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RESEARCH REPORTS

COMING EFFECTS OF CURRENT EVENTS

The Federal Reserve's Program for Inflation

When a nation is at war, the extraordinary outlays involved can be financed in only two ways: by heavier taxation or by the creation of Government promises to pay (in some instances supplemented by devaluation). In the present instance, we have refused to accept the really bitter sacrifices that would be involved in raising all of the costs of war from taxation. We cannot cut down on war expenditures. Therefore, we are forced to increase the Government debt at a rate of at least $30,000,000,000 per year. It is acknowledged that only the lesser part of this total will be purchased from genuine savings, and the Treasury is looking to the commercial banks to absorb the remainder. Inasmuch as the commercial banks can do so only by methods that involve the creation of additional purchasing media, a continuous inflationary process will be established. The stage directions for the program are in the hands of the Federal Reserve authorities with the United States Treasury performing the role of producer.

The officials of the Nation's commercial banking system are well aware of the part assigned to them, and all classes of banks have subscribed heavily to Government issues. The large city banks have taken a more considerable portion of the Government's new security issues than have the banks in the smaller cities and towns. According to the latest figures, Government bonds constitute 61 per cent of total loans and investments of the New York City banks, about 60 per cent for the Chicago banks, 50 per cent for the other large city banks, and 49 per cent for the banks in the smaller cities and towns, referred to as "country banks."

Although the banks in the smaller cities have been able to create credits for the purchase of Government securities by virtue of their possessing cash deposits with the Federal Reserve Banks substantially in excess of reserve requirements, the New York and Chicago banks were in a less comfortable position with respect to excess reserves and would have had to abandon their program of purchasing Treasury issues, had not the Federal Reserve authorities intervened. The action taken by the Federal Reserve System was recently summarized as follows: "In order to meet the banks' current need for additional reserves, the Federal Reserve System made considerable purchases of United States Government obligations in the open market and the Board of Governors reduced reserve requirements for demand deposits at central reserve city banks in New York and Chicago where the decline in reserves was concentrated. A first reduction in requirements, from 26 to 24 per cent, became effective on August 20; a second, to 22 per cent, on September 14; and a further reduction, to 20 per cent, on October 3."

The Federal Reserve's policy to promote the Treasury's funding of Government securities through the commercial banking system is gradually revealing itself. The commercial banks' reserve requirements are at all times to be adjusted so that they will have an adequate supply of excess cash reserves to enable them to add to their holdings of Treasury issues. In addition, the Federal Reserve Banks stand ready to purchase Government securities when other markets fail to absorb offerings. At the present time, the System holds Government securities to the value of $4,225,000,000, an increase of approximately $2,000,000,000 since we entered the war. In order to encourage the purchase of Government securities by the commercial banks, the Federal Reserve Banks in some of the districts have recently decreased their rediscount rates. The possibilities in this respect are restricted, because rediscount rates are now about as low as they can go without the banks in the Federal Reserve System incurring the danger of operational deficits.

It is apparent that an increasing burden will be placed on the Federal Reserve System as the problem of war financing becomes more acute. The situation is altogether too reminiscent of that existing in France and Germany during the postwar inflation of the 1920's. The outpouring of purchasing media in those countries was piped through the central banks, of which our Federal Reserve System is essentially a counterpart.

In the German inflation, the Government issued short-term treasury notes, which were discounted at the Reichsbank. In payment for the notes, the Government received Reichsbank notes that were used as currency and became purchasing media, as checking accounts do here in the United States. A similar process in this country would be the sale of Government notes to the Federal Reserve Banks in return for Federal Reserve notes and the distribution of these notes by the Government. The process currently being followed is different in that bonds are first sold by the Treasury to the commercial banks which create checking-account deposits in payment therefor. The bonds may later be either discounted at the Reserve Banks or sold to the Reserve Banks. The two processes are essentially the same because they afford the means for a virtually indefinite expansion of the purchasing media available to the public.

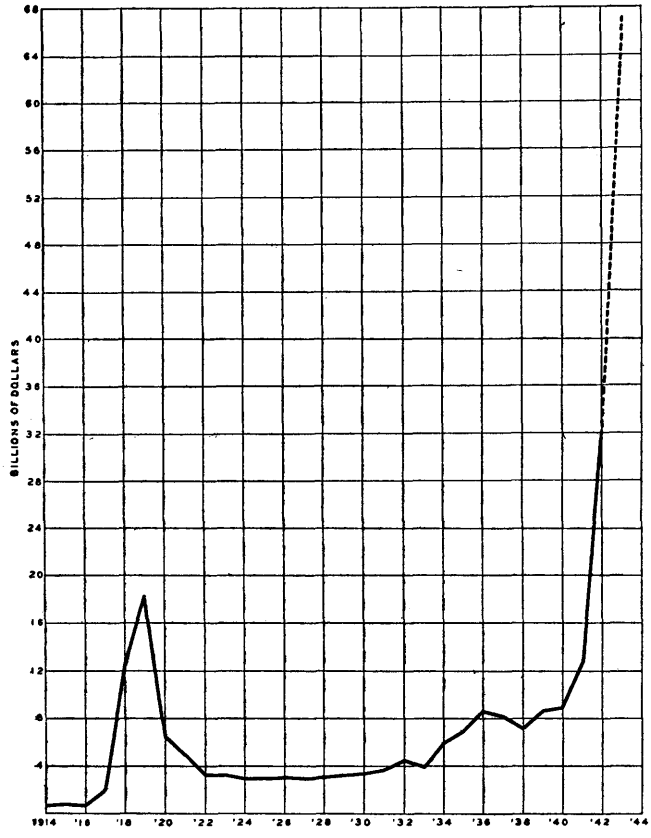
The Magnitude of War Spending

Economists have recently pointed out the difficulty, if not the impossibility of the human mind's contriving to grasp the significance of a $1,000,000,000 outlay, to say nothing of attempting to conceive the potentialities involved in the multi-billion-dollar war-spending program. The most common devices suggested for obtaining an inkling of the $1,000,000,000 concept may be recalled. One such aid is the suggestion that $1,000,000 be visualized (a difficult task in itself), then realize that $1,000,000 bears the same relationship to $1,000,000,000 that one cent does to a ten-dollar bill. Another device is to divide the $1,000,000,000 by the number of families in the United States. There are 30,000,000 families, and therefore it is concluded that each $1,000,000,000 spent by the Government costs every family $33. Again we are asked to envisage $1,000,000,000 as the lifetime earnings of 20,000 workers in the United States. It is also suggested that, in order to have spent $1,000,000,000 since the beginning of the Christian Era, an outlay of about $1,400 a day would have been necessary.

None of these examples are very helpful in attempting to assess the magnitude of present-day war costs. It is somewhat easier to grasp the significance of the cost of the present conflict in relation to the expenditures made during the first World War. We at least know something of the economic upheavals that came as the aftermath of that war, and, by comparing the rate of spending today with the earlier rate, we can obtain some indication of the potentialities for trouble inherent in the present situation.

The following chart affords some idea of the relative magnitude of expenditures during the two war periods, even though it includes what may be only the beginning of the outlays for the present conflict. Federal expenditures, exclusive of debt retirements, are shown for the years ending June 30 of the dates indicated. The 1943 figure represents a recent estimate of $67,000,000,000, which at the present spending rate may be understated.

FEDERAL EXPENDITURES
(Fiscal Years)



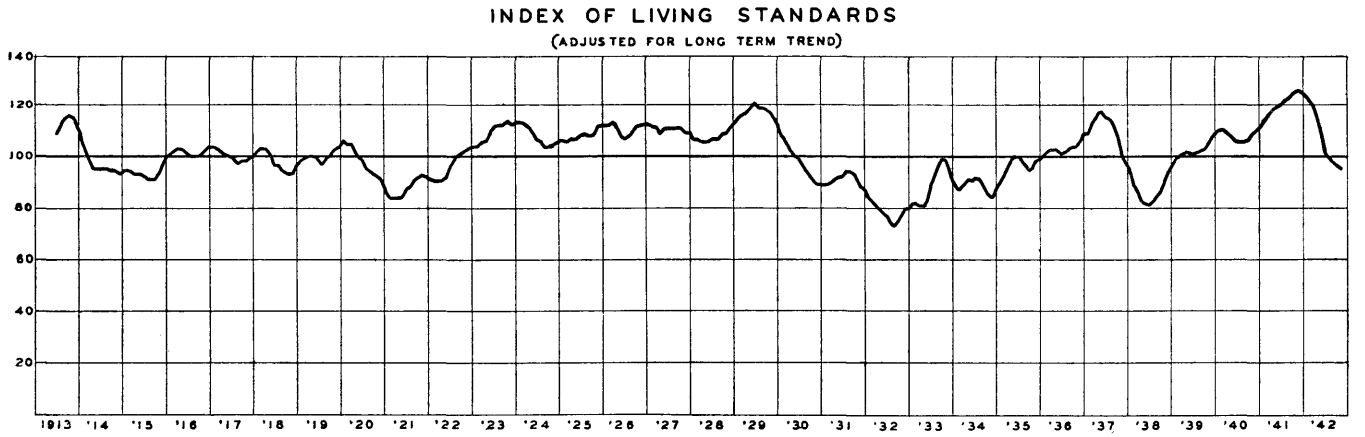
Before the first World War, the cost of supporting the Federal Government was virtually negligible compared with its cost during any period since that time. Although the extraordinary outlays made during the fiscal years ending June 30, 1918 and 1919 were reduced substantially following the establishment of peace, normal yearly Federal expenditures during the period of the 1920's were about four times the rate that had prevailed previous to the first world conflict. Although they were greatly expanded during the New Deal spending period, they did not in any one year reach wartime proportions until 1941, when the country began to rearm. The following table shows the average spending rate of the Federal Government during the ten years preceding the first and second World Wars, the expenditures during the first World War period, and those for the first four years of the present conflict.

FEDERAL EXPENDITURES
EXCLUSIVE OF DEBT RETIREMENT
(Figures in Billions)

Pre-World War I and World War I Period		*Pre-World War II Period and First Two Years of World War II*	
1905–15 Average	0.7	1930–39 Average	6.1
1916	0.7	1940	9.0
1917	2.0	1941	12.7
1918	12.7	1942	32.4
1919	18.5	1943	(Est.) 67.0

The table shows that the Federal expenditures made during the first World War came as extraordinary costs of a governing establishment that normally constituted only a slight burden on the people. On the other hand, the enormous costs of the second World War were superimposed on the annual expenditures of an organization already geared to a high spending rate. Even allowing for the increase in population of somewhat less than forty per cent that occurred between the two prewar periods for which averages are shown, Federal expenditures for the second period were seven times those for the first period.

The foregoing table and chart, in addition to affording some idea of the relative magnitude of the two spending periods, point to the certainty that the costs of the Federal Government after the present war will not return to the level that prevailed before the war. The greater responsibilities assumed by the Government during the decade of the 1930's and the heavy debt service that will remain after the present war is over are determining factors in establishing a tax burden on the people that will be a threat to our future living standards After the war is over, we may be able to take some action to stem the rising tide of lavish governmental spending, but we must also be prepared to adjust our lives to new circumstances restricting the possibilities of individual economic advancement.



BUSINESS

Index of Living Standards

The index of living standards, shown in the chart at the top of this page, reflects changes in the per capita volume of consumer goods produced in the United States. It is a six months' moving average plotted at the sixth month to allow for the normal time for such goods to reach the hands of consumers. It is adjusted for long-term trend by adapting "weights" given to the component series of the index each year, so that each item has an influence proportional to the value of the year's production.

The index has declined during each month since we entered the war last December, but the downward trend has been somewhat more moderate during the past few months than it was earlier in the year. Although last month's decline brought the index somewhat further below the estimated normal level, its present position is not typical of that existing during most of the depression years of the three decades covered by the chart.

The important influences that have governed the trend of the index of living standards during the war period are described in last month's *Federal Reserve Bulletin*.[1] Although space is not available to reproduce the discussion in this issue, we believe that subscribers will find significant the concluding paragraph that deals with the probable future trend:

"With a large and increasing proportion of economic activity being devoted to war purposes, it is evident that sooner or later the supply of goods in many civilian markets will decline. This transition to a lower level of supplies may be gradual because of the existence of large stocks and continued large production in some lines, but over a longer period substantial reduction in available supplies appears certain. Meantime, consumers are using up the services of some durable goods which cannot be replaced. Thus, standards of consumption for civilians will decline. The decline, however, may be expected to be much less than in the countries devastated by military operations or in countries with more limited resources and greater dependence on world markets."

THE FUNDAMENTALS

Supply

The steel-ingot production rate was unchanged last week at 100½ per cent of theoretical capacity. The favorable implications of the current high rate of steel production are now tempered somewhat by doubt as to whether the railroads can continue to operate adequately unless equipment companies are allowed heavier steel allocations. In last week's issue, *The Iron Age* expressed concern regarding this situation in the following statement: "Whether the carriers can continue to handle the tremendous movement of war goods without faltering in the early part of the year seems to depend on the promptness with which they are given additional locomotives, cars, and rails. Industry generally has helped the railroads in taking steps to get maximum use out of existing equipment. Steel manufacturers have been leaders in speeding unloading of cars, with some companies operating under a system under which any car held more than forty-eight hours starts an investigation. ODT's recent order requiring cars to be loaded to their marked capacity may not produce the excess cars expected because many shippers in the metal industries have been loading to capacity for months. Since heavier loading will hasten breakdowns, more materials will be needed for repairs. A point has now been reached where any substantial increase in freight movement will turn the rail transportation into one of the war's most difficult problems."

	1929	*1932*	*1937*	*1938*	*1941*	*1942*
Per Cent of Capacity	80.0	20.0	55.0	57.5	94.5	100.5

(Latest 1942 weekly data; corresponding week earlier years)

The electric-power companies generated 3,752,571,000 kilowatt-hours last week, compared with output of 3,340,768,000 generated during the corresponding week of 1941. The gain in comparison with output last year remained substantially unchanged at about 13 per cent.

Last week the War Production Board revoked priority ratings for hydroelectric power projects. Presumably this action would not have been taken had the possibility of a power shortage appeared to be in prospect. The delivery of electric power to war industries is so vital to the production program that all precautions must be taken to insure an adequate supply.

	1929	*1932*	*1937*	*1938*	*1941*	*1942*
Billion Killowatt-Hours	1.82	1.53	2.26	2.23	3.34	3.75

Last week lumber production decreased when an increase is normal. The seasonally adjusted index declined from 120.6 in the preceding week to 113.1 per cent of the 1935–39 average. It is reported that the Government's efforts to prevent the migration of workers from lumber-operating establishments to the more highly paid industries have not been successful.

	1929	*1932*	*1937*	*1938*	*1941*	*1942*
New York Times Index	126.5	36.2	72.4	84.0	122.4	113.1

[1] *Federal Reserve Bulletin*, October 1942, pages 987–988.

Demand

Last week the dollar volume of department-store sales was 18 per cent greater than that of the corresponding week of 1941. A year ago, department-store sales had decreased substantially from the high levels that prevailed in July, August, and September, although they remained above the 1923–25 average. Therefore, comparisons with sales in the corresponding period a year ago now appear to be more favorable than they did a few weeks ago. The War Production Board has announced that the inventory-control plan for retailers, wholesalers, and manufacturers of consumer goods will soon be put into effect. This will tend to hold down prices while retail merchants are reducing their stocks of goods. Demand in the wholesale markets will be restricted. It is expected that the holiday-buying season will facilitate the process of adjusting the ratio of retail inventories to sales desired by the Government.

Prices

Neither of the sensitive wholesale commodity price indexes showed decisive trends last week. Moody's Spot Commodity Price Index was 234.1 on October 22 and 232.4 on October 29. The Dow-Jones Index of Commodity Futures closed at 84.39 on October 22 and at 83.76 on October 29.

The sensitive wholesale commodity price indexes have not changed materially during the past three months. The spot commodity price index has remained about 60 per cent higher than it was at the end of August 1939, just before the war started the price advance. The futures index has held its position at a level nearly 80 per cent higher than it was at the end of August 1939. Although the advance in the combined wholesale commodity price index, compiled by the United States Bureau of Labor Statistics, which is a weighted average of 889 quotations, has been more moderate than that of the sensitive commodity price indexes, it has continued an upward trend during the past few months when the sensitive indexes have remained unchanged. It is now about 33 per cent higher than it was just before the war started in 1939.

FINANCE

New Capital Issues

Since we entered the war, in fact since we started our large-scale national defense program, nearly all new capital sought by industrial corporations has been intended to finance the construction of plants primarily adapted for the production of war materials. Now that the Government is placing emphasis on war production from existing facilities rather than permitting the diversion of materials for the creation of new facilities, a further contraction in the volume of new capital issues is to be expected. That this is occurring is indicated by last month's statement of total new corporate financing. The aggregate par value of new issues during September was $28,000,000, compared with a total of $59,000,000 reported for August. About equal amounts of the September total were borrowed by public utilities and by industrial corporations. The railroads were represented by only one relatively small issue of equipment-trust certificates.

New corporate financing in September and in the first nine months of each year during the past seventeen years is shown in the accompanying summary.

New Corporate Financing in the United States

Year	September (In Millions of Dollars)	Nine Months (In Millions of Dollars)	Year	September (In Millions of Dollars)	Nine Months (In Millions of Dollars)
1926	283	3,345	1935	45	231
1927	368	3,722	1936	75	766
1928	383	3,520	1937	114	1,075
1929	662	5,326	1938	85	702
1930	215	4,250	1939	16	308
1931	156	1,624	1940	68	456
1932	7	356	1941	34	789
1933	9	135	1942	28	611
1934	7	134			

Source: *Financial and Commercial Chronicle.*

SECURITIES

Bonds

Bond prices declined moderately last week following a three-month period of advancing trend. In view of the necessity for the Government's maintaining its easy-money policy to facilitate the Treasury's war financing, last week's decline can probably be viewed merely as a natural reaction following an extended upward movement. The Dow-Jones average of 40 bonds was 91.08 on October 22 and 90.95 on October 29. The current average is about one point higher than the average recorded in the corresponding week of 1941.

Stocks

During October, the industrial, utility, and railroad stock-price averages fluctuated more widely than they did last summer, and the volume of transactions was substantially greater. The general price level was also higher. There has evidently been an increase in speculative interest in the market. It seems logical to connect this with the inflationary progression that is developing in this country.

RECOMMENDED BOOKS

"*Economic Problems of War,*" by Raymond T. Bye and Irving B. Kravis, F. S. Crofts & Company, New York (50 cents).

This fifty-nine-page booklet, written by Professor Bye of the University of Pennsylvania and Mr. Kravis of the War Production Board, briefly summarizes the economic problems arising from the war and sets forth the authors' ideas as to their solution. We recommend it to the attention of our subscribers not because we agree with its recommendations (its factual statements are generally correct), but because it appears to reflect the attitude of the National Administration regarding the functions of the Federal Government in times of peace as well as war. It is evident that the Nation is expected to submit to a permanent program of "increased Government intervention in economic life." The average citizen in a democracy should at least keep track of what is being planned for him in the national capital.

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