

AMERICAN INSTITUTE *for* ECONOMIC RESEARCH

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RESEARCH REPORTS

COMING EFFECTS OF CURRENT EVENTS

Inflation Probabilities

The contrast afforded by the excited prosperity of the New Era days of the 1920's and the widespread despair of the succeeding depression should be an ample illustration of the extent to which our lives are affected by money-credit trends. Businessmen and investors habitually deal with problems that require estimates of the future respecting inflation and deflation. Both the long-term and short-term prospects for inflation are of great importance. Many financial problems require solutions that will serve for the long term, as long as three or four decades. Among these problems are the individual's life insurance and retirement plans. However, ordinarily, the majority of business and personal decisions that may be affected by money-credit trends involve periods of much shorter duration.

As the Harwood Index of Inflation published in the June 28, 1943 Research Report bulletin shows, inflation has proceeded to a degree exceeding the proportions of the experiences during the first World War and during the 1929 stock-market speculation. It is of vital importance to determine as far as possible whether this trend is going to continue.

The principal questions regarding the future may be summarized as follows:

1. How much farther will the present inflationary trend go before there is a deflationary reaction of some severity?

2. Will there be a thorough deflation as a result of a complete reversal of the spending program, and, if so, when?

3. Or, will the inflationary trend continue virtually without interruption for several years?

We would answer these questions at present as follows:

1. A deflationary interlude of some severity but probably not of major proportions may occur at any time; for example, as the temporary aftermath of reverses in one or more of the United Nations' campaigns; or from some other reason not readily foreseeable.

2. There is a slight possibility of a thorough deflation if the war should end suddenly and spending should diminish greatly while taxes remained high. Such a development seems improbable, and continued large spending is virtually assured. (The new independence of Congress may reflect a fundamental change, however.)

3. The most probable development at this time appears to be a continuation of the inflationary trend without major interruption.

In view of the foregoing, it would be undesirable, in our opinion, to liquidate security holdings now in the expectation of repurchasing at much lower prices later. However, if industry in general does not use profits for expansion, if we have now created enough capital equipment to win the war, and if corporate plus individual savings are used for the liquidation of debt at a rapid rate, it is possible that the degree of inflation will either increase less rapidly or will even decrease. The Institute's staff is following the situation closely, and, if our views are altered by future developments, revised conclusions will be presented in later bulletins.

BUSINESS

Civilian Supply

It is of vital importance to the public to have a general knowledge of the supply situation in respect especially to necessary civilian demand for food, clothing, the maintenance of shelter and transportation services. Civilian supply was ample before the United States became an active belligerent. Production was increased so substantially that the current consumption was maintained at a high level and substantial inventories of consumer durable goods were accumulated at the same time that war materials for Lend-Lease and for our national defense program were produced in great quantities.

In 1942, it is estimated that more than 30 per cent of the gross value of all output was devoted to war purposes. The production of civilian goods was drastically curtailed, and shortages of numerous commodities became evident. The large inventories amassed in 1941 have been exceedingly helpful for the maintenance of the civilian economy, but these have now been drastically reduced.

The United States Department of Commerce possesses the resources for collecting and analyzing statistical material relating to the economic processes in the United States to a greater extent than any other statistical organization. It is therefore interesting to obtain the following brief appraisal of the situation during the present year that was presented in the June 1943 issue of the "Survey of Current Business":

"During 1943 a substantial further growth in the volume of war output is, of course, scheduled. Furthermore, we are continually drawing nearer to points of

full utilization of resources. This is true not only of materials, which have consistently been a limiting factor in the war program, but also of labor. Primarily as a result of the increasing difficulties in supplying all our manpower requirements, the rate of expansion in total production, which was steady during 1941 and 1942, is beginning to slacken off. Thus it is plain that production for civilians this year will show a substantial additional decline. The decline should, however, be relatively smaller than that experienced last year both (a) because the process of conversion has been virtually completed and (b) because as the year progresses we shall be drawing ever closer to the point of minimum civilian requirements. Beyond this point further cuts in civilian output would be damaging to the war effort."

It is somewhat encouraging to find that one important Government organization recognizes that the war effort would suffer if the civilian economy is further restricted. During the war period, there have been numerous instances of irksome restrictions placed on activities that were not especially affecting the war program. The theory is apparently entertained by some zealous officials that the war can be won more quickly if war conditions are made as onerous as possible. As a matter of fact, industrial workers would be more inclined to produce at maximum efficiency if they felt that they could employ at least a part of their earnings to obtain the consumer goods desired by any normal individual.

THE FUNDAMENTALS

Supply

There was a decrease in the steel-ingot production rate last week from 96½ to 95½ per cent of theoretical capacity. The further decline in the steel rate was attributed to coal shortages resulting from the strikes. The Pittsburgh district was especially affected, where the operating rate fell to 92 per cent of capacity, and fourteen blast furnaces were reported shut down because of lack of fuel. *The Iron Age* stated: "The steel-for-victory drive has been hampered definitely. Strategic stockpiles of coal and coke probably cannot be rebuilt to a comfortable level for the duration of the war. No immediate step which will end the troubles at the mines appears to be in sight. Demand for fourth quarter steel by claimant agencies is reported to be approximately 22,700,000 tons against a supply of about 17,000,000 tons."

	1929	1932	1937	1938	1942	1943
Per Cent of Capacity	95.0	22.0	83.0	33.0	98.0	95.5

(Latest 1943 weekly data; corresponding week earlier years)

Electric-power output decreased last week, when a seasonal increase was expected. There was a substantial increase in power production during the corresponding week of 1942, and consequently the comparison was much less favorable than it was a week ago. The gain in production compared with output during the corresponding week of 1942 was reduced from 20.1 per cent to 14.3 per cent.

	1929	1932	1937	1938	1942	1943
Billion Kilowatt-Hours	1.72	1.44	2.26	2.08	3.43	3.92

Lumber output was sharply reduced last week, and the index declined from 115.1 to 102.2 per cent of the 1935-1939 monthly average. Last week's rate indi-

cated that production was 13 per cent smaller than it was during the corresponding week in 1942.

	1929	1932	1937	1938	1942	1943
New York Times Index	134.2	38.5	92.0	72.4	123.5	102.2

Demand

The full effects of the withholding tax as a limiting factor on demand in the retail markets will not be observable until after the end of the month. However, probably the greater part of the wartime increase in incomes has been derived from industrial pay rolls that are customarily on a weekly basis. If there is no appreciable let-down in retail buying during the next few weeks, it may be assumed that the influence of the withholding tax on consumer demand will not be especially important.

Prices

The sensitive wholesale commodity price indexes remained within a narrow range last week. Moody's Spot Commodity Price Index was 244.4 on July 8 and 244.1 on July 15. The Dow-Jones Index of Commodity Futures closed at 93.59 on July 8 and at 92.87 on July 15.

FINANCE

Indicators of Money-Credit Trends

Purchasing media, created from sources shown in the chart on page 116, are available to the public in the form of currency and checking-account deposits. Both this chart and the chart of the Harwood Index of Inflation, which is published in each monthly Research Report bulletin, indicate the extent of the growth of inflationary purchasing media that has occurred since the beginning of the war in Europe. Although the proportion of inflationary purchasing media to the total available to the public was only moderate at the time of our entrance into the war, the total of inflationary purchasing media had increased from about \$3,000,000,000 in 1938 to \$8,000,000,000 at the end of 1941. The rate of increase in the total of inflationary purchasing media has been much greater since we entered the war.

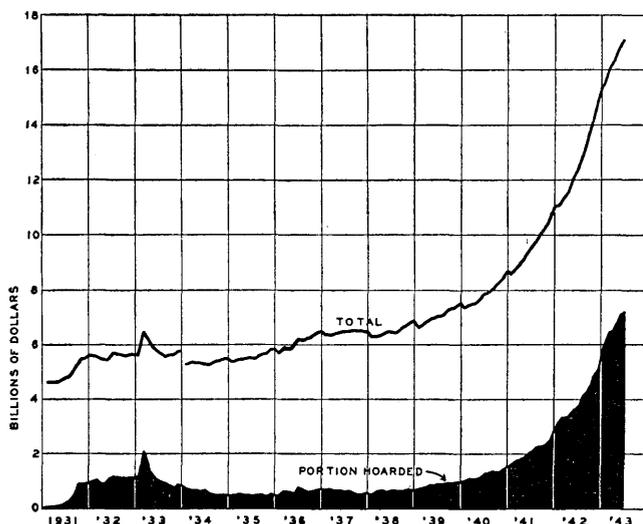
Government price controls and rationing systems have proved to be only partially effective and have so seriously interfered with the country's economic processes that some commodities have been driven out of the normal markets, thus depriving the general public of supplies that they might otherwise be able to obtain. The greatly increased volume of purchasing media that has been created as a result of the inflationary financing of war expenditures has not been fully exerted against the price level, although it has made possible a substantial advance in prices during the period 1941-1943. If these purchasing media were all actively bidding for goods in the commodity markets or devoted to speculative purposes in the stock market or the real-estate market, price advances of more extreme violence could not be prevented by any means available to the Government. The exertion of restraint on the part of the public in using the purchasing media has been the most effective influence tending to limit the rapidity of the wartime price advance. The series of charts accompanying this discussion afford information concerning some of the reasons why inflation has

not yet had an effect on prices commensurate with its extensive development.

Currency in Circulation

At the present time, 23 per cent of the Nation's purchasing media, outside of the United States Treasury, consist of circulating currency. Currency in circulation increased from about \$7,000,000,000 in August 1939 to more than \$17,000,000,000 at the end of June 1943.

CURRENCY IN CIRCULATION AND PORTION HOARDED



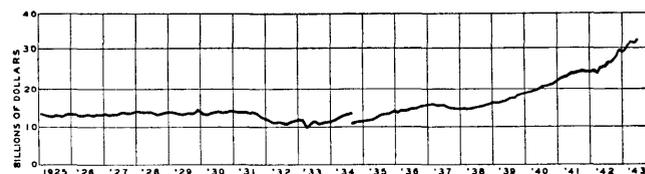
Gold coin omitted from reports beginning January 1934.

The foregoing chart presents the monthly record of currency in circulation during the past twelve and a half years. The shaded section in the chart indicates the amount of currency estimated as hoarded during each month of the period shown. The vertical distance between the top of the shaded portion and the lines indicating the total currency in circulation affords a more accurate measure of circulating currency than does the vertical distance between the top line and the bottom of the chart, because the hoarded currency does not actually appear as demand in any market. The chart indicates that, although there has been an increase of currency in circulation of about \$10,000,000,000 during the second World War period, about \$6,000,000,000 of this has been hoarded.

Demand Deposits

Bank checks drawn on demand deposits are the customary media of exchange in business and are also widely applied by individuals as the most convenient means for settling financial accounts. Therefore, although the largest number of exchanges are made by using currency as the purchasing medium, the larger dollar volume of transactions is effected by means of bank checks. Checking-account deposits constitute more than three-quarters of the total available purchasing media. The following chart shows the extent to which demand deposits have increased during the war period. The total increase has been greater than the aggregate increase of currency in circulation but the proportional gain has not been so great as the proportional increase in circulating currency.

DEMAND DEPOSITS (Reporting Member Banks)



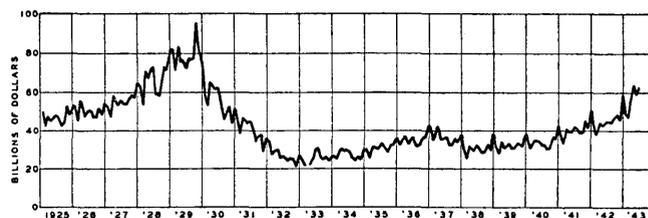
Beginning September 1934, United States Government deposits and items in process of collection excluded.

The chart shows only the deposits with the 101 member banks of the Federal Reserve System that make weekly reports of these items. Approximately two-thirds of the dollar volume of all checking accounts is on deposit with this group of banks, and our studies indicate that the trend of deposits made in these banks is usually typical of that for the entire banking system. The extent to which the depositors have hoarded checking accounts cannot be measured by the same tests that were applied to currency in circulation. However, the degree of checking-account hoarding can be judged by observing the trends of checking-account transactions.

Checking-Account Activity

The activity of demand deposits (checking accounts) is revealed by records of bank debits covering transactions of a group of banks not identical with the member banks of the Federal Reserve System but including most of those institutions. The debits that are reported are charges against the checking accounts of individual and companies. These differ from bank clearings, inasmuch as the latter represent the value of checks passing through the city clearing houses and involve some duplications. The debits provide the more accurate measure, because duplications in the records of transactions are eliminated. The reporting banks, the data for which are plotted on the accompanying chart, transact about two-thirds of the total checking-account business of the country.

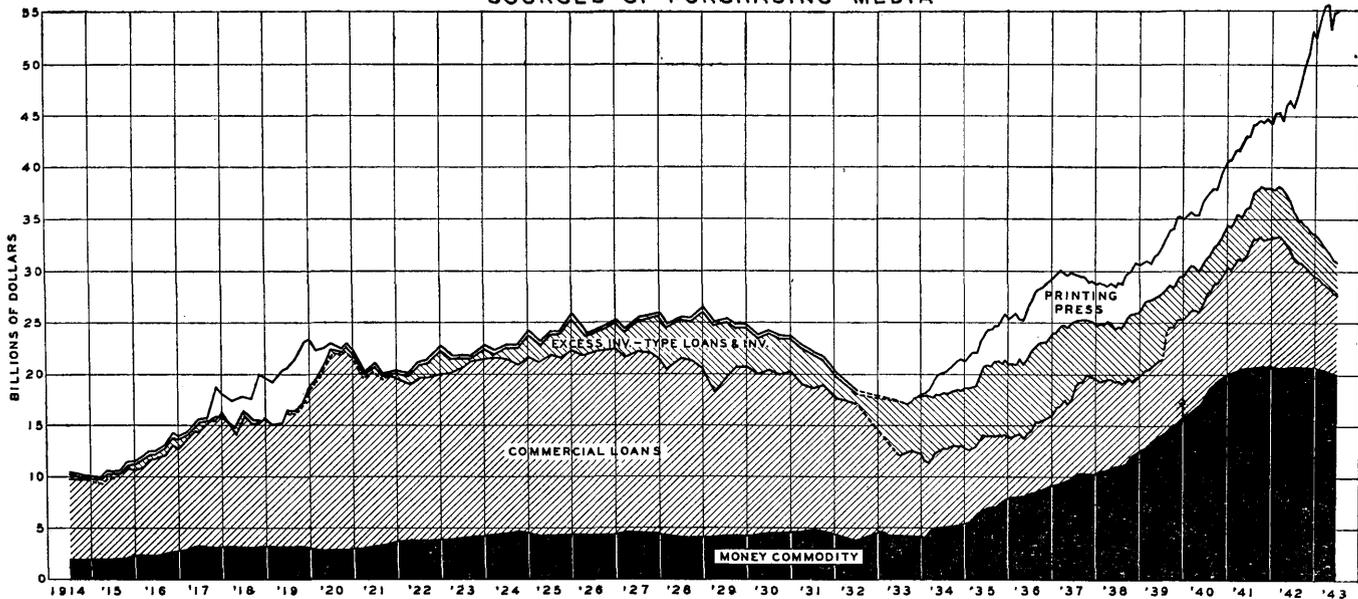
BANK DEBITS (141 Centers)



Break in chart in March 1933 caused by bank holiday.

The trends of the bank-debit chart show that transactions have increased substantially during the past two and a half years and now greatly exceed the volume that prevailed during the 1936-1937 inflationary period. In fact, if the recent trend of expansion continues during the remainder of the year, the total will be as great as that characteristic of the 1928-1929 period. The increase in the volume of bank debits has lagged the upward trend in demand deposits. This indicates that checking-account deposits are being hoarded just as currency is being hoarded.

SOURCES OF PURCHASING MEDIA



Demand deposits and currency in circulation will probably continue to increase during the war period, and as long as the war lasts a substantial proportion of the newly created purchasing media will be hoarded. Such behavior is typical of periods of uncertainty. The hoarding movement caused by the people's doubts about the future is probably a more important factor in retarding the development of the present inflationary progression than is the system of Government price controls. After the war, if political conditions in the United States are more favorable in respect to the private enterprise system than they were during the New Deal reform era, uncertainties will be less grave and a general dehoarding movement will be encouraged. Such a development would of course tend to create a speculative movement of a magnitude that would court subsequent disaster such as followed the speculative splurge of the late 1920's.

Sources of Purchasing Media

As the accompanying chart shows, there was only moderate increase in the purchasing media available to the public during June. The total has not yet regained the aggregate reached early this year before the War Loan Drive last April caused the withdrawal of purchasing media from the public when payments were made for Government bonds purchased at that time.

There was only a small decrease in purchasing media from the money-commodity source last month. The decrease of \$40,000,000 was much less than the average reduction that has occurred during the past six months. When we entered the war publication of gold import and export statistics was suspended; however, data indicating changes in the United States gold stocks are released, and these indicate that the volume of gold shipments from the United States since we entered the war has been more than \$400,000,000.

There was a more moderate decrease in purchasing media derived from commercial loans last month than was reported during earlier months this year. Loans

extended by reporting member banks of the Federal Reserve System classified as "commercial, industrial, and agricultural" increased during the early part of the war but reached a high level of \$7,800,000,000 on March 25, 1942 and since then decreased steadily. At the end of June 1943, they were only \$5,540,000,000. If the experience of the reporting member banks of the Federal Reserve System is typical of that for the Nation's whole banking system, a decrease of more than \$3,000,000,000 in this type of bank credit has occurred during the past year and a quarter. Contraction in this type of credit was advocated by the United States Treasury and Federal Reserve authorities, and the extent to which it has proceeded indicates the influence that the Government can exert over the banking system.

During June there was a moderate increase 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 commercial banks disposed of some Government-guaranteed and "other" securities.

The increase in purchasing media from the fourth source was responsible for the net increase for the month in the aggregate. Although there was an actual decrease in the value of Government securities in the commercial banks' portfolios during the month, this was offset as a deflationary factor by a substantial decrease in Government deposits with the Federal Reserve Banks and with other depositories. Government deposits are deducted from the total purchasing media derived from the printing press, because such deposits represent funds temporarily not available to business. When the Treasury's bank balances are depleted, this indicates the distribution of purchasing media that had been previously withheld by the Government.

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