AMERICAN INSTITUTE *for* ECONOMIC RESEARCH

54 Dunster Street, Harvard Square - Cambridge, Mass.

MONTHLY BULLETIN

August 31 1942

RESEARCH REPORTS

COMING EFFECTS OF CURRENT EVENTS

The Coming Explosive Stage of Inflation

Last week President Roosevelt announced that he is about to propose a new program for controlling the effects of the wartime inflation on the Nation's price structure. Some attempt is apparently planned to fill in the vital gaps in the emergency price-control act created by its omission of both farm price and wage control from its restrictions. There is no reason to suppose that the same political considerations that have so far prevented the establishment of a comprehensive price-control measure will not continue to operate. Even if such factors do not nullify the effects of such price controls as are enacted, a genuine and lasting stabilization of prices cannot be expected.

None of the price controls proposed and given serious consideration by the Government have really attacked the core of the problem; that is, the prevention of inflation itself, rather than the treatment of its symptoms. As history has shown, governments are virtually helpless to control the commodity-price level during inflationary progressions. The development of the latter when the Nation is at war can be avoided only by the acceptance of great hardships by the people. Only a few courageous leaders, such as Senator Byrd, have really fought to show the people that the alternative to present sacrifice is future disastrous inflation.

The action of the Harwood Index of Inflation this year clearly indicates that the explosive stage of an inflationary progression can only be postponed, not avoided. The climax of the explosive stage of the first World War inflation did not occur until after the conflict had ended. A similar timing of the inflationary progression may be experienced in this war period but, if our participation in the second World War is more protracted and costly than was our experience in the first World War, the earlier pattern may not be followed.

If we accept the lessons of history, neither exhortations nor threats nor punishments will prevent inflation or debasements of the coinage from being reflected in commodity prices. Of course, everyone hopes that controls will be more effectively applied in the present instance, but it is obviously unwise to rely on any government to control inflation. Therefore, it is clear that the individual must prepare as best he can to protect himself from an ultimate rise in the cost of living that will be considerably more extensive than that which has so far occurred in the present war.

Inflation like war is a destructive process, and its ravages will be most profoundly felt by those who have failed to take the protective measures that are still available. In order to give subscribers the benefit of the latest work on the subject of inflation undertaken by the Institute's research staff, a special series of articles will be presented in the Research Report bulletins during the fall months. The material used in preparing the Institute's booklet *What Will Inflation and Devaluation Mean to You?* will be reviewed in the light of the current situation of a world at war. Further light has been thrown on the subject by studies of economic developments in nations that have now been at war for three years or more. These records of experiences during different degrees of inflation will be used to formulate guides for the individual who must anticipate the time when inflation reaches a more acute stage than has yet been seen.

THE FUNDAMENTALS

Industrial Production

Preliminary data indicate that industrial output of war materials during the first three weeks of August increased from the July level, although there was some contraction in the operations of the consumer goods industries. The Institute's index of industrial production for August at 160.0 is slightly higher than the revised index of 159.3 for July.

The Institute's index of industrial production is adjusted for long-term trend as well as for seasonal variations. The bar diagram in the lower left-hand corner of the industrial production chart on page 139 shows the volume of industrial production (not adjusted) for significant periods from 1900 to date. The physical volume of goods now being produced is shown to be substantially greater than it has been at any other time in the Nation's history. The Institute's production index, adjusted for long-term trend, shows that the present rate of manufacturing activity is higher than the peak levels reached either in the first World War or in the New Era boom that culminated in 1929.

The Federal Reserve index of industrial production, from which the Institute's index is calculated, is based on the combined data for 83 separate industries. Of these, 20 are classified as durable manufactures, virtually all of which are now primarily devoted to the production of war materials. The Federal Reserve index of durable manufactures is now about 25 per cent

higher than it was a year ago; whereas, the nondurable goods index is somewhat lower than it was at this time last year.

In general, the heavy industries are producing war materials at a rate never achieved for the production of civilian goods. For example, the automobile industry is producing armaments at a rate 25 per cent greater than that attained at the peak level of passenger-car production (measured by the dollar value of output). A similar record is being made by the shipbuilding industry, which, according to Federal Reserve Board reports delivered 71 merchant vessels in July having an aggregate weight of 790,000 tons, thereby establishing an all-time record for a single month's delivery.

The steel-ingot production rate advanced last week from 96½ to 97½ per cent of the revised theoretical capacity. The lack of adequate steel-scrap supplies is still a deterrent to production, but the situation is expected to improve. "From reliable sources *The Iron Age* is told that a strong movement is underfoot to bring scrap from Great Britain where supplies are said to be comfortable for practically all mills there. The vast amount of lend-lease activity has sent abroad hundreds of thousands of tons of 'home' scrap which has made a dent in the United States supplies. Now it appears that there is a good chance that soon the scrap movement will be reversed and Britain, which for years imported scrap, will be helping out the United Nations' efforts by sending scrap back to this country as ballast."

	1929	*1932*	*1937*	*1938*	*1941*	*1942*
Per Cent of Capacity	89.0	13.0	84.0	44.0	97.0	97.5

(Latest 1942 weekly data; corresponding week earlier years)

Last week, there was a substantial increase in electric-power output, and a new high record was established for the industry. Output was 13.7 per cent larger than it was during the corresponding week of 1941.

	1929	*1932*	*1937*	*1938*	*1941*	*1942*
Billion Kilowatt-Hours	1.76	1.44	2.30	2.13	3.23	3.67

Lumber production increased last week, and the seasonally adjusted index advanced from 118.0 in the preceding week to 120.8. Although the volume of orders on hand is considerably larger than it was, the rate of production is lower. The lumber operators are encountering difficulties in obtaining machinery and skilled workmen.

	1929	*1932*	*1937*	*1938*	*1941*	*1942*
New York Times Index	134.5	35.2	82.9	75.3	131.1	120.8

The Harwood Index of Inflation

The revised Index of Inflation (ratio form) for July at 125.1 was four points higher than the preliminary Index of 121.0. The preliminary Index for August was 126.3, but is based on data as of August 19, and the increase for the full month will probably be larger than that indicated by the preliminary figure.

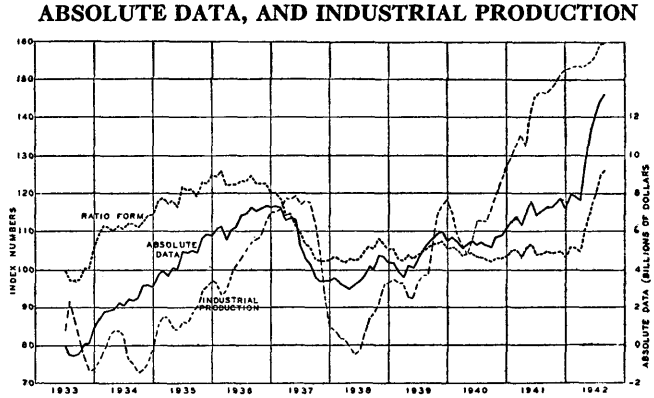
During the first three weeks of August, the banks extended additional credit to the Government through the purchase of Treasury securities in the amount of $1,650,000,000. The Government did not immediately spend all of the checking-account credits created by the commercial banks in payment for Government securities purchased. Therefore, the newly created purchasing media are only partially reflected in the Index. The funds held as Treasury bank balances on August 19 were unusually large, totaling nearly $4,000,000,000, a considerable portion of which will probably be disbursed before the September 15 installment of the income tax must be paid.

The Harwood Index of Inflation is primarily a means of measuring the quantity of inflationary purchasing media available to the public. Inflation is defined as a condition arising when the banks or other agencies, such as the Treasury printing press, create purchasing media in excess of those required to represent goods produced that are currently coming to market. The chart on page 139 shows the Index in ratio form, which is the ratio of all purchasing media available for use to the portion that is not inflationary. The broken line on the same chart shows the absolute data, which are the inflationary purchasing media totals. (The scale for the ratio form is at the left of the chart, and the scale in billions of dollars for inflationary purchasing media is at the right.)

As the chart on page 139 shows, the absolute amount of inflationary purchasing media now far exceeds that available to the public at any time during the past three decades. Furthermore, the proportion of inflationary purchasing media to the total is greater than it has been at any time during the period shown, with the exception of the first World War period and the height of the New Era boom in 1929. It is obvious that the situation is becoming increasingly menacing.

The chart below shows the two curves, the ratio form and the inflationary purchasing media (absolute data), since June 1933, together with the curve of industrial production.

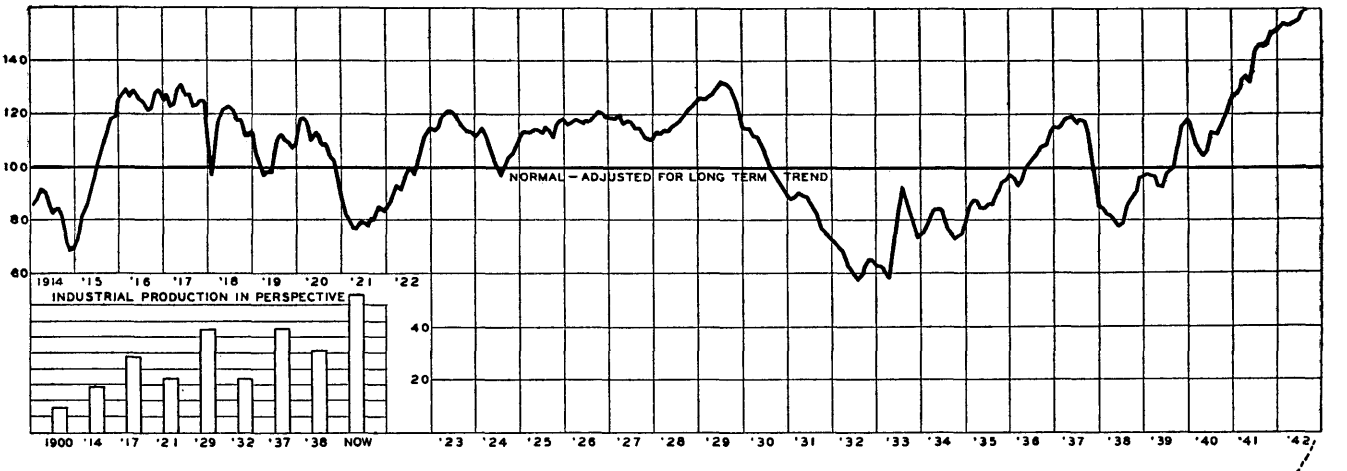
HARWOOD INDEX OF INFLATION, RATIO FORM, ABSOLUTE DATA, AND INDUSTRIAL PRODUCTION



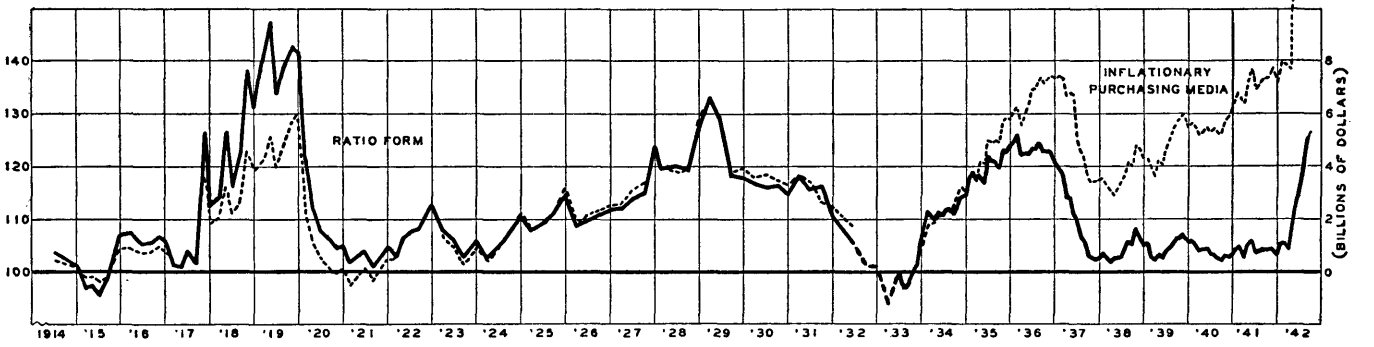
During the first two years of the present World War, the upward trend of industrial production preceded the upward movement of the Inflation Index. Increased demand was made possible in advance of the emission of inflationary credit purchasing media by the great volume of gold imports that was sent here by England (and to a lesser extent by France) in exchange for our supplies. This source of new purchasing media is no longer available. The credit creations required to finance the existing huge volume of industrial production, much of which is being shipped out of the country, are reflected in the sharp upward movements of the two money-credit curves.

The effect of the vast war expenditures on our economy was clearly described by Mr. Alfred H. Williams, president of the Federal Reserve Bank of Philadelphia, to members of the United States Treasury Victory Fund Committee of the Third Federal Reserve District, of which Mr. Williams is chairman. The following excerpts were taken from his statement:

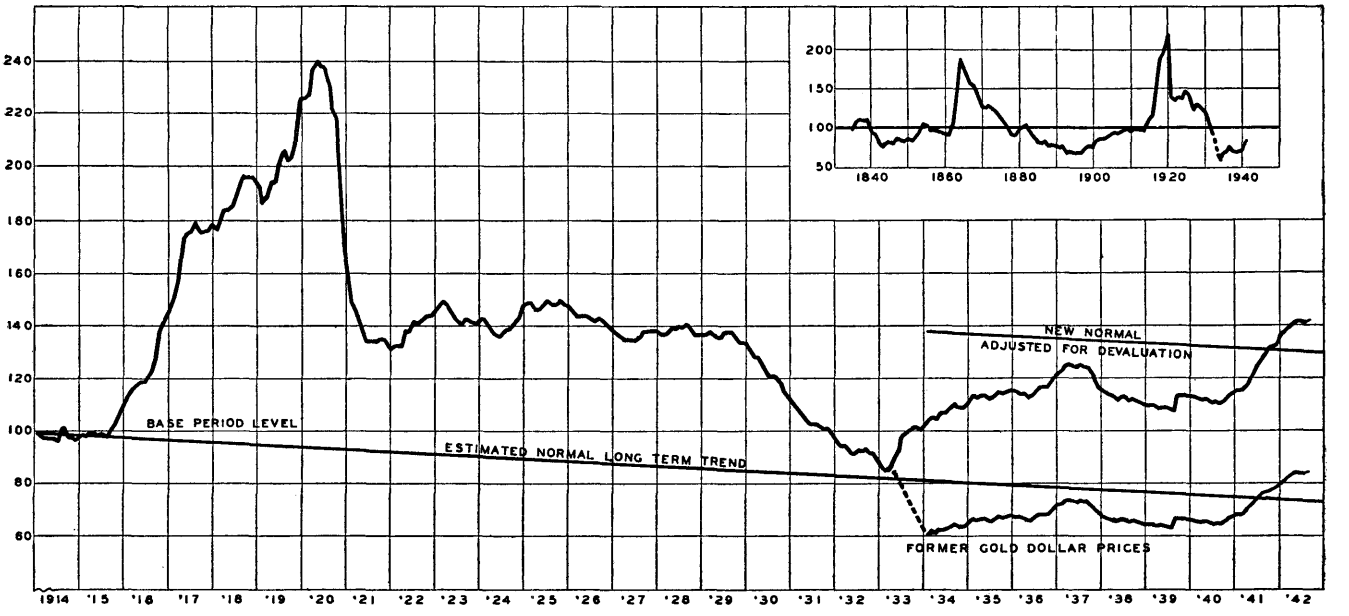
INDUSTRIAL PRODUCTION



HARWOOD INDEX OF INFLATION



COMMODITY PRICES



"Modern war is a highly organized system of destruction of all resources. To wage it with complete success, incredibly large financial resources must be effectively mobilized. During the fiscal year beginning July 1, 1942, the United States Treasury must provide at least $77 billion to meet the vast financial operations of the Government.

"There are two sources from which the Treasury can get the needed funds: (1) taxes and (2) borrowings. Only about $24 billion or less may be expected from taxes. The remainder—$53 billion— must be borrowed.

"The methods used to borrow this colossal sum are of the utmost importance because they will affect prices of materials, wages of labor, rents, and cost of living generally. Upon the way in which funds are obtained for current requirements may depend the state of morale of the people and so may affect the conduct of the war. The first essential is to borrow as much as possible from current income and as little as possible through the expansion of bank credit.

"How much current income is available for lending to the Government?

"Estimates indicate that at the present rate of national income the amount of spendable funds in excess of taxes may total as much as $95 billion, while the volume of goods available for purchase at current prices may be $65 billion or much less. The difference of $30 billion represents unused funds that are likely to result in an upward pressure on prices and costs, thus raising the cost of living. If these funds are not absorbed through such means as taxation and savings, there will be a scramble for goods; prices will go up and the value of money will decline as it did in the last World War, when the buying power of the retail dollar was more than halved."

Other Demand Factors

The dollar volume of department-store sales last week was three per cent smaller than it was in the corresponding week of 1941 according to reports made to the Federal Reserve System. The Government's pressure on retail merchants to reduce their volume of inventories is having an effect contrary to the Government's desire to restrict consumer purchases. In order to reduce their stocks of goods, the stores are advertising sales at lower prices tending to stimulate public demand for consumer goods. However, this will probable prove to be a short-lived influence.

Commodity Prices

The United States Bureau of Labor Statistics combined index of wholesale commodity prices advanced from 141.1 in July to 141.7 (preliminary) in August. This index, which is shown in chart form on page 139, is a weighted average of 889 quotations, adjusted so that the 1913 monthly average equals 100 (also shown on the former gold basis since January 1934 when the dollar was devalued). The estimated long-term trend line and the new normal long-term trend line, adjusted for devaluation, are valuable features of the chart. The small chart in the upper right-hand corner of the commodity-price chart shows changes in commodity prices during the past century on the basis of the former gold dollar. The advance in the combined index since the war began in September 1939 has raised it to a position about ten per cent above the level indicated as normal after devaluation of the dollar.

The advance in the combined index last month was primarily attributable to increases in the prices of farm products and food. Changes in the other major classifications were fractional and were about equally divided between slight gains and slight losses. Among the three economic classes, the raw-materials average recorded a gain of about a point; there was a fractional decline in the semimanufactures index; and the finished goods index advanced slightly.

The accompanying table shows changes that have occurred in the major classifications of the index. The August 1942 preliminary indexes are compared with the revised indexes of earlier significant periods.

United States Bureau of Labor Statistics
Wholesale Commodity Price Index
(*Monthly Average 1913 = 100*)

	Aug. 1929	*Aug. 1932*	*Aug. 1941*	*July 1942*	*Aug.* 1942*
Farm Products	150.4	68.7	122.2	147.4	148.3
Foods	161.2	96.3	135.8	155.0	156.5
Hides and Leather	160.8	102.4	161.8	174.4	174.4
Textile Products	156.7	94.2	154.1	168.9	168.4
Fuel and Light	134.0	117.6	128.9	129.7	130.0
Metals and Products	110.6	88.2	108.6	114.4	114.4
Building Materials	167.9	122.7	186.1	194.2	194.4
Chemicals and Drugs	†	†	107.2	120.1	120.1
House Furnishings	167.5	130.7	169.4	185.4	184.9
Miscellaneous	118.6	92.6	119.9	128.1	127.5
Raw Materials	144.1	81.0	127.3	145.5	146.5
Semimanufactures	124.9	77.3	119.5	123.8	123.6
Finished Goods	137.1	101.9	131.8	142.4	142.8
All Commodities	137.9	93.4	129.4	141.1	141.7

* Preliminary Estimate. † Not Available.

The sensitive wholesale commodity price indexes remained substantially unchanged last week. Moody's Spot Commodity Price Index was 231.1 on August 20 and 230.5 on August 27. The Dow-Jones Index of Commodity Futures closed at 84.39 on August 20 and at 83.94 on August 27.

American Institute for Economic Research is a non-political, non-commercial organization engaged in impartial economic research.

Statistical Summary; Production, Purchasing Media, and Prices

	1941					1942							
	Aug.	*Sept.*	*Oct.*	*Nov.*	*Dec.*	*Jan.*	*Feb.*	*Mar.*	*Apr.*	*May*	*June*	*July*	**Aug.*
Index of Industrial Production.	146.5	147.3	148.9	151.3	152.0	152.7	153.4	153.2	153.9	154.5	156.0	159.3	160.0
Index of Inflation (Ratio Form)	104.4	104.3	104.4	104.6	103.1	105.8	105.3	104.8	111.0	116.1	119.7	125.1	126.3
Commodity Price Index.....	129.4	130.9	131.4	132.5	134.1	137.5	138.5	139.8	141.4	141.5	141.0	141.1	141.7
Commodity Price Index..... (In terms of former gold dollar)	76.6	77.4	77.8	78.4	79.3	81.4	82.0	82.7	83.7	83.7	83.4	83.5	83.8

*Preliminary Estimate.