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RESEARCH REPORTS

COMING EFFECTS OF CURRENT EVENTS

More Government Subsidies

The Office of Price Administration's efforts to control living costs and to prevent an acceleration of the wage-price spiral are leading this agency into an increasingly involved situation. The latest proposal to "roll back" consumer prices by granting Government subsidies is another precarious step in building up a system of centralized economic management that cannot be readily abandoned after the war.

The proposal reveals the readiness of the Administration to turn to Federal subsidies as a cure-all for economic maladjustments. The record shows that the Administration was tardy in taking decisive measures for the control of the war-time inflation at its source and measures that were taken were ineffective. Evidence has also been brought forth to show that the Government has failed to give adequate attention to the flow of necessary supplies to the civilian population that would delay the disastrous effects of the inflationary expansion in purchasing media. Instead, unsatisfactory and dangerous stop-gap methods have been adopted.

There are always great political difficulties encountered when attempts are made to abandon subsidies once they are granted. "Aids to Agriculture" that were started to meet the emergency of the depression years have been retained and have become a permanent Government "activity" listed in the expenditure section of the Federal budget. Even now, when prices for farm products are at abnormally high levels, Government hand-outs to the farmers are maintained at the rate of about $1,000,000,000 per year. There is also the tendency to demand larger and larger subsidies to offset the growing pressure of inflation on the price level.

The proposed subsidies will mask the effects of inflation on prices that would be immediately revealed if the subsidies were later withdrawn. Furthermore, there is the danger that as each expedient applied in the attempt to control inflation proves futile, another will be tried; each of these essays into economic management leaves behind it a monument in the form of one more burden on the general taxpayer.

THE BACKGROUND OF INVESTMENT

Public Obligations

There is an essential distinction between investments in productive enterprise and the purchase of public obligations. The expectation of return from the former is based on the earning power of producers goods, the acquisition of which the investment has financed Some public obligations may have been incurred to finance the creation of durable goods that afford income-earning services. This is not true in the case of all public debt and is of minor consideration in the case of Federal obligations.

Federal Government Securities

With the exception of the new debt created during the period of New Deal social experimentation, substantially all of our national debt has been created in connection with the prosecution of war. Large-scale military operations involve extraordinary financial requirements, and it has usually been found inexpedient to attempt to obtain the necessary funds by taxation of current income. The national debt burden that is built up during periods of conflict represents a charge on the Nation, in return for protection of the national interests. Even though they accomplish their purpose, the funds that have been invested in the new debt have not in general added to the real wealth of the Nation, but have been employed as insurance against the loss of wealth. In practice, swords cannot be beaten into plowshares, and the wartime debt remains as an additional burden on the taxpayer.

The holders of Government bonds, therefore, must place their reliance on the power and willingness of the Government, as representative of the people, to meet debt-service payments through taxation. It is necessary to emphasize the willingness of the Government to meet these charges by taxation, because the individual holder does not possess the ordinary legal compulsion to require payment of Government security contracts provided in the indentures of private corporate securities. Thus, it is apparent that the holder of Government securities is dependent on the good faith of the Government as well as its ability to meet its obligations through taxation.

The tremendous growth in the public debt during the present war period is too well known to require comment. It seems inevitable that it will aggregate between $200,000,000,000 and $250,000,000,000 at the very least before the present emergency is past. The volume of Government securities will dwarf all other forms of debt in the national economy.

The Government's good faith in recognizing its obligations will be a major consideration in the postwar period. There are cogent reasons supporting the probability that the Government will recognize its full responsibility to holders of Government securities. The people will realize that a considerable proportion of the debt has been purchased for patriotic reasons and that these investments should be secure even though the purchasers may have felt that their contributions to the war effort were worthwhile even if full repayment could not be made. Furthermore, it is essential for the Government to maintain its credit standing, so that its borrowing position will be unimpaired to meet future emergencies.

After the war, the influence of the Government debt will permeate the Nation's whole social and economic structure. Government securities will be the mainstay of all savings institutions. The existence of the whole commercial banking system will be dependent on the maintenance of the Federal Government's credit. The Government must therefore exert in full its great powers for the maintenance of its credit standing.

The Government's determination to maintain its credit standing must also be supported by its ability to do so. This raises the question, How large a national debt can the Nation support? The factor to be considered is the magnitude of the annual interest charges and other necessary Federal budgetary items in relation to all yearly income payments received by the people.

The average rate of interest on the Government debt is of course extremely important in determining the burden on the taxpayers. This rate has been considerably reduced during the past decade. In 1933, the rate of interest on the Federal debt was 3.35 per cent; during the first quarter of 1943, the average only slightly exceeded two per cent. However, there has subsequently been a tendency for the average rate to increase. If interest rates on the entire debt were as low as those on Treasury notes and bills, which are scarcely more than nominal, the service charge on a debt of $250,000,000,000 would not be burdensome. Even skillful Treasury management can maintain only a relatively small proportion of the total debt in short-term issues, and the coupon rate on long-term bonds must be the major determinant of the debt-service charge over an extended period of years. If a stable debt situation is to be established after the war, the Treasury must undertake refunding operations on its short-term debt, and an average rate of about 2½ per cent will probably be necessary. Annual interest charges on a debt of $250,000,000,000 will therefore be approximately $6,000,000,000.

It seems futile to indulge in attempts to estimate what the Nation's income will be in the postwar period. If the Federal budget is prudently managed, the income of a country with as great resources as ours should be sufficient to support a high enough rate of taxation to meet service charges on the debt. However, there seems to be little basis for expecting a reduction in the Federal debt proportionate to that effected in the World War debt during the period of 1920's.

The fact that Government debt holdings are widely distributed throughout the population through direct ownership and through the holdings of savings institutions has been pointed out by some social theorists as indicating that the debt has little or no effect on the Nation's economy. The funds collected through taxes are quickly passed back to the people, affording an increase in the country's income payments, substantially equivalent to the taxes withdrawn to meet these payments. They fail to acknowledge that the debt service constitutes a burden on productive enterprise and therefore tends to impair incentive as a potent factor in the economy. It is of course vital that the Government debt holdings be distributed as widely as possible in order to support the public's determination to sustain national credit and to demand economy in Federal expenditures.

The existence of a swollen public debt and the manner in which it has been created are of vital importance in determining the future economic trends of the country. The wartime debt will have an especially serious influence on the commodity-price level and therefore on the cost of living. It may lead to a subsequent devaluation of the dollar and to an impairment of the purchasing value of investments in Government securities as well as in any fixed-income-bearing debt. However, this is a factor primarily for consideration in determining the proportion of bondholdings suitable for the individual's investment program. It does not impair the status of Government bonds, which, in the case of United States Savings Bonds redeemable on call, may be considered as cash or equivalent in an investment list. Federal securities of fixed maturity are entitled to be classified as high-grade issues.

The discussion of public obligations will be continued in next week's bulletin.

BUSINESS

Indexes of Retail Sales

The chart of durable goods and nondurable goods retail sales, shown at the top of page 79, was prepared from data compiled by the United States Bureau of Foreign and Domestic Commerce. The series represents the most comprehensive indicator of current consumer goods purchases in the country. A description of the composition of the two indexes shown was published in the April 12, 1943 Research Report bulletin (page 58), and the chart is presented in this issue to show the subsequent trend.

During March, the most recent month for which data are available, the two indexes exhibited divergent trends. The durable goods index advanced slightly from the level of the preceding month. At this level, the index was approximately in the same position in relation to the base period as it was at the outbreak of war in Europe in September 1939.

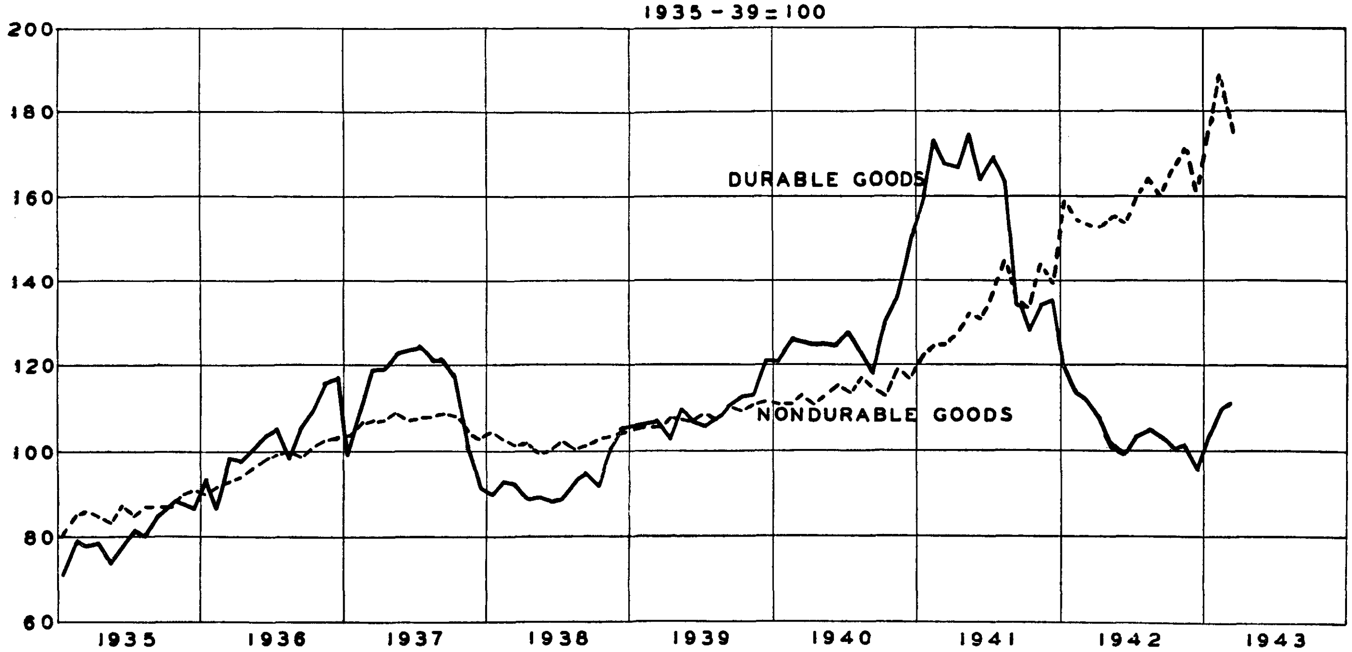
The sharp decline in the nondurable goods index in March from the February level represented the most substantial decline in this index in any one month since the index was compiled as of January 1935. The decline appears to be attributable to two factors. The first was the difference in the Easter date this year, which fell three weeks later than it did in 1942. The second was the increased personal income-tax liabilities that had to be met on March 15. When the comprehensive indexes of retail sales are available for April, it probably will be found that there was a substantial recovery in the nondurable goods index. The volume of department-store sales during April this year compared favorably with the volume for March, and in the past this has usually indicated an increase in the more comprehensive index of all retail sales.

The Trend of Commercial Failures

Commercial failures reported during April were less serious than they have been in any month since the present series was compiled by Dun & Bradstreet

INDEXES OF RETAIL SALES

1935 - 39 = 100



beginning January 1939. Both the number and the liabilities involved in business insolvencies were substantially lower than they were either in the preceding month or the corresponding month of 1942.

The war has multiplied the difficulties of doing business, and it seems obvious that the downward trend of the two statistical series representing commercial failures has been made possible by the development of inflation. The monthly series of the number and liabilities of failures include, in addition to voluntary and involuntary bankruptcies, other losses to creditors through concerns forced out of business by foreclosure or attachment with insufficient assets to cover all claims. The data for each month of the past two years and for the first four months of 1943 are presented in the accompanying table.

Commercial Failures, Number and Liability

	Number of Failures			Liabilities of Failures (000 Omitted)		
	1941	*1942*	*1943*	*1941*	*1942*	*1943*
January	1,124	962	458	$11,888	$9,916	$5,515
February	1,129	916	422	13,483	9,631	4,163
March	1,211	1,048	410	13,444	12,011	7,282
April	1,149	938	362	13,827	9,282	3,523
May	1,119	955		10,065	9,839	
June	970	804		9,449	9,906	
July	908	764		13,422	8,598	
August	954	698		11,134	6,786	
September	735	556		9,393	5,473	
October	809	673		7,333	7,181	
November	842	585		9,197	5,245	
December	898	506		13,469	6,950	
	11,848	9,405	880	$136,104	$100,818	$9,678

THE FUNDAMENTALS

Supply

The steel-ingot production rate last week advanced from 98 to 99½ per cent of theoretical capacity. The current situation in the steel industry was summarized as follows by *The Iron Age:* "The smashing success of the Tunisian campaign has made necessary new timetables, which will create a variance of demands upon the United States metals and metalworking industries. The expected new shifts dictated by military strategy are not likely to cause any serious problems overnight, however. For months, American business has been experiencing sudden changes, not only in wartime production contracts but in material procurement, manpower, and other phases of industry. It is doubtful if steel ingot production this year will reach the goal of 92,000,000 net tons which was set by WPB. The industry certainly has done its best and there is no evidence that the lag can be blamed upon it."

	1929	*1932*	*1937*	*1938*	*1942*	*1943*
Per Cent of Capacity	97.5	22.0	92.0	30.5	99.5	99.5

(Latest 1943 weekly data; corresponding week earlier years)

There was an increase in electric-power production last week, but it was somewhat less than the gain recorded during the corresponding week of 1942. The gain, in comparison with output in the corresponding week of 1942, was 16 per cent, compared with a gain of 17 per cent reported in the preceding week. The outstanding gain (of 32.9 per cent) was reported from the Pacific Coast region.

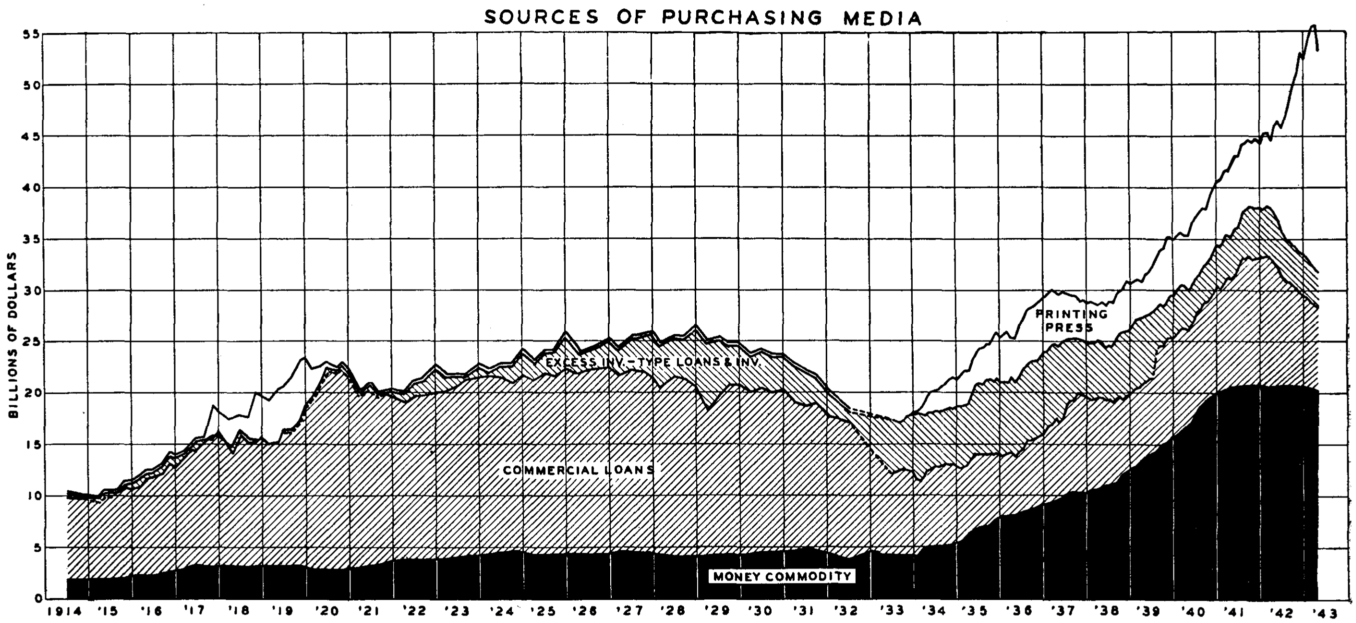
	1929	*1932*	*1937*	*1938*	*1942*	*1943*
Billion Kilowatt-Hours	1.70	1.44	2.20	1.97	3.37	3.90

Lumber production decreased last week, and the seasonally adjusted index declined from 108.6 in the preceding week to 106.6. There was also a decrease in the volume of shipments, but there was an increase in the volume of new orders.

	1929	*1932*	*1937*	*1938*	*1942*	*1943*
New York Times Index	132.3	42.1	93.8	58.7	115.7	106.6

Demand

Manufacturing plants have been so thoroughly converted to war production that demand for the products of the heavy industries during recent months has primarily represented Government orders. Therefore, the announcement made last week by the War Production Board that all orders for new plants and machine tools would be cancelled is of major importance. The total contracts involved may exceed $10,000,000,000 in



value. Ordinarily, such a development would precipitate an industrial crisis and even under wartime schedules will have an appreciable effect on aggregate demand. Civilian demand for the products of these industries will not be reasserted on a major scale until after the conflict is ended, so that overall demand may now have passed its wartime peak.

Prices

The sensitive wholesale commodity price indexes were reactionary last week. Moody's Spot Commodity Price Index was 246.8 on May 6 and 244.2 on May 13. The Dow-Jones Index of Commodity Futures closed at 91.88 on May 6 and at 90.81 on May 13.

FINANCE

Sources of Purchasing Media

As the accompanying chart shows, there was a substantial decrease in the purchasing media available to the public during April. This was primarily attributable to the effects of the Second War Loan drive, which will be discussed in a subsequent paragraph.

There was a relatively small decrease in purchasing media from the money-commodity source during the month, continuing the trend that has prevailed recently, when a minor portion of the Nation's monetary gold stock has been employed for war purposes.

There was another decrease in purchasing media derived from commercial loans during April. The shrinkage in purchasing media from this source has been continuous since the early part of last year. Private economic activities have been supplanted by the Government to an increasing degree as the Nation has assumed a full wartime status. It is therefore inevitable that bank loans, based on the production and movement of civilian goods, will be retired.

There was a moderate decrease in purchasing media derived from the third source (an excess of investment-type assets representing tangible property with respect to savings available to the banking system). The banks' holdings of corporate bond issues and loans on corporate securities, from which these purchasing media are originated, decreased last month.

The success of the Treasury's new security offerings during April caused the most substantial shrinkage in purchasing media available to the public that has occurred during the war period. Checking-account deposits were reduced when payment was made for the Government issues. Funds in the Treasury's bank depositaries increased from about $3,000,000,000 at the end of March to more than $10,000,000,000 at the end of April. This withdrawal of purchasing media from the public appears to be huge when viewed in relation to normal conditions. In 1937, the withdrawal of a smaller amount of purchasing media over an extended period precipitated the business recession that occurred in 1937–1938. However, at that time, Government expenditures were not so great as to distribute funds to the public within a short period of time.

The rate of Government spending now exceeds $7,000,000,000 per month, and most of this constitutes budgetary deficit, except in the months when income-tax payments are due. Until after the enactment of new Federal tax legislation, it is impossible to estimate the length of time that the Treasury can subsist on the backlog of checking accounts built up by the Second War Loan drive. However, it appears to be certain that the decrease in purchasing media available to the public as a consequence of the drive's success will be short-lived. Treasury reports for the early part of May indicate that Government bank balances are being sustained by a flow of delayed payments for Government issues sold in the preceding month.

Although the decrease in purchasing media available to the public, which is indicated by the chart, can represent only a temporary interruption to the wartime inflationary progression, there is the possibility that it will have an adverse effect on the security markets. It is possible that the position of margin-account speculators has been weakened in respect to meeting a technical reaction that is always a possible occurrence in the security markets. Deflationary interludes that occur during an inflationary progression may be an unimportant aspect of the movement but may cause serious embarrassment to speculators having an overextended market position.