and that the resumption of operations can quickly make up the loss, particularly because the coal and steel industries were not operating at full capacity when the shutdowns started. Also, the recent settlements in parts of the automobile industry and elsewhere decrease the range within which the steel controversy could spread to other areas.

Yet it goes almost without saying that a protracted shutdown in coal or steel would incalculably weaken both the economic and the psychological forces now moving the economy forward. Therefore, the immediate parties to the coal and steel controversies must exercise utmost diligence to compose their quarrel, lest they force the country to travel along the less desirable avenue to industrial peace through public intervention.

The Business Outlook. Looking forward to the fourth quarter, the favorable developments of the third quarter provided some basis for expecting a strong and improving situation in the fourth quarter if that prospect is not marred by the adverse effects of international currency devaluation and the damage of labor stoppages. The direct effects of these developments will appear gradually, but they introduce present uncertainty into the business situation at the very time when uncertainty is the factor most to be feared.

Whether the course of business recovery will carry far enough to restore full employment must be a matter of continuing concern. Levels of production and employment equal to those attained in 1948 will not represent maximum production and employment, the goal of the Employment Act, when the growing population shall have produced a much larger labor force and the productivity of all workers shall have been increased by additional capital investment and other technological improvements.

The problem of progressively achieving these higher levels is complicated by the fact that some basic adjustments yet to be made may for a time operate in the opposite direction. In particular, there is likelihood of some decline in the rate of investment in industrial plant

and equipment, and automobile production cannot be expected to continue at the present level.

Thus, while the immediate economic outlook is generally favorable, there will be continuing problems of satisfactory rate of growth in the economy. This will be true even if there are no prolonged strikes.

Recommendation. We renew the recommendation which we made in connection with your Midyear Economic Report that there be no increase in tax rates, and that the general anti-deflation programs of the government need not be reinforced by extensive expansion of government action. Business recovery is not yet fully established, and it would not be prudent to burden business and investment with additional taxes. On the other hand, the improvement in the economic outlook is encouraging enough to justify reliance for the present upon market processes, supported by existing government policies, to expand the demand for labor still further.

Our first task is to liquidate the forces of recession and thereby to establish the base from which the economy can move forward. But there are some programs and policies, involved in the ensuing problem of sustained economic growth, which may be reviewed and improved without further delay. The expansion of the social security program has already been initiated. The overhauling of the tax structure, often discussed and always deferred "for the present", should also be undertaken. We believe that the economic conditions when the next session of the Congress convenes will be as favorable for consideration of general tax legislation as they may be expected to be at any time in the next few years, and we recommend that the preparatory work be launched at once in order that in your next annual Economic Report you may be able to make specific recommendations for changes in our tax laws.