

Inflation Since Korea and Bank Loan Expansion

Since the outbreak of hostilities in Korea on June 25, 1950 there has been a significant rise in the general price level, an increase which has been accompanied by a rapid expansion in bank loans during the last 6 months. There has been a tendency for many observers to conclude that this increase in commercial bank loans is the major cause of the price rise and that general monetary controls would have been effective either in eliminating the inflation or in reducing it to a bare minimum.

It is the purpose of this memorandum to study in some detail the inflation that took place since the Korean attack, to examine the relative importance of the various factors in the price rise, particularly the role played by private bank credit.

First of all, it is important to take a look at the nation's economic environment immediately before the Korean attack. The country had largely recovered from the 1949 inventory readjustment period. During the first half of 1950 prices had gone up slowly. The consumer price index rose by 2½% during this 6 months and wholesale prices were up 1½%, with farm prices heading the rise. The rise in industrial prices was less pronounced, although there was a rise in building materials and sharp rises in some metals and in rubber. The rise in prices was accompanied by an increase of more than 10% in the Federal Reserve index of industrial production during the first half of 1950 so that by the time of the Korean attack production had already exceeded the previous postwar peak reached in the fall of 1946. Inventory accumulation had begun early in the year and during the second quarter was proceeding at a substantial rate; corporate profits before taxes in the second quarter were already at an annual rate of over \$37 billion. Personal income was at an

all time peak rate of \$216 billion a year during the first half of 1950, swelled in part by the payment out of the Treasury of \$2-1/2 billion of National Service Life Insurance dividends. The beginning of another round of wage increases and the continued expansion of employment also characterized the period. The unusually high levels of residential construction activity during the first half of 1950 played an important role in the economic events of the pre-Korea period.

This was our economy at the time of the Korean attack -- an economy which was already operating at high levels of activity. Without Korea economic activity would probably have continued to expand through the second half of the year, and with continued upward pressures on prices. With Korea, however, the situation was altered significantly.

The Korean attack served not only to stimulate inflationary factors which were either dormant or were effectively counterbalanced in the pre-Korea period; it also served to stimulate a host of new inflationary pressures. The threat of an immediate all-out war had an electrifying effect on business men and on consumers, in whose minds the memories of World War II shortages were still fresh. Business men were particularly sensitive to the situation and it did not take them long to realize that the incidence of Government stockpiling of strategic materials and the needs of military procurement were matters of critical importance to them. Speculators saw the point too, and wasted no time in taking advantage of it. It is not surprising, therefore, that the Bureau of Labor Statistics spot index of market prices for 28 key commodities rose by 12% within one month after Korea. The climb continued so that just 6 months after Korea the rise was almost 50%. The prices of industrial raw

materials led the procession, with an increase of close to 50% for the 5 months period, with foodstuffs up a little less than 25%. Among specific commodities the price of steel scrap rose by 20% in the last 5 months. Cotton was up over 30%, lead almost 50%, print cloth over 30%, shellac over 60%, cottonseed oil over 70%, rosin 80%, lard 80%, wool-tops over 105%, burlap over 105%, silk about 115%, tin 140%, rubber over 160%, and tallow 280%. There is typically a significant lag in the reflection of these prices in the overall indexes. The slower moving B.L.S. all-commodity index has, however, already gone up by more than 15% since June and there has been a rise of 5% in consumers prices through December alone.

These price increases for specific commodities are indicative of areas which responded swiftly to the changed environment after Korea. They are areas of price increases which occurred not necessarily as a result of any monetary phenomena but rather as a direct result of the anticipation of physical shortages in their impact upon thousands of individual business men. It is no wonder then that business inventories rose substantially during this period to new all time highs, despite the existence of a huge buying wave by consumers. The buying of metals is a case in point. Smelter stocks of refined copper and lead, for example, both reached peaks for the last decade during the year before Korea. By December 1950 stocks of copper had declined 77% from the peak and stocks of lead were down 64%. In addition, zinc stocks were down 90% during the calendar year 1950. The prospect of shortages was uppermost in the minds of many consumers as well and the decision as to whether to buy a new automobile loaded with extras today or to wait 6 months and either get no car at all or

have to pay 10% more for it was really no decision at all.

The primary characteristic, then, of the inflation since Korea has been an unprecedented rush for goods. Not only was price secondary in the events of the period; means of financing was often secondary too. The expansion of bank credit did contribute to the inflation, and unnecessary loans should have been curtailed. Nevertheless, much of this expansion in prices probably would have taken place without any extension of bank credit at all. During the calendar year 1950, for example, total corporate requirements for funds (exclusive of additions to inter-corporate receivables and cash and Governments) amounted to about \$28 billion. This money was required to pay for expenditures on plant and equipment, on inventories, and to cover the net increase in receivables. How was this \$28 billion of expansion financed? Almost \$20 billion came directly from retained earnings and current depreciation allowances. Some of the balance came from new security issues. One billion dollars came from new mortgages. Only \$2-1/2 billion came from expansion in the commercial and industrial loans made by banks.

Thus private bank credit only accounted for about a tenth of the 1950 needs of corporations. Had bank credit been unavailable more of the \$44 billion of cash and Government securities held by these corporations would undoubtedly have been utilized. Borrowing happened to be a simpler and more comfortable avenue of approach to many corporations to meet their immediate needs. It was not necessarily the only approach. If the increase in borrowing had been cut down drastically there is no assurance that the price rises since Korea would have been much less dramatic.

Somewhat the same sort of analysis is pertinent in characterizing the consumer buying rush. The desire for acquisition of the goods was primary. The fact that there was a small rise in price may have been distasteful, but it obviously offered no effective deterrent to anyone who believed that prices were going to rise still further. The means by which the purchases were financed was in many cases of even less importance. Immediate imposition on July 1, 1950 of stringent consumer credit controls would have helped significantly. In itself, however, even that would not have been adequate.

One of the reasons why this is so relates to the \$200 billion of liquid assets that individuals have at the present time, which provides a reservoir out of which vast amounts of consumer spending can take place without one iota of bank credit extension. As a matter of record the rates of turnover on demand deposits, on savings accounts in both mutual savings banks and savings and loan associations, and on savings bonds all increased during the third quarter consumer buying spurt. This turnover of liquid assets -- really the velocity of money as it is referred to traditionally -- is a factor which has a potential for inflation not generally appreciated.

Private bank credit has a somewhat less important role in the economy today as compared with years past. In contrast the role played by accumulated private savings is much greater. For example, before World War I the outstanding amount of private credit extended by commercial banks (loans plus corporate and municipal securities) was about equal to the total liquid assets of all private investors put together (individuals, corporations, and other nonbank institutions). Just before World War II -- 25 years later -- liquid

assets were three times the amount of private bank credit; now the ratio is approximately 4-1/2 times. The comparison can be put another way. In 1914 the total output of the country was about 2-1/2 times the amount of private bank credit outstanding. In 1939 it was almost 4 times and it is almost 5 times now.

This does not mean that private bank credit is of no significance any more and that we need not worry about it. Quite the contrary; strenuous efforts should be made to restrain its expansion in specific areas. It does mean, however, that private bank credit is only one of a number of factors involved in the financing of the increases in demand for goods during the last half of 1950. And it was the demand for goods which was the basic cause of the inflationary price rises, not the way in which the buying was financed.