

October 19, 1950

MEMORANDUM

To: The President

From: The Council of Economic Advisers

Subject: Quarterly Report on the Economic Situation

Our Weekly Summaries of Economic Developments have sought to keep you briefed on very short-range changes in the factual situation. On September 26, 1950, we furnished you with a Special Report on Economic Trends and Policies, which surveyed in some detail the policies then deemed necessary.

In this regular Quarterly Report on the Economic Situation, we review developments since approximately the time of the Korean outbreak, appraise the outlook for the fourth quarter of this year, and present policy recommendations.

Highlights of the Third Quarter

As the third quarter of the year opened, the domestic economy was being rapidly permeated with tension. The entry of the United States late in June into hostilities, under conditions which some feared might quickly lead the country into major involvement, brought sharp recollection to consumers and businessmen of the supply problems of World War II. Many yielded to the impulse to protect themselves before limitations could be imposed upon the free markets.

Early in July, buying by consumers reached proportions which might have been characterized as frenzied had it not been so clearly discriminating. At the outset, there was a brief flurry of unreasoned buying of sugar, nylon hosiery, and a few other products. But this quickly subsided in the presence of obviously adequate supplies of these goods. The more persistent buying was centered upon automobiles, tires, household appliances, television sets, furniture, and household linen. These were the civilian goods requiring for their manufacture the use of those raw materials which the public knew from experience would be largely diverted to military supplies in any large defense program. Many purchases that would ordinarily not have been made until autumn and winter were made in July.

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**DECLASSIFIED**

October 19, 1950

There was also active ordering by businessmen in anticipation of their needs. This was especially noticeable in the construction industry. Builders abandoned their customary procurement schedules, and scoured the markets for materials needed for completion of houses and other structures under way and also for building for which final plans had been made and financing arranged. In the same spirit, merchants greatly increased their orders, and manufacturers struggled unsuccessfully to acquire raw materials for inventory.

The second phase of economic change developed in August. In the preceding month, the impact of the new international development had been felt in the markets for goods but not in production and employment, which declined seasonally slightly below the record levels attained in June. However, the response of the business world to the booming market demand for goods was not long delayed. Beginning in August, industrial production increased sharply, and nonagricultural employment rose above the previous all-time record. The more expansive view of businessmen was also reflected in their plans for new capital investment in plant and equipment. These plans were repeatedly revised upward, with consequent increases in orders for new machinery until manufacturers were swamped. The financial outlook for the railroads improved so greatly that they were again able to order new freight cars. By far the most important enlargement of business plans was in the steel industry, which informed the Secretary of Commerce of settled plans for the building within two years of new facilities to produce an additional 9 million tons of steel a year.

The step-up of consumer buying, which had commenced in July, was not initiated by an increase in consumer incomes. Moreover, although employment expanded, wages moved upward, farm prices rose, and dividends and business profits increased, these factors were not sufficient to keep incomes relatively in step with buying. Consumers made up the difference by saving less, and by cashing savings bonds, drawing on savings accounts, and using easy instalment credit.

The role played by bank credit in the increase of business buying should be clearly understood. The increase in business buying was the cause and not the result of the increase in bank loans for business purposes. The credit had been readily available previously, but was brought into existence only as demand for goods arose from the changed economic outlook. The spending on goods of the bank credit dollars induced further demand on the part of the sellers just as the spending of dollars from any other source would do. The increase in bank credit thus played a passive role by facilitating both the expansion of industrial production and the bidding up of prices. Neither could have taken place at as great a rate except for bank credit, but the initiating force was the desire of businessmen to buy.

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**DECLASSIFIED**

October 19, 1950

### Third Quarter Trends in Detail

Increased consumer spending accounted for more than 10 billion dollars of the 12 billion dollar annual rate increase in the gross national product from the second quarter to the third quarter of 1950. This was the sharpest rise in consumer expenditures since the third quarter of 1946. About one-half of the rise in gross national product and in consumer expenditures represented an increase in prices.

Consumers also invested heavily in new homes. By September, over a million new homes had been started in 1950, or more than in the whole of 1949--the previous record year. The construction industry was pressing against the limits of the physical capacity of the industry, as shortages of many materials, and in some cases of manpower, began to develop.

Business investment. Expenditures for producers' durable equipment rose from an annual rate of 21.6 billion dollars in the second quarter of 1950 to 25 billion in the third quarter, a rise of 3.4 billion or 16 percent. This was the highest rate of expenditure for this purpose on record.

Private credit reached new highs during the third quarter, and so did the money supply in the hands of the public. Consumer credit rose about 1.7 billion dollars, or nearly 9 percent. Commercial, industrial, and agricultural loans of reporting member banks climbed 16 percent between the Korean outbreak and September 27. By the end of August, demand deposits totaled \$7.5 billion, nearly 1 billion above the previous high set in 1947.

Total employment rose in August, but declined in September. The drop in September was due largely to seasonal factors, including the return to school of large numbers who work during the summer months. Nonagricultural employment increased from 52.4 million in June to 53.4 million in September. Weekly hours of work in manufacturing rose from 40.4 in June to 41.2 in August, and dropped to 40.9 in September. Overtime went into effect in many industries. There were spotty reports of shortages of skilled workers from some areas of the country.

Unemployment, which in June was 3.4 million or 5.2 percent of the civilian labor force, dropped steadily to 2.3 million or about 3.7 percent of the labor force in September. At the level of 2.3 million, unemployment was the lowest since December 1948.

Production had recovered from the recession of 1949, and before the outbreak in Korea had exceeded the postwar peak reached in the autumn of 1948. Immediately following the vacation period in July, an exceptionally rapid enlargement of the output of goods began, continuing throughout

**DECLASSIFIED**

October 19, 1950

the third quarter and carrying the industrial production index in September well above the June level. The increase in the durable goods index was 7.6 percent, and that of the nondurable goods index was 6.6 percent. Steel production, about 20 percent above the level in the corresponding period in 1949, constantly crowded and often exceeded the larger-rated capacity of the industry. Soon after the July 4 holiday, electric power output established an all-time record, from which it progressed to a level, at the end of the quarter, 8 percent higher.

Wholesale prices at the end of the quarter were about 8 percent higher than they were before the Korean outbreak. The rise in wholesale prices during the period was the sharpest that has taken place in any three-month period since the price rises immediately following the termination of price controls in the second half of 1946.

The largest increases were in wholesale food prices, which rose more than 9 percent during the third quarter. Farm products advanced by about 8.9 percent, most of the rise occurring in July and early August. These prices are still considerably below their postwar peaks. Prices of manufactured goods rose steadily, increased about 6.8 percent during the quarter, and reached new postwar highs. The groups of industrial products which showed the largest price increases were textile products, building materials, and chemicals. Less pronounced were the increases in fuels and metals and metal products, although there were very sharp rises for some individual metals. Although steel prices, in general, remained stable during this period, late in September a number of steel producers began to raise prices on some of their products, in what may be the prelude to a general advance.

During the early part of the quarter, the rise in prices was most pronounced for raw materials. The sharpness of the rise in raw material prices may be seen in the fact that the average price of 28 basic commodities rose more than 22 percent during the period. Subsequently, prices of finished goods joined in the upward movement. While the rise in finished goods prices continued, the favorable news from Korea brought about a decline in the prices of many raw materials in the latter part of September.

Consumers' prices rose more moderately during this period, increasing 1.6 percent between June and August to a level about 1 percent below the postwar peak. Initially there was a sharp rise during July, as a result of the upsurge in retail food prices. Other retail prices showed little change. Subsequently, there was some decline in retail food prices, but retail prices of other items began to rise in response to the increases in wholesale prices. There was a further slight increase in consumers' prices during August. Since the prices of products other than foods have not yet fully reflected the increases of wholesale prices,

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DECLASSIFIED

October 19, 1950

further price increase in these goods are to be expected. Food prices appear to have stabilized for the present. Sharp increases in the consumers' price index are not likely to take place during the rest of the year, since seasonal factors are likely to keep the prices of food down.

Wages and salaries in the private segment of the economy rose from an annual rate of about 119 billion dollars in the second quarter to 124 billion in the third quarter. The effect of the boom was to stimulate the granting of wage increases to workers, as a result of normal negotiations and the reopening of contracts, and also in many cases as a result of voluntary action on the part of management. There was a significant shift during the third quarter away from emphasis on fringe benefits and pensions, which had marked the period prior to the Korean development, towards straight wage increases involving improvement factors and compensation for increases in the cost of living. More and more wage contracts were negotiated which tied wage rates to changes in the cost-of-living index.

During July and August, the wage increases granted generally clustered around a 10-cent pattern. In September and early October, however, the pattern moved upward so that it is currently around 15 cents.

The United States export surplus declined after midyear. In August the surplus on merchandise account disappeared. While the export surplus may continue low during the short-term future, it must be expected that when European rearmament gets under way Europe's imports from the United States will increase. At the same time, its rearmament will reduce the quantity of goods available for export. Consequently, the U. S. export surplus will probably not stay long at the low levels now prevailing.

Budget expenditures of the Federal Government during the third quarter of the calendar year responded slowly to the greatly increased commitments which the defense program and the operations in Korea entailed. They were considerably below expected levels, and 2 billion dollars below the same period last year. A moderate surplus of 296 million dollars was achieved. The cash surplus was somewhat larger, about 1.0 billion dollars.

Operations of the Commodity Credit Corporation accounted for a considerable part of the change since last year. Because of the improvement in farm prices, loans were liquidated on a large scale, and the Corporation had an excess of receipts over expenditures in the third quarter. The outflow of funds from the FNMA was also sharply reduced.

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**DECLASSIFIED**

October 19, 1950

The Outlook for the Fourth Quarter

The leveling off of market demand, and of many prices, since the middle of September does not promise a stabilization of the domestic economy. Retail prices have not yet reflected very substantially the increases in wholesale prices of manufactured goods. Nor has the large increase in the cost of raw materials been fully worked out in factory prices. There is little reason to believe, as some business observers suggest, that the recent relative quiet in consumer buying may be the forerunner of real market softening in the near future. It is more likely that market demand will be great enough to permit recent increases in costs of production to move into retail prices.

The inflationary forces already operating will be strengthened in the fourth quarter by a steady rise in individual incomes, as employment increases and wages advance. The heavy seasonal increase in retail sales will place pressure upon the inventories of merchants, who were unable to build up their stocks because the summer lull never came. These cumulative forces will be growing, at the very time when the productive factors of manpower and physical facilities are being increasingly withdrawn from the civilian economy.

Business reports are agreed that production for civilian uses has not yet felt any particular effect of Government orders. But the defense and related programs already under way will, before many months, almost double the annual rate of about 17 billion dollars at which these expenditures have been running. This will mean an increase from the current 6 percent to about 12 percent in the absorption of the national product by Government defense programs, and a corresponding decrease in the share of the national product available to consumers and business firms.

No trend toward a reduction in the total demand for essential materials can be expected from the recent order giving preference to certain users since it leaves others to compete without restriction for the remaining supply. There has been no limitation of commercial construction.

The increase in wage rates will undoubtedly continue to run through the field of industry, and costs of production will be increasing. The indirect controls which might establish a fair degree of stability in the economy generally will not prevent the market demand for basic materials in short supply from pressing prices rapidly upward.

Whatever may be the course of upward or downward movements from week to week, over the longer pull the inflationary storm is gathering too rapidly to permit yielding to any inclination to move slowly in imposing counteracting measures. Policy should be guided accordingly.

**STRICTLY CONFIDENTIAL**  
**DECLASSIFIED**

October 19, 1950

### POLICY RECOMMENDATIONS

In view of the detailed treatment of policy recommendations in its Special Report on Economic Trends and Policies, September 26, 1950, the Council limits itself in this Quarterly Report to some high points of emphasis.

#### Programming of Supply and Requirements

While the Council is not primarily concerned with administrative matters, there are certain administrative steps which are so inseparably connected with the development of sound economic policy that we cannot neglect reference to them.

Executive Order No. 10161, September 9, 1950, assigns special segments of responsibility under the Defense Production Act to a number of agencies. Each segment of responsibility has its special problems, in the meeting of which the experience and trained staffs of these agencies are invaluable assets. The economic policy to be carried into effect, however, should be a unified policy for all agencies and all functions. Accordingly, it is imperative that each of these specialized functions be guided by a consistent over-all program. Such a program can be developed only if it is based upon current and constantly revised analysis of available resources and competing military and civilian needs for those resources. For example, regulations to cut back the volume of housing or of automobiles must be largely steps in the dark unless based on a determination of how large these cutbacks should be, which in turn must rest upon analysis of what materials and manpower will be released by these cutbacks and to what more necessary purposes the released materials and manpower will flow. Allocations and limitation orders, likewise, must be founded upon reasonably full and current factual information about total available supplies and the priority of competing requirements. Price and wage policy must also rest, if it is to be realistic, on broad analysis of the effect of the defense program on the resources which should be assigned to plant expansion and other kinds of productive investment and on resources which will be available for consumption. Even tax policy, which is designed to cut down demand at some points in order that more goods and services may be available at other points, must rest upon the same kind of analysis of our resources and of the uses to which these may best be put in the face of the situation confronting us.

In short, the success of the intense economic program upon which the Government is now embarked for an indefinite period of time depends on sound decisions concerning the relative priority of the basic competing needs for consumer, industrial, military, non-military international, and stockpiling purposes. And there is no way of determining

SECRET  
**DECLASSIFIED**

Memorandum to  
The President

- 8 -

October 19, 1950

priority of need soundly, without first being informed about total availability of key supplies and where they are now flowing, and about prospective additions to supply through expanding production and imports.

This does not mean that the programming of key supplies and key requirements needs to be as comprehensive or detailed as it was at the peak of World War II, but it should at least keep pace with whatever scope of economic mobilization is currently under way. It cannot safely be deferred until the economic mobilization becomes more "complex"; in fact, if such deferment is attempted, the economic mobilization effort will become not only complex beyond necessity, but also confused.

Without this kind of operation, there can be no adequate basis for the issuance of directives to, or the resolution of conflicts among, the various agencies charged with responsibility for portions of the defense program. In the case of the Council of Economic Advisers, its function of watching the broad aspects of economic developments and recommending general policies of adjustment cannot be effectively performed without comprehensive and current information on key supply and key requirements. To understand and deal with the problems of the economy in the days ahead, such information must be added to the peacetime requirements for information about employment and unemployment, national income and gross national product, business investment, and farm production, which are essential at all times to effective work by the Council.

It seems clear that this broad programming operation, resting upon a continuous inventory of major lines of supply and requirements, should not be undertaken by the different agencies operating specialized programs. For that not only would be wasteful duplication, but also would result in competing and conflicting assumptions, instead of one set of common assumptions to guide all specific programs. It follows that there ought to be one central location for the direction of the operation of inventorying and programming supply and requirements. Under the plan of operation established by Executive Order No. 10161, and we believe it to be a sound plan of operations, it seems that the only logical place for this function is the National Security Resources Board. The Chairman of that Board has the over-all responsibility of directing, expediting, and coordinating the various specific programs. He should have control of the development of the economic data without which he cannot intelligently perform that responsibility.

It should not be inferred that the task of inventorying and programming key supply and key requirements has not been commenced, or that progress is not being made. Much has been done. But this function is so crucial to dealing effectively with the economic problems which are now arising, that we feel bound to stress the urgent needs for developing it to a high degree of comprehensiveness as quickly as feasible.

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October 19, 1950

### Firming Up Estimates of Public Outlays, Particularly Defense

The programming operation referred to above requires a firming up, insofar as feasible, of estimates of how much will be spent on defense during the balance of fiscal 1951 and in fiscal 1952. For until these are fairly well established, agencies in charge of the various aspects of the economic program cannot know the size of their problems or how far they must go to facilitate the defense program. This lack presents great obstacles to the development of an economic program which will meet the need but not be unnecessarily and harmfully restrictive. While the Council appreciates the difficulty of deciding on levels of defense outlays, and recognizes the need for the most careful consideration prior to such decision, we feel obliged to stress the importance of further clarification of this central controlling issue as soon as practical. This is necessary, not only as a guide to government programs, but also in order that the economic community and general public may have a better understanding of the problems and responsibilities confronting them. For example, the government economic program cannot be fully successful if the public is not made fully aware that the ending of the difficulty in Korea is not the end of the difficulties of the international situation generally.

### Indirect Controls Through Credit Restraints

It is clear from the facts presented in earlier sections of this report that the country faces a serious inflationary threat. No temporary "softening" of some markets, if it occurs, and no protests from those industries which are crying before they are hurt about regulations already in effect, should be allowed to slow down the development of a drastic anti-inflationary program. It is imperative that such a program be in operation by the early part of next year.

The mounting discussion of price and wage controls appears to be diverting public attention from other more basic measures. This could be a dangerous development. It is important to place emphasis on those methods, notably taxation and credit controls, which help to prevent an excess of purchasing power, rather than on suppressing it after it occurs. The earlier these measures are used with vigor, the more effectively will they counter growing inflationary forces and prevent them from snowballing. If they are now used aggressively, they will postpone or even perhaps avoid the need for general price and wage controls. If they are used timidly, they will permit inflation to enter upon a spiral, which would soon confront business with the necessity for rigorous price, wage, credit, and allocation controls.

The Council finds encouragement in the recent substantial tightening of controls over consumer credit. The initial regulations governing housing credit seem adequate, but not too drastic, for the

STRICTLY CONFIDENTIAL  
**DECLASSIFIED**

October 19, 1950

current situation. In this, the Federal Reserve Board and the Housing Agency have done well.

There is need quickly to develop regulations covering multi-family structures. Because of the reduction in the supply of new housing, there is need for the strengthening of rent control at the earliest possible moment, to recontrol some of the decontrolled areas and to tighten up on existing controls.

### Higher Taxation

The Council reiterates its recommendation that another tax increase in excess of 10 billion dollars, and possibly as high as 15 billion dollars, be sought and attained at the earliest practicable time. Securing tax increases of this magnitude faces the difficulty that the deficit for the fiscal year 1951 is likely to be small. Attention needs to be focused upon the situation confronting us in later fiscal years. Prompt action is important, for the sooner the issue is joined, the greater are the probabilities of obtaining the necessary tax increases on a very broad front before possible reaction against increasing the tax burden sets in. Certainly, a comprehensive tax program should be made ready in the immediate future.

### Priorities and Limitation Orders

As the Council has previously indicated, the orders thus far issued to control materials in short supply do not meet the problem. The mere grant of a priority to the military and to the Atomic Energy Commission does not face the fact that some of the needs in these two areas may be more essential than others, nor the fact that some needs outside these areas are also essential. Further, the shortages of some materials are already so clear that there should be affirmative limitations upon their non-essential use. Beyond this, the Government is placed in a most difficult position when such necessities as housing have been severely curtailed, while no order has been issued dealing with non-essential or even superfluous construction.

We urge the issuance, within the next month or so, of orders covering the various phases of the problem of shortages. Here again, however, we are obliged to stress the difficulty of issuing such orders until there is a firming up of the size of the defense program, and until there is a more comprehensive general programming of resources and requirements, along the lines indicated in the first two sections of these Policy Recommendations.

### Price and Wage Controls

Speculation about when or what price and wage controls may be imposed is premature and distracting. The first task, in any event, is

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to set up an effective organization to study the problem in detail and to make the preparations without which any action in this field would be a fiasco.

The following principles are pertinent at this point:

- (1) Despite misleading talk about "not being able to control anything without controlling everything", consideration should be given to selective controls before general controls;
- (2) Before selective controls are imposed, there should be further development of a price-wage policy. This policy should be founded upon careful general analysis of the economic situation, instead of arising opportunistically out of specific controversies. The formulation of this policy also depends, as has been indicated, upon an improved general programming and inventory of supply and requirements;
- (3) Consideration of mandatory price and wage controls, even on a selective basis, does not exclude recognition of the fact that a large measure of voluntary cooperation will be necessary. Therefore, the agency responsible for the administration of price and wage controls should initiate concerted action with management and labor, selecting first those industries where the problem seems likely to become most acute.

There could be nothing on the economic front more dangerous than precipitate action on price and wage controls, without the most careful thinking through of the problems involved in initiating and maintaining these controls for an indefinite period of time without the galvanizing effect of war conditions.

The Council is now studying the problems of price-wage policy as they relate to the over-all economy, and we hope this will prove helpful to those administering that segment of the anti-inflationary effort.

#### Expansion of Production

The Council has repeatedly emphasized, since its establishment four years ago, that genuine economic expansion is at the core of all our economic strength in the long run. Since Korea, we have again emphasized, in the setting of new international developments, the long-range importance

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of expanding the production of vital supplies. While this expansion cannot take place rapidly enough to avoid cutbacks in the short run, nonetheless this expansion must begin now in order to get us out into the clear in the long run.

The Council is particularly impressed by the vigor with which this expansion problem has been attacked by the National Security Resources Board and by some other agencies. The problem of iron ore, steel, aluminum, and copper, for example, are receiving particular attention.

In all or most of these critical areas, there is need for vigorous use in proper combination of the tools made available under the Defense Production Act, and otherwise available to the Government, for the expansion of production. It is doubtless true that additional legislation will be required, but the sooner the existing tools are made use of, the sooner the nature of the new tools needed will be revealed.

The need for the centralization of the programming function, as previously stressed in this Quarterly Report, is particularly vital in the case of expansion programs. For expansion programs must be based upon a single guiding analysis of the priority of needs. Expansion requires materials and manpower, and consequently there must be a careful balance between the diversion of resources to expansion and their diversion to other purposes such as the military and stockpiling. In this connection, the Council notes with approval that a large measure of the responsibility for utilizing the tax amortization device to promote expansion is lodged in the National Security Resources Board.

Expansion is needed not only in the factory but also on the farm. The Department of Agriculture is adjusting its programs to encourage and stimulate, on a properly selective basis, maximum farm output for the years ahead. To be sure, there is need for further reconciliation of farm policy with other aspects of economic policy, which again illustrates the need for a central programming operation.

Manpower policies need also to concentrate upon expanding production. Aside for the issue of the lengthening of the work-week, it appears most urgent: (1) to find jobs for as many as possible of the 3.7 percent of the labor force still unemployed; (2) to utilize more fully part-time and otherwise under-utilized workers; (3) to consider plans for drawing older persons and physically handicapped into the labor force; (4) to accelerate the inter-area recruitment program by the USES so that operations can move rapidly into high gear; (5) to amplify apprentice, on-the-job, and technical school training programs; (6) to consider the advisability of temporarily suspending the provision in the Social Security Act that older persons lose their entitlement to old-age insurance payments if their earnings exceed \$50 a month.

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Memorandum to  
The President

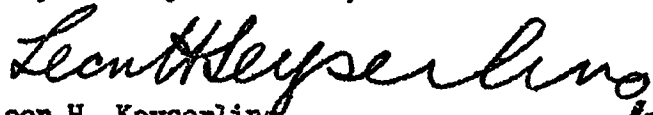
- 13 -

October 19, 1950

International Economic Program

The international economic programs upon which the Government is embarked are also a claimant for our materials and manpower. Sufficient progress has not yet been made toward integrating consideration of these international economic programs with consideration of general domestic economic policy. An important step toward this integration would be the further improvement of the central operation (referred to above) for measuring the relative priority of consumer, industrial, military, non-military international, and stockpiling requirements. The Council is not now prepared to suggest the appropriate machinery for this improved integration. The National Security Council can deal with this problem in its generalized aspects and indicate over-all policy. But there is need for a more detailed examination and processing of competing domestic and international requirements closer to the operating level than the National Security Council.

Respectfully submitted,



Leon H. Keyserling  
Chairman



John D. Clark



Roy Blough

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