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UNITED STATES DEPARTMENT OF AGRICULTURE
Bureau of Agricultural Economics

NATIONAL INCOME AND THE GENERAL PRICE LEVEL

Summary of address by M. Joseph Meehan, Assistant Director, Office of Business Economics, U. S. Department of Commerce, at the 24th Annual Agricultural Outlook Conference, Washington, D. C., October 7, 1946.

To get a proper view of the economic situation as it is likely to look during the next year or so requires an accurate appraisal of the significant elements in the present picture and some perspective on their relation to past as well as future developments.

During the initial phase of the reconversion period the trend of the gross national product--which is simply the market value of goods and services supplied by the private sector of the economy and by the Government--was reduced from a war peak annual rate of \$208 billion to about \$180 billion. This was a decline of about one-seventh, and was concentrated in the Government segment which went down to \$41 billion, from \$100 billion. However, private spending for goods and services increased by about \$31 billion, enough to offset more than half of the reduction in Government spending.

By the end of the first quarter of 1946, the postwar decline occasioned by reconversion and demobilization was halted. With rising output--and rising prices, as controls have been eliminated in many instances and eased in others--the gross national product has advanced to an annual rate of about \$195 billion in the third quarter, according to preliminary data. This includes \$32 billion in Government outlays, private capital formation aggregating about \$35 billion, and consumer expenditures sufficient to account for the remainder.

Several factors help to explain why such a decline in the gross national product was not accompanied by more evident signs of adjustment in trade and industry. The flow of income to individuals was maintained at a high rate, the decline there being only about a quarter of the drop in the gross national product. This was largely the result of the reduction of business taxes which reduced the gross national product but did not directly influence income payments, and a rapid rise in transfer payments to individuals. The latter, as a result of discharge benefits to military personnel, and unemployment aids, rose from an annual rate of around \$6 billion to \$12 billion. The flow of proprietors' incomes was sustained.

The big decline occurred in wages and salaries, which dropped from about \$115 in early 1945 to less than \$100 billion a year later. This drop was about equally divided between military and civilian payments.

How did consumers increase their expenditures by \$20 billion in a period when their income declined by \$7 billion? Principally because (a) their tax liabilities were reduced by the downward adjustment of individual income tax rates; and (b) the abnormally high wartime rate of savings went down to little more than in the prewar period: from a savings rate equivalent to about one-fourth of incomes, savings declined to about one-eighth.

We have passed through the first year of reconversion and many of its problems are now behind us. Goods are flowing in increased volume and this increase will continue from here on. We are not at peak yet, although we can now see that high volume output of finished goods is not far ahead--barring important prolonged work stoppages.

During the last quarter we have witnessed a further rise in industry output, a marked advance in prices, continued increase in capital expenditures by business, and a substantial upping in the amount spent by consumers.

Current Evidence of Problems Ahead

Having thus briefly examined the postwar path to the present, it is necessary to go into more detail in order to establish the motivating factors and the likely direction of future movements.

Of the three categories of spending which make up the market, the Government was the more important element on the demand side during the war. It then took half of the gross national product, and financed more than half of that expenditure by borrowing. This naturally contributed to postwar inflationary pressure. Now, however, the Government cash income-outgo is a neutral factor, and it is likely to become before the end of the current fiscal year a negative factor--in the sense that cash income is very likely under conditions of rising prices and income to substantially exceed cash expenditures.

Therefore, the private segment will at least be on its own, and the closest examination must be made of the two remaining main categories of spending which it embraces. The first of these, the so-called capital formation, is made up of business expenditures for construction and equipment, residential construction, changes in inventories and the net export of goods and services. It was mentioned earlier that aggregate expenditures in this category have risen to a current annual rate approximating \$35 billion. This is about five times what they were at the end of the war, and represents a larger share of the national output than for any year since 1929.

The dynamic elements in the capital formation area are now clearly (a) construction and equipment outlays, and (b) inventories. The net foreign trade balance is currently high, but because of its present composition the recent total is not likely to be exceeded.

The rate of inventory accumulation has recently accelerated. It has moved up in the last four quarters in progressive steps from an annual rate of \$1 billion in the fourth quarter of 1945 to an estimated \$12 billion annual rate in the quarter just ended. Although price increases have been a factor in this increase, they do not account for the major portion of it.

Inventories are still low in relation to current sales, and the inventory position of business is unbalanced. There is still room for increase and there is reason to expect that inventories will continue to expand in the months just ahead. Nevertheless, when inventories cease expanding, demand drops and somebody's sales decline. If inventories are then found to be too high, sales are reduced by more than the incremental amount which was being added.

With total production increasing not only to satisfy ultimate consumers and to fill the inventory pipelines of those whose orders are based on future sales expectations, it should be kept in mind that when these inventory pipelines are filled the relationship of finished goods to total goods produced will return to normal.

Granting that there is room for considerable further expansion in construction and equipment outlays, it is evident that these would have to increase by about one-third to maintain total capital formation at the current rate without the contribution now provided by continuing inventory accumulation. The inventory situation is patently a key factor in appraising the business outlook.

The third, and last, major category of spending to be examined is consumer expenditures which, with capital formation, comprises the private segment of the gross national product.

Consumers are now spending out of their disposable income--which is the income they receive, less taxes--an amount which is about in line with the pre-war relationship of their expenditures to such income. But current statistics show that they are expending much more for non-durable goods (food, clothing, etc.) and much less on durable goods (automobiles, electrical appliances, etc.) than they did in the prewar period. As increased volumes of durable goods have become available to consumers there has recently been a tendency for expenditures on such items to rise, and for expenditures on nondurables to decline. This is after allowance for price changes since sales of both types of goods have been increasing in terms of currently advancing prices.

With the supply of goods continuing to mount, will consumer expenditures be sufficiently high to maintain the upward pressure on prices? The answer to this question is derived essentially from the fact that the rising trend in the value of consumers' goods output will not of itself bring about a corresponding increase in the disposable income of consumers. This is so because a large part of the value of the added output will be drawn off into taxes or will be retained as undistributed profits.

Up to the present time we have encountered no difficulty in maintaining disposable income at a rate sufficient to underwrite expenditures for a rising volume of finished goods sales to consumers. However, the explanation is that it has been possible to increase consumers' expenditures at the expense of a reduction from the abnormally high wartime level of savings. As the rate of savings was cut in half--to \$20 billion--it is apparent that this method of financing consumers' expenditures cannot be relied upon indefinitely.

What are the Prospects?

This last consideration, and the preceding point about inventory accumulation gradually or suddenly diminishing, has some implications for the future level of prices.

Right now, demand continues high in relation to supplies and we still witness the effects of this in rising prices. There have been wide differences in movement among various types of commodities, but in the overall the rise has been substantial and is continuing.

Next year, with reconversion difficulties behind us and a high level of output of finished goods, we would expect the postwar price level to be subjected to more of a test than has been experienced to date. The testing level will be determined by the degree to which the advance in prices continues in the months ahead.

We may look for some of the underlying strength of the demand factors to be sapped next year, at the same time that the flow of goods is rising. With high-level output and more balanced operations established, improvement may be expected in the efficiency of production, and this is likely to have a favorable influence upon costs. Under conditions of lessened intensity of demand, this factor may also exert a downward influence on prices.

As some of the temporary demand subsides, of which inventory buying is the most important single element although there are others, it is possible for other expenditures to increase at a rate sufficient to take up the slack. Yet, analysis of the underlying position of consumption--and the segments of capital expenditures other than inventories--suggests caution in accepting the probability of this eventuating with the requisite precise timing.

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