EXECUTIVE OFFICE OF THE PRESIDENT
COUNCIL OF ECONOMIC ADVISERS
WASHINGTON, D.C.

July 29, 1948

MEMORANDUM

To: The President
From: The Council of Economic Advisers
Subject: The Government's Anti-Inflation Program

In response to a request from Mr. Clifford, we are in this memorandum undertaking to make clear our position as to the possible effectiveness of proposed anti-Inflation measures and making certain suggestions of measures which might lessen the inflationary danger.

The Inflation Situation

The upward movement of prices in the last twelve months has completed another full cycle of increasing costs, rising prices, and advances in wage rates. Now the country appears to be well started upon the next inflationary cycle. With the closing of the third round of postwar wage increases, basic industries have already increased or announced their intention of increasing prices on account of increased costs. The cost of living is again moving rapidly upward, and the situation is bound to be aggravated as recent wage advances lead to the increase of industrial prices and they in turn influence the prices of consumers' goods.

This situation challenges us to do something to break the inflationary spiral at some safe point so that it shall not rush on until it breaks itself in a disastrous collapse which will undermine our national prosperity. It
would be reckless to wait for inflation to subside of itself, for the
major factors of demand are too strong to justify any such expectation.
The violent break in grain prices last winter failed to reverse the general
upward course of the wholesale price index. The prices of food products
have surged upward to the highest level in history, and the vastly improved
prospect for grain supplies will not have its full effect for some time.
While our people groan under the burden of high prices and the clouds grow
darker on the business horizon, industrial production is scarcely greater
then it was a year and a half ago. We cannot longer await the promised
expansion of production which was to follow the end of wartime price control.

Likewise, we are forced to the realization that the problem of inflation
will not be solved merely by voluntary action. The individual business
manager knows that his own production costs are steadily climbing, that his
own price policy cannot improve the situation even if he were to take a
loss on his goods, and that nothing is being done in the business world as
a whole to halt the inflation. The worker is certain that he has shown
restraint in his wage demands while his cost of living has moved away from
him, and all that he can see is that his sacrifice has not interrupted the
rise in prices and in business profits. The individual consumer believes
that he is the helpless victim of inflation, already compelled by high
prices to curtail his purchases unreasonably and unnecessarily.

The Government is challenged to take every step it can to deal with this
inflationary situation. At the same time, we must emphasize our belief that
no set of new legislative measures could at this juncture really stem the
inflationary tide unless they were so recklessly devised and executed that
they would themselves precipitate the business collapse which it is our task
to forestall. The situation is much too complex and depends much—if not more—
on sound, mutually consistent, and courageous administration, public and private, within the present institutional structure.

Our suggestions fall under three general heads: fiscal and credit controls, control of materials, and price and wage control and rationing.

Fiscal and credit controls

With monetary purchasing power available in the market in amounts in excess of the present or prospective supply of goods, the one thing that would be most widely and directly effective toward halting inflation would be the mopping up of a larger amount of this loose purchasing power through taxation. It has repeatedly been stated that the disappearance of the Government's cash surplus through the omission of tax reduction and expanded foreign aid and defense programs deprives the Government of its most potent anti-inflationary power. The determination of the Congress to reduce personal income taxes has destroyed the only important anti-inflationary policy we have had during the last year. The very large Treasury surplus which was rolled up during the first quarter of this year was used to gain the maximum deflationary effect of this process of exacting more from the public in taxes than is returned to the public in Government payments. Now the effect of that surplus-accumulation has been exhausted. If there is any Government surplus in this fiscal year, which is doubtful, it will develop in January. Until then, Treasury receipts and disbursements will be no more than be in balance.

But only in order to curb inflation, but to enable us to continue the prudent policy of reducing the public debt during this period of active and
prosperous business, taxes should be increased by at least the amount of
the recent reduction. To reach so large a figure as this, there would
have to be a restoration of individual income taxes.

As this is probably impossible of accomplishment at this time, the
only alternative would seem to be an excess profits tax. Such a tax should
be steeply progressive, not as to the size of the total profit but as to
the rate of return on invested capital (this presents a practical difficulty
in view of the marked difference in the proportion of fixed capital in
different lines of business) or stepped up as the volume of profits exceeds
that of a designated base period. The yield of an excess profits tax on
any practicable rates would obviously be much less than that of a personal
income tax. It also would be vigorously attacked in almost all business and
financial circles.

As for credit control, the extended consideration of the proposal to
enlarge the power of the Federal Reserve System to limit credit should now
be resolved by removing the authority of the Board of Governors to regulate
consumer credit and by granting authority to require the commercial banks to
maintain larger reserve funds. The Board of Governors has presented two
plans, the one for the outright increase of reserve requirements, the other
with a permission granted to any bank to hold its added reserve in Government
bonds and thereby secure some income upon these frozen assets. Either plan
would permit the Board of Governors to induce tighter credit conditions and
thereby limit the inflationary pressure within the economy.

The Federal Reserve System cannot now do this through the traditional
process of raising discount rates unless it abandons the policy of supporting
the Government bond market. This policy is too important to be jeopardized, and every occasion should be taken to reassure the American people that it will not be abandoned. The Government will not yield to any suggestion that the price of long-term 2½% bonds be permitted to drop "a little below par." Far is a fixed point which the people understand; if it is abandoned, the people would never have any confidence in official assurance that some other price point would really be protected.

The application of higher reserves as a brake on a strong inflationary movement is, however, a very delicate operation. It must actually induce enough dampening of operations to produce a certain amount of disemployment and yet do this at times and places where the displaced workers will rather promptly be reabsorbed. Otherwise a downward spiral is started which may get out of hand.

While the readjustment of credit controls is desirable, it cannot be very effective in the total situation. Probably a larger inflationary impact comes from the enlarging volume of mortgage credit. We doubt that any new legislation can materially hold down this mortgage credit, although proper administrative action in the Farm Credit Administration and in the housing agencies could do something significant in this direction. If new housing legislation is enacted at this time, it should not enlarge the total amount of house building or of mortgage credit. It should affect a shift from housing of luxurious types or for veterans at prices beyond what they can afford or for people who could readily do without for a while and to modest housing at costs within the means of people so seriously hurt by the current housing shortage that it becomes a primary economic problem. The total of mortgage credit (and of housing) should not be expanded and could properly be somewhat reduced to alleviate one of the strongly inflationary areas.
Control of materials

We believe that legislation providing for the allocation of scarce materials is called for by the present situation and that it offers good promise of being effective. A law imposing some control on the distribution and use of industrial critical materials would remove causes of dislocation in industry. This, besides assuring the effectiveness of the defense program, would make civilian production more orderly, thus enlarging output and reducing costs by lessening the scramble for materials in short supply. By thus promoting more efficient productive operations, such a limited control-of-materials act could be expected to have a noticeable, though no spectacular, effect in checking further inflation or even easing prices at important industrial points. Steel, lead, tin, copper, zinc, and several other minor commodities head the list of materials on which controls are now needed or likely to be required by the stockpiling program.

The limited compulsory control now exercised over tin and antimony, with export priorities and import restrictions, and the voluntary system of control of steel should be consolidated, with necessary additions, in a coordinated control-of-materials office. Powers of this agency should not be limited to establishing priority of claims. This alone does little or nothing to lessen the intensity of the competition for scarce goods and its inflationary consequences. The law must provide that nonessential or less essential uses be prohibited to the amount necessary to relieve the pressure of demand on the market to a noninflationary point or to such degree of deflation of overstimulated prices as may be deemed necessary.

While a large number of producers claim that they can themselves allot materials and restrict supplies as effectively and more flexibly
than a control agency, our observation leads us to believe that their allocation will inevitably "take care of their customers" in such a way as to nurture the good will and retain the patronage of these customers after the emergency has passed. Since the post-emergency market is by definition one in which the expansion of nonessential uses will be the very essence of business enterprise, the criterion which governs voluntary allocation is basically incompatible with the needs of a situation tight to the point of inflation and market demoralization. If government is to do anything significant toward combating inflation, power to impose reasonable restriction on the use of scarce materials must be provided at once and applied with such timing and intensity as the unfolding conditions require.

The law should provide for maximum use of voluntary cooperation in carrying out the actual allocation of materials. Voluntary control schemes thus far have not been highly successful or adequate to the demands of the situation. We believe, however, that if positive limitations of use and principles of priority are laid down in the act, a large amount of voluntary administration of details can be secured. Emphasis should be placed on accountability for results in the spirit as well as the letter of the law.

Price and Wage Controls and Rationing

The basis on which the Council previously concurred in proposals to reestablish some authority for price and wage control and rationing was not that the Nation was then confronted with an economic situation comparable to wartime. The basis was, rather, that in certain strategic points in the economy relative shortages and extraordinary demand combined or threatened to combine to drive the price-wage spiral upward, and that pointed
and discriminating measures might need to be invoked to combat these specific pressures and to isolate their consequences. These selective measures were to be regarded as supplementary to more general fiscal measures, such as a budget surplus and credit controls. When and how far they would be applied would depend on how much anti-inflationary affect the general measures.

The developing economic situation, reviewed at the outset of this memorandum, does not make a case for complete abandonment of the proposals earlier made to authorize some controls that would be used selectively.

Nor does it in our judgment justify proposals for controls more rigorous and far-reaching than those earlier made. In fact, they are lessened in so far as there was then an acute shortage in the corn crop and poor crops in Europe.

On the subject of price control, it is probably not practical to identify in legislation the precise items for which the exercise of control might prove to be of some utility. On the other hand, we feel that a request for sweeping and unreserved authority to control any and all prices would be economically unwise inasmuch as it would be interpreted to imply that things present or foreseeable in the economic situation called for such sweeping, drastic, and complex action. Further, we feel that it would be strategically undesirable from the viewpoint of economic psychology, and would also militate against the securing of such limited measures as might be helpful, if too large a gap were to be created between what is asked for and what may reasonably be needed. Furthermore, it would entail a drain on funds and on administrative personnel of scarce kinds. It would also multiply uncertainties in the business world which is already wrestling with complicated problems of rapidly changing costs and markets and such special factors as the burning-point decision.
Faced with this dilemma between too little government action and too much, we can offer no more refined suggestion than a repetition of the general formula contained in the price control proposal earlier made, i.e., that the language be broad enough not to prevent selectively as circumstances may require, but not so broad as not to stress the point that the exercise of authority would be highly selective rather than general.

[Mr. Kiewe does not see any practical midway ground of selective controls which would not break down in practice owing to the large number of articles collateral to those on which initial control would be imposed.]

On the subject of wage control, we cannot see economic merit in authority to control prices unaccompanied by any firm power to deal with wages, since the two are inseparably connected. However, we do not feel that a wage proposal at this time should be so broad as to contain even the implication that full scope will not be afforded to collective bargaining, or that the Government would have the authority to draw itself into the center of every wage negotiation. The formula best suited to this purpose would seem to be the one earlier advanced, i.e., that the Government should be empowered to disapprove such wage increases as would make it unrealistic to maintain any price ceiling it imposed. This formula should contain an exception to cover hardship cases where wages have lagged substantially behind the cost of living, even though an adjustment of such wages might require some price increases.

On the subject of consumer rationing, we are not prepared to suggest any variation in the formula earlier proposed, and we feel that if selective
authority for price and wage action is made available it should be rounded out by some authority to ration commodities such as meat.

We suggest, also, that consideration be given to a supplementary proposal that would require notification of proposed price increases on the part of corporations of substantial size, so that, aside from the exercise of such authority as may be granted, the force of publicity and public opinion may be brought more effectively to bear upon such proposed price increases.

We further suggest that this is the time to urge the Congress to amend the recent agricultural act to make the long-range program effective January 1, 1949, instead of January 1, 1950. The Steagall measure, which in the closing rush of the Congress, was extended through 1949 contained rates which were designed to stimulate production as a war measure and continue them enough after the war to give the farmers adequate guarantees. Owing to the late date on which the war was officially ended, these stimulative rates have been continued longer than was intended, though the nature of the impact was modified by crop conditions here and abroad last year. It would seem now that the substitution of the flexible supports of the new bill would somewhat ease food prices and at the same time lessen the Government's exposure to heavy outlays in case of very large crops this year and next while still giving farmers adequate protection.

We conclude with the word of caution that our peacetime economy and our popular psychology have proceeded to the point where controls would be difficult to establish and even more difficult to enforce. Consequently, the most that can be said for them at this time is that they should, if
excellently administered, add some weight to available anti-inflationary pressures. It follows that any claim that these controls would provide a quick and easy solution for the whole problem of inflation would be an overstatement of dubious help in meeting the real economic dangers confronting the country.

Also, we would like to add that, while it may not be practical to write a great amount of detail into legislation, there should be no repetition of the situation which existed last fall. Thus, the proponents of legislation could offer but little, consistent or compelling explanation or justification of why broad, general authorizations were being requested of the Congress or how they would be exercised if granted. If proposals are again going to be made, responsibility should be centrally located and forcefully exercised to develop a sharing that the proposals being made have been preceded by study and reflection and that, if the authority requested were to be granted, it would be succeeded by intelligent and dispassionate action. This is a task primarily for the operating agencies, and it is not enough to tell them that they should "get in line" with a formulated general policy. Instead, only if the formulated general policy rests upon the experience and knowledge of the operating agencies, while being coordinated from the overall viewpoint, can there be any presumption that the formulated general policy is meritorious.

In conclusion, we are disturbed by reports that proposals are contemplated which would authorize the re-establishment of "another GPA", which presumably would need to be accompanied by counterparts of the War Labor Board and the War Production Board to synchronize price-wage-materials policy. If action is to be highly selective, and only thus could there be any prospect for accomplishment, consideration should be given to utilizing existing Departments
and special agencies — such as Agriculture and Commerce — for the processing of the interrelated price-wage-allocation problems in various commodity areas. On top of this, there would need to be only a very small policy coordinating group, preferably headed by a single Administrator.