Chapter 2

Prosperity With General Price Stability

THE EXPANSION of the economy continued without pause throughout the past year. Virtually every month new records were achieved in production, employment, trade, and income, only to be exceeded again a month or two later. The average level of consumer prices, on the other hand, remained quite steady. Full employment, rising incomes, and a stable dollar have been cherished goals of our society. The practical attainment of these ideals during 1955 was the year's great economic achievement. To derive from recent experiences useful guidance for the future, we must first analyze the processes that led to that achievement. The diversities of fortune in our vast economy will receive full attention later in this Report.

I. How the Process of Expansion Cumulated

With governmental policies fostering a mood of widespread confidence, the general economic readjustment that followed the close of hostilities in Korea proved brief and mild. Prompt and extensive easing of credit conditions, prompt and sizable tax reductions for both individuals and businesses, improved housekeeping policies on the part of government, and a broad program for reinforcing the floor of security for individuals, all helped to pave the way for a resumption of economic growth. But the basic drive of the expansion came from private citizens, who were willing to risk accumulated savings on many new tools of production, to borrow as well as to save, to work longer hours and in increasing numbers, and to spend freely on new homes and current consumption in order to meet the better their aspirations for good living. Foreign economic conditions, especially in Western Europe, also favored domestic expansion. Our commercial exports, which during most of 1954 ran well above the levels of the preceding year, spurted in the closing months of the year to a still higher level.

Already in the fall and winter of 1953, some signs of emerging recovery became visible. Stock prices, which are an imperfect but nevertheless significant indicator of business sentiment, began rising in September and approached the year's highest values before the year ended. In December, the new orders for durable goods received by manufacturers began a slow recovery from their brief but sharp decline of preceding months. The following month contracts for commercial construction commenced a sustained advance, reinforcing the continued rise of housing starts. Liabilities involved in business failures, which had increased sharply during 1953, reached their peak in February 1954, then moved to lower levels. In the same month, bank debits outside New York City, which have long provided economic observers with a rough clue to the circulation of money in commercial and industrial markets, resumed their advance. In the meantime, interest rates on loans of both short and long maturities, which had been falling for some months, kept on their downward course, and credit became more readily available to businessmen, homeowners, and consumers.

These early improvements in financial markets and in the preparatory stages of investment spread quickly to other parts of the economic system. The slow but continued rise in the Nation's disposable personal income, which kept defying the contraction of output and employment, also made its influence felt. So too did the high level of exports, which reflected the resurgence of the economy of Western Europe. In December 1953 the decline in the production of nondurable manufactures came to a halt. In February 1954 retail sales resumed their advance. In April the decline of the average workweek in manufacturing ceased. Business inventories, which had been exerting strong downward pressure on economic activity, continued to decline. However, their rate of decline diminished materially, so that a larger part of people's increasing purchases was met by current production instead of withdrawals from warehouses or dealers' shelves. Federal outlays on goods and services accelerated their downward course, but the rest of the economy was in a mood to absorb the substantial resources released by the Federal Government. Between the first and second quarters of 1954, consumer expenditures increased, and so too did private investment in fixed capital, foreign investment, and State and local expenditures. In response to these developments, total production stopped declining early in 1954, then held to a sidewise course for several months, while the realignment of orders, sales, and inventories smoothed the path for a fresh advance.

About mid-1954, with the drop in Federal expenditure abating, the continued surge of private spending tipped the economic balance definitely on the side of expansion. Between July and September the output of durable manufactures as a class, mineral production, and nonagricultural employment resumed their advance. By then the recovery had already gathered sufficient strength to launch both total production and total employment on a new expansion. Imports soon began rising again, as they usually do when economic activity increases. The economic contraction, one of the very briefest and mildest in the entire history of business fluctuations, was over. It had lasted about 12 months during which total output declined 3 to 4 percent, while employment declined 2½ percent and personal incomes after taxes actually increased.

CHART 5

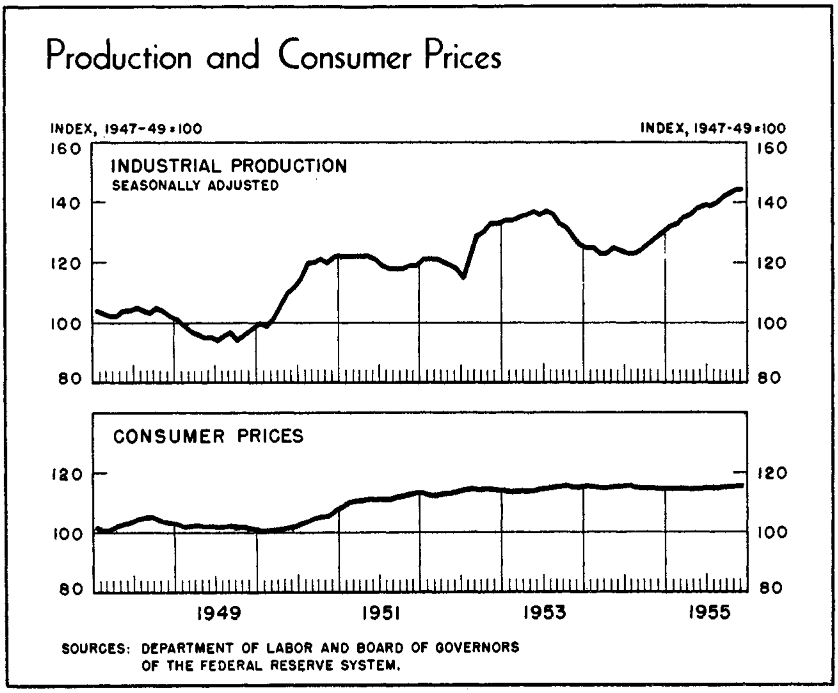


CHART 6

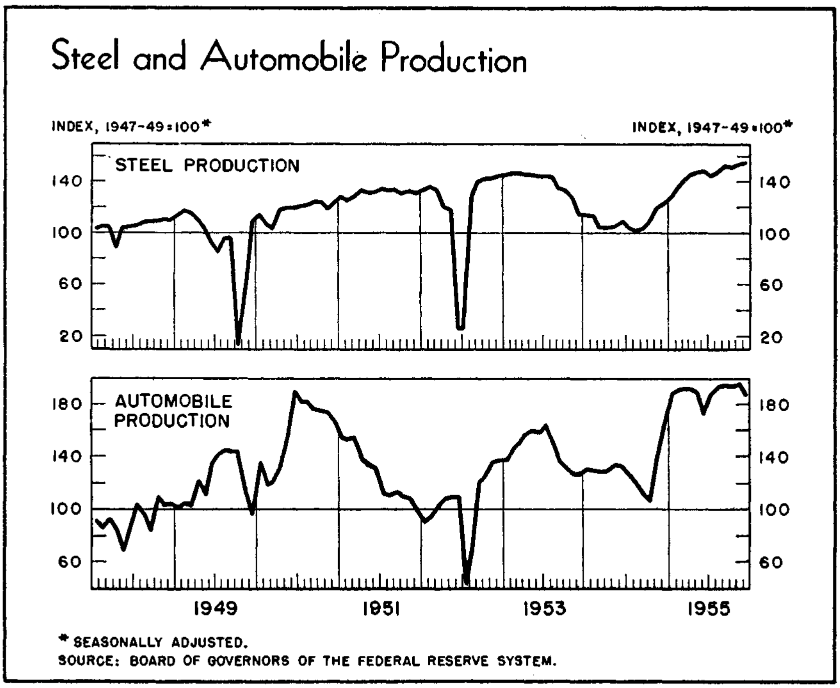
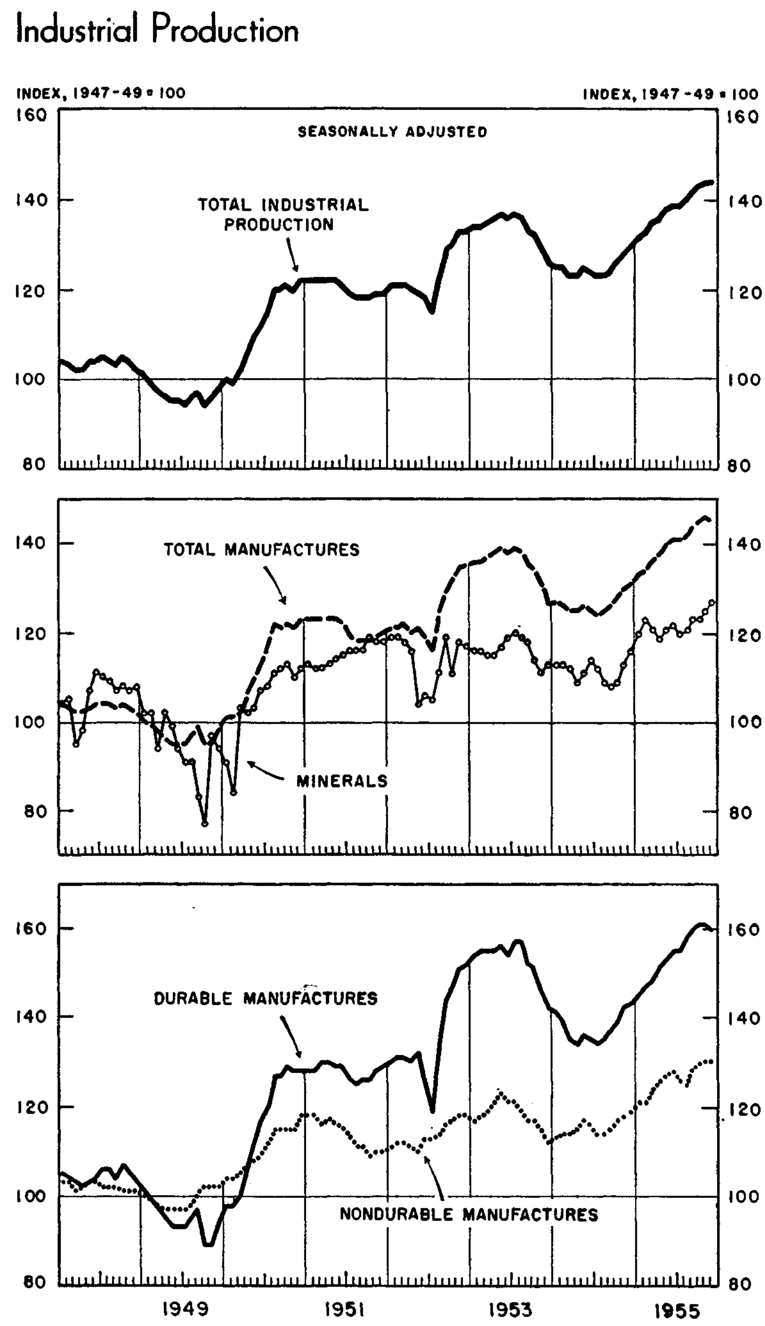


CHART 7



SOURCE: BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM.

CHART 8

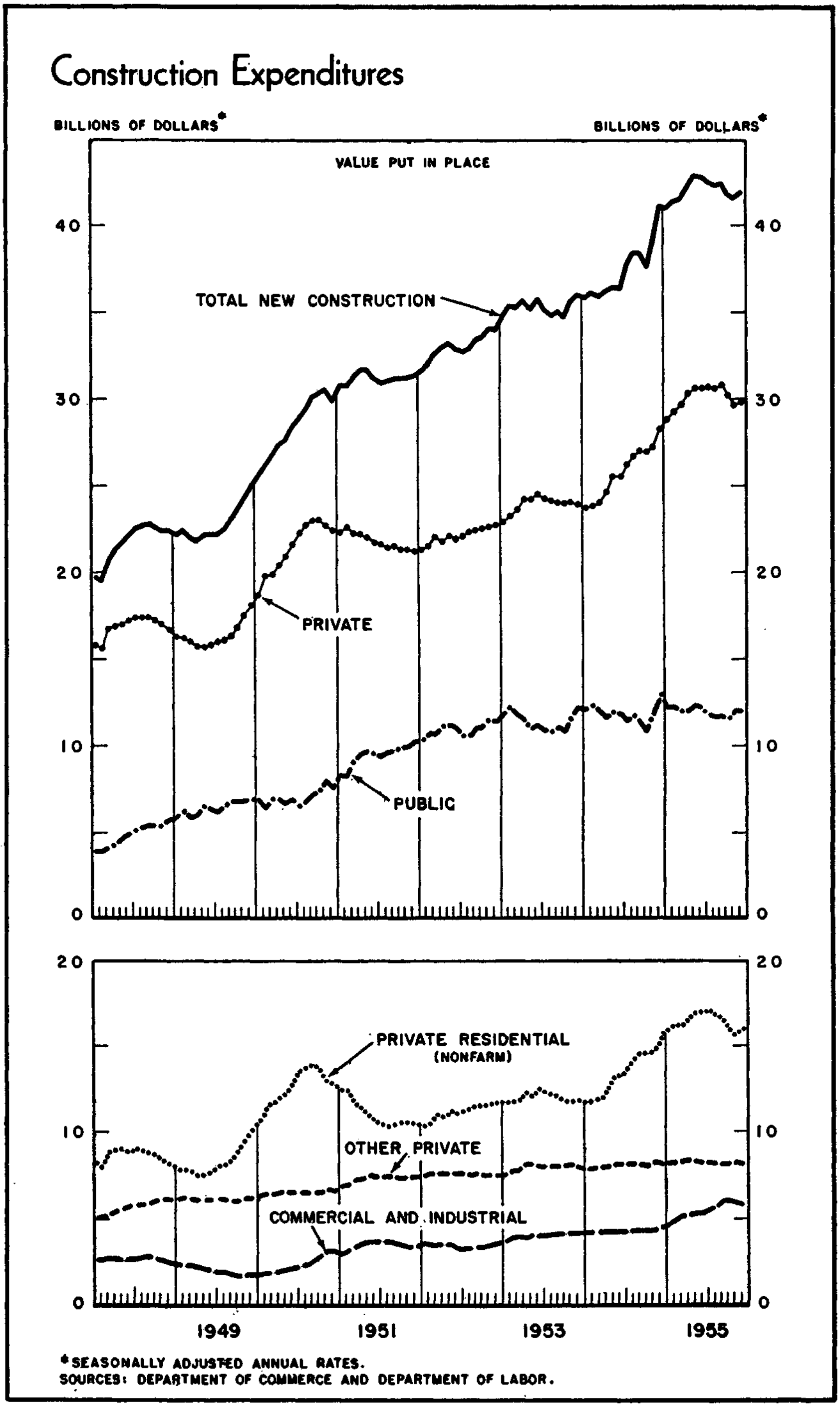
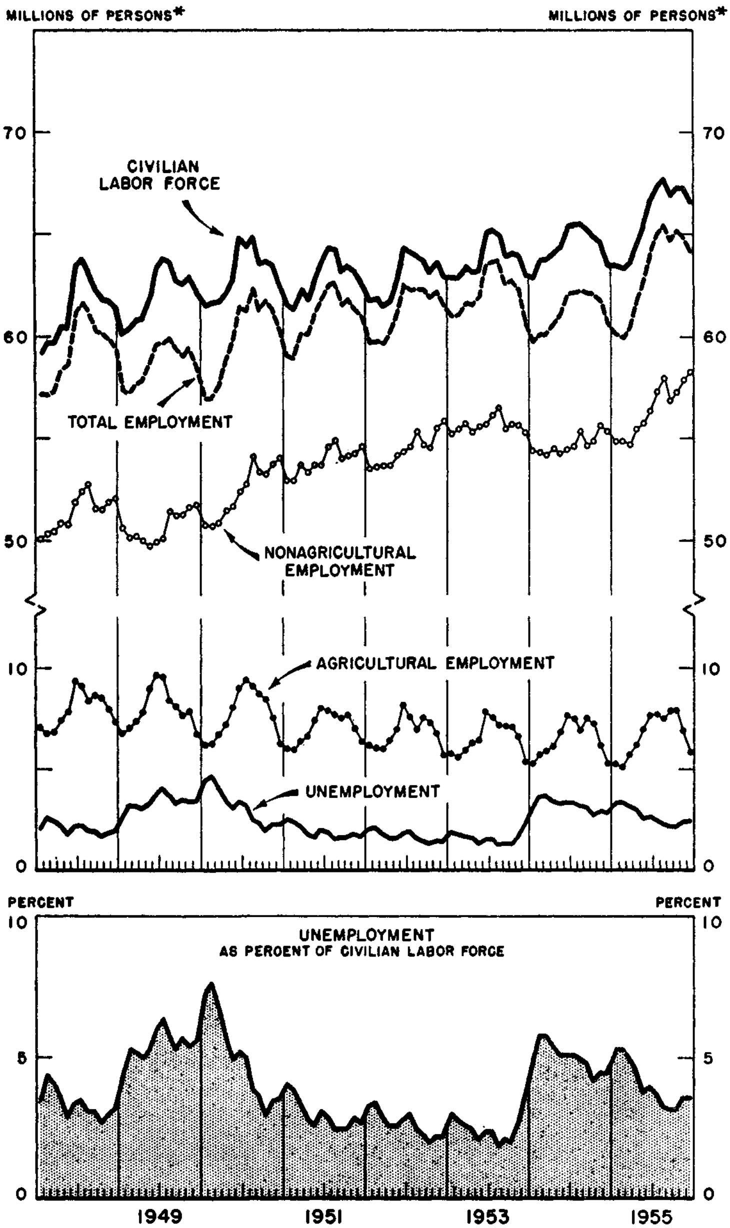

Construction Expenditures
BILLIONS OF DOLLARS*
BILLIONS OF DOLLARS*
VALUE PUT IN PLACE
TOTAL NEW CONSTRUCTION
PRIVATE
PUBLIC
PRIVATE RESIDENTIAL (NONFARM)
OTHER PRIVATE
COMMERCIAL AND INDUSTRIAL
40
30
20
10
0
20
10
0
1949
1951
1953
1955
*SEASONALLY ADJUSTED ANNUAL RATES.
SOURCES: DEPARTMENT OF COMMERCE AND DEPARTMENT OF LABOR.

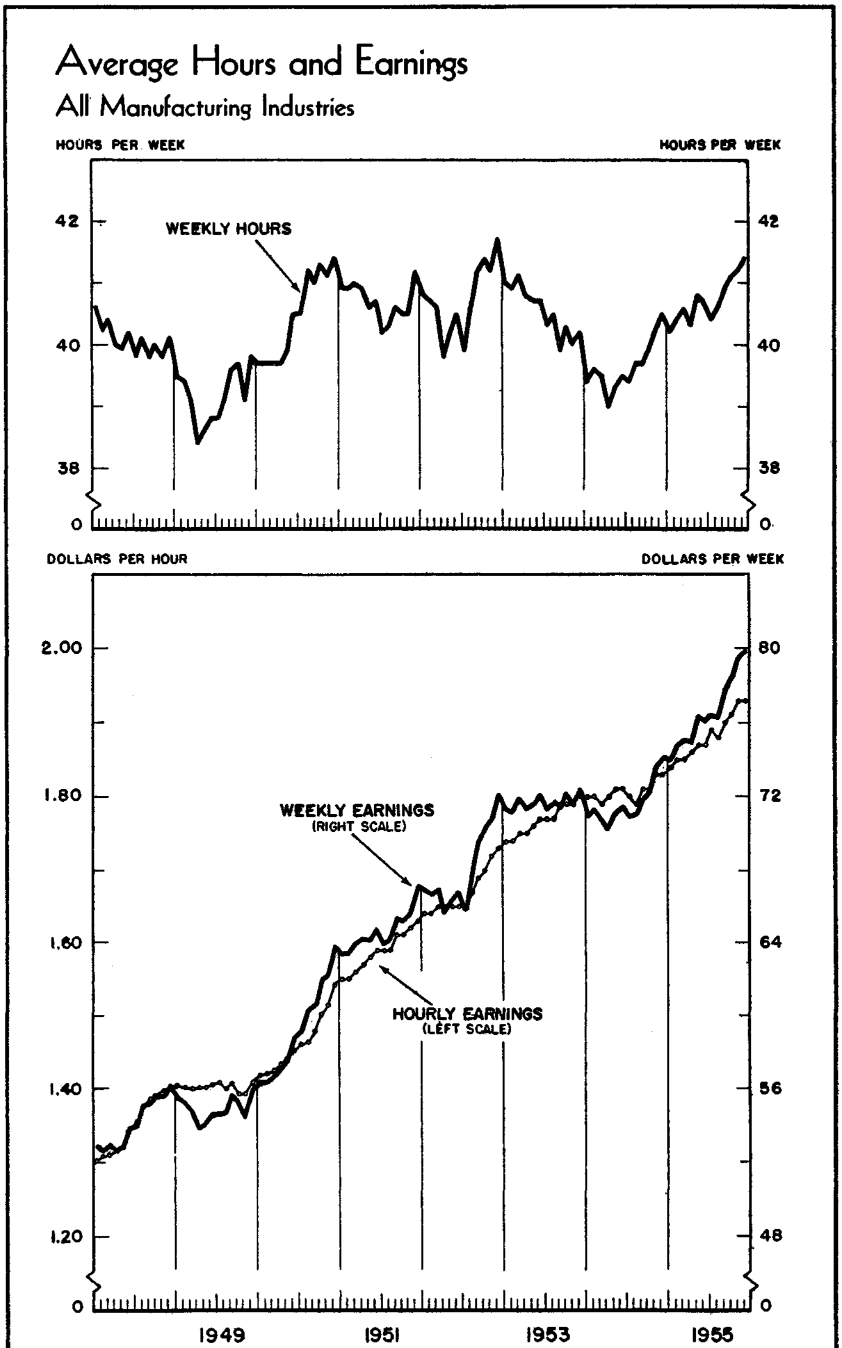
CHART 9

Labor Force, Employment, and Unemployment



* 14 YEARS OF AGE AND OVER.
SOURCE: DEPARTMENT OF COMMERCE.

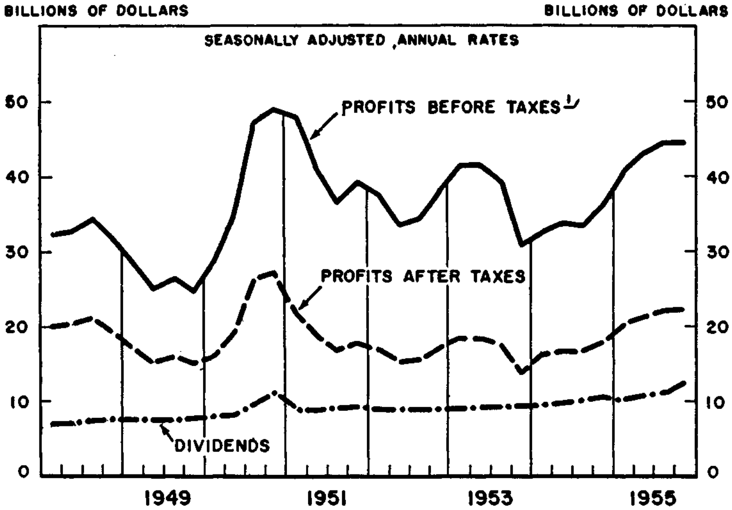
CHART 10



NOTE: DATA PERTAIN ONLY TO PRODUCTION WORKERS.
SOURCE: DEPARTMENT OF LABOR.

CHART 11

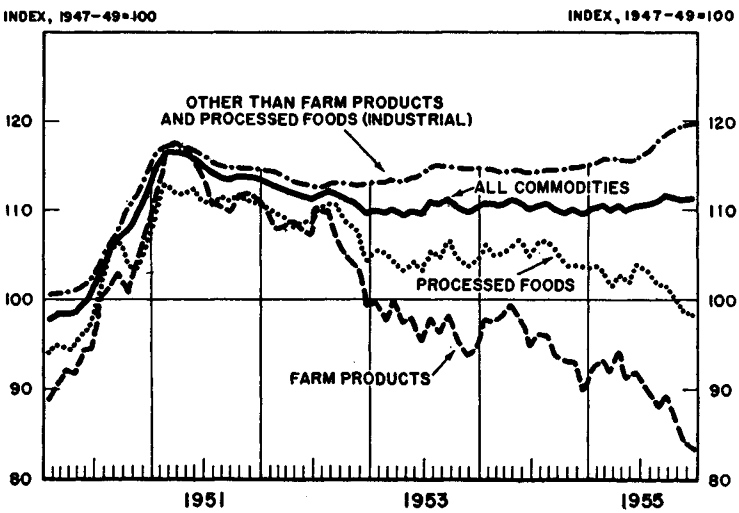
Corporate Profits Before and After Taxes



1/ NO ALLOWANCE FOR INVENTORY VALUATION ADJUSTMENT.
SOURCES: DEPARTMENT OF COMMERCE AND COUNCIL OF ECONOMIC ADVISERS.

CHART 12

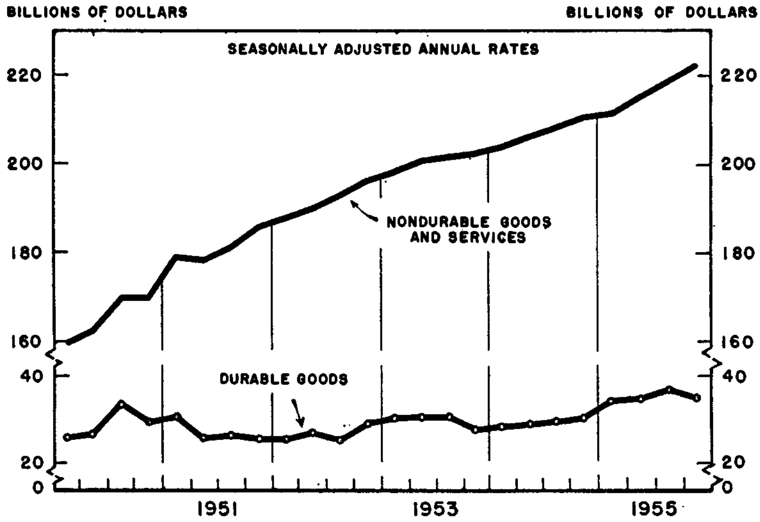
Wholesale Prices



SOURCE: DEPARTMENT OF LABOR.

CHART 13

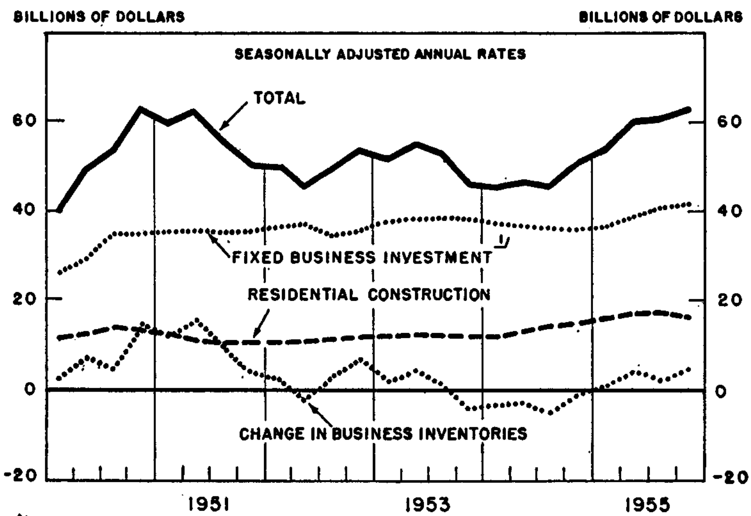
Consumer Expenditures



SOURCES: DEPARTMENT OF COMMERCE AND COUNCIL OF ECONOMIC ADVISERS.

CHART 14

Gross Private Domestic Investment



1/ PRODUCERS' DURABLE EQUIPMENT AND NONRESIDENTIAL CONSTRUCTION.
SOURCES: DEPARTMENT OF COMMERCE AND COUNCIL OF ECONOMIC ADVISERS.

In succeeding months, while activity in some parts of the economy remained dull, the scope of the expansion became progressively wider. The decline of business inventories stopped in October 1954, and a gradual process of rebuilding stocks to meet the larger requirements of manufacturers and distributors got under way. The increase of industrial production was gentle at the start. But it rapidly gained momentum once the newly designed automobiles, which were destined to capture the public's fancy and pocketbooks, began rolling off the assembly lines in the fall of 1954. A spectacular advance of automobile production and rapid expansion of homebuilding stimulated expansion in the steel, lumber, glass, and a host of other industries over the entire country. Allowing for seasonal factors, automobile production increased 59 percent and housing starts 17 percent between August 1954 and January 1955; total industrial production increased 7 percent.

Before long even industries which had been hard-pressed for years, such as the railroads, coal mining, and textiles, felt the impulse of increasing activity all around them. The output of consumer soft goods industries, which generally increased throughout 1954, rose more rapidly in the first half of 1955. The like was true of commercial construction, except that the acceleration was greater and continued longer. Outlays on industrial plant, machinery, and equipment, which kept declining until the early months of 1955, joined the expansion in the spring. Total business expenditures on plant and equipment increased sharply after the first quarter of 1955, rising 20 percent by the end of the year. The major impetus of expansion thus shifted increasingly from the automobile and homebuilding industries to business construction and the machinery and equipment trades. In the course of this process the expansion became more widely diffused and better balanced, and a groundwork was laid for continued growth of productivity in the future.

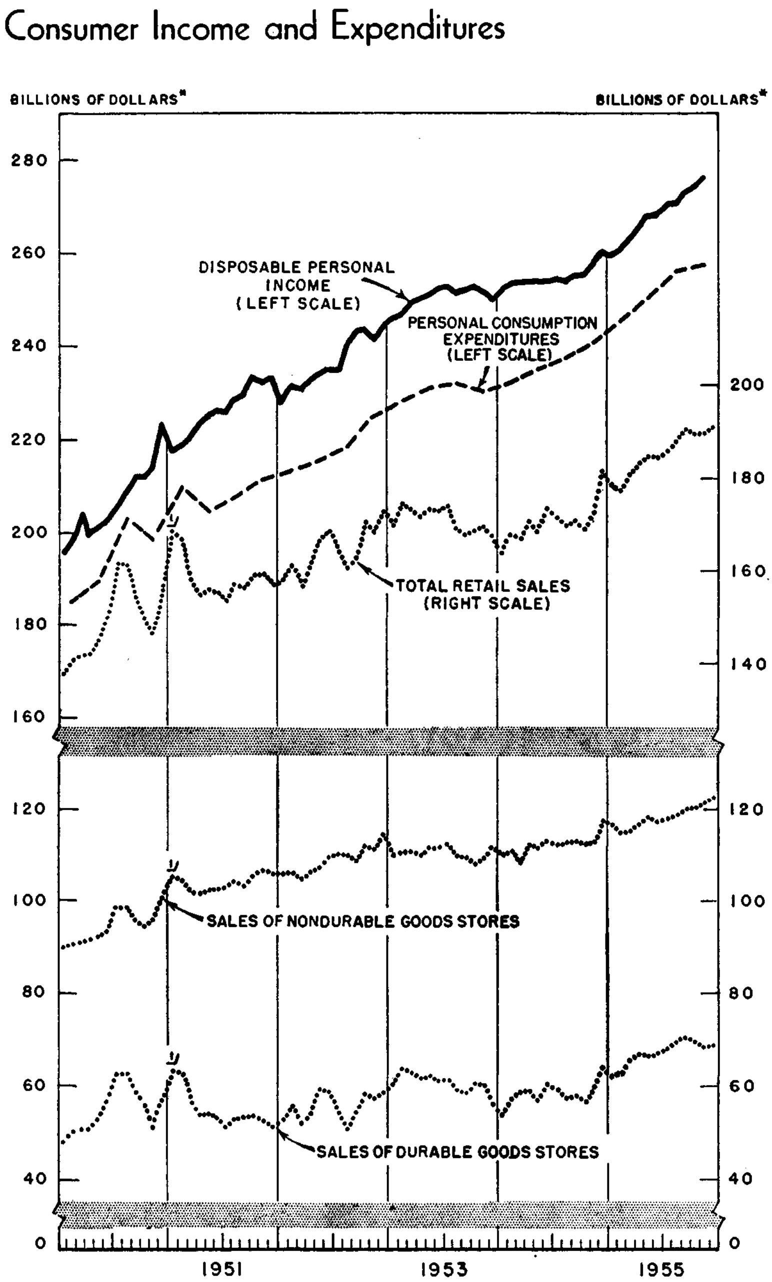
As industrial activity grew, part-time operations diminished and the resort to overtime increased. The average length of the workweek in manufacturing rose, crossed the 40-hour mark in November 1954, and still kept rising. Between June 1954 and June 1955 the average length of the workweek increased 1.6 hours in metal mining, 5.8 hours in bituminous coal mining, 0.9 hour on the railroads, 1.2 hours in durable manufactures, and 1.0 hour in nondurable manufactures. The numbers employed rose slowly in the initial stages of the expansion, since many businesses found that they could handle moderate increases in output with the employees on hand. However, after the turn of the year, as the advance of production continued and spread outward, jobs expanded swiftly. Between the last quarters of 1954 and 1955, employment increased by over 3 million. Meanwhile, unemployment declined despite the tremendous numbers, especially of women and young people, who were attracted into the labor market by high wages and widening opportunities. By mid-1955 unemployment at large was well below 4 percent of the labor force. The unemployment rate among married men living with their families, who form the hard core of the labor force, fell below 2 percent.

In the initial stages of the expansion both wage rates and prices, on the whole, moved little. Since increases in production ordinarily did not require proportionate increases in labor input, labor costs per unit of output declined on the average. With unit profit margins widening at the very time when the volume of sales was increasing, profits rose rapidly. But shortly after the turn of the year, unit labor costs stabilized, then began rising. The increase of overtime at premium rates of pay, higher wage rates and fringe benefits, greater resort by business firms to older and less efficient units of equipment in order to meet the pressing requirements of their customers, and the growing difficulties in finding suitable workers, all served to increase unit labor costs. Their advance became marked around the middle of 1955 and in turn exerted persistent and increasing pressure on both profit margins and prices. Favored by the state of demand, the average of industrial prices in wholesale markets, which had increased only about 1 percent between August 1954 and June 1955, rose 3½ percent in the next six months. The rise in aggregate profits tapered off after the first quarter of 1955, but profits generally continued to improve. With varying shifts of pace, both wages and profits therefore reflected the advance of prosperity and favored its continuance, but only if due restraint were exercised by both business and labor.

Not only did the flow of incomes to individuals from production rise, but the rate of rise increased. Corporations paid out larger dividends to their stockholders and at the same time increased still more rapidly the earnings retained for reinvestment. Interest payments increased. So also did the income of proprietors, except of farm operators whose record output during 1955 added to the excessive supply of agricultural commodities. Much the largest increase, both in dollars and relative to the whole, occurred in labor income. Taken altogether, the annual rate of disbursement to individuals from production increased by 6.8 billion dollars between the second quarter of 1954 and the first quarter of 1955. The disposable personal income—that is, income after taxes—increased a little more. In these months the restraints on the growth of disposable income, which are ordinarily exercised during an economic expansion through a rise in income tax payments and a decline of unemployment compensation, were more than offset by the effects of the tax and social security legislation of 1954. After the first quarter of 1955, the normal fiscal restraints on the growth of disposable income became operative again; but in the meanwhile, personal income from production increased rapidly and disposable income was able to grow at a much higher rate than before.

In these circumstances substantial increases of consumer spending could be expected and actually occurred. The rise in consumer spending was not, however, a passive accompaniment of rising incomes. On the contrary, it was a highly dynamic factor in the process of economic expansion. Con-

CHART 15



*SEASONALLY ADJUSTED ANNUAL RATES.
1/ NEW SERIES LINKED TO OLD SERIES.

SOURCES: DEPARTMENT OF COMMERCE, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, AND COUNCIL OF ECONOMIC ADVISERS.

sumers were of a mind to buy better things and increase their spending. This pervasive attitude, combined with the willingness of women and young people to take on jobs so that their families might better approximate the plane of living they wished to attain, has been an outstanding feature of recent experience. These factors were basic, and they were reinforced by aggressive selling efforts of businessmen, who sought out customers more energetically than had become customary in recent years, and offered liberal credit terms and often bargain prices as well. Consumer spending increased in all directions, but credit purchases of expensive items, notably of the 1955 automobile models, increased with special rapidity. Between the first and third quarters of 1954, the annual rate of disposable personal income rose by 1.4 billion dollars; the expansion in the rate of consumer spending was much larger, 5.7 billion. Over the next year disposable income increased 17.2 billion, and the increase of consumer spending was again larger—17.8 billion. Reflecting these developments, net personal savings out of current income diminished both in dollars and in relation to income. Personal savings, which constituted 8.3 percent of disposable personal income in the first quarter of 1954, fell to about 6 percent by the first quarter of 1955 and remained at that level through the third quarter.

Consumers made huge commitments for new homes, besides spending freely on current consumption. The confidence in the economic future so dramatically displayed by them was likewise felt and displayed by businessmen and investors. Favored by easy mortgage terms, homebuilding grew rapidly throughout 1954 and the early months of 1955. Expenditures on residential construction increased 26 percent between November 1953 and November 1954, then rose another 16 percent by mid-1955. When they declined somewhat later in the year, expenditures on business construction and producers' equipment kept on increasing. The reason was that soon after the turn of 1955 the expansion of business capital outlays had spread from the commercial sector to practically the entire range of industry. With sales rising, profits improving, depreciation reserves increasing, and more and more shortages of facilities emerging or impending, established firms were both willing and able to risk increasingly large sums on the expansion or modernization of plant and equipment. Meanwhile, the formation of new firms proceeded at a high rate and they added to the demands on the construction, machinery, and equipment industries. Between the first and final quarters of 1955, the annual rate of business expenditures on new plant and equipment rose from 25.6 billion dollars to 30.9 billion. Manufacturers of durable goods and of nondurables, commercial establishments, mining concerns, and public utility enterprises, all participated in the expansion of investment. Even railroads, whose low earnings had previously forced a sharp reduction of capital outlays, raised the annual rate of such outlays from 740 million dollars to 1,150 million.

The financial markets both reflected the growing exuberance of the economy and added to it. Prices of common stocks fluttered at times, but their trend continued upward and outstripped the rise in corporate profits. The rise in stock prices facilitated corporate financing by equity issues, which had seriously lagged in recent years. At the same time it kindled the financial imagination of some people, fostered favorable expectations, and stimulated the use of credit for speculative trading in securities. The revaluation of risks became general, and was reflected in shrinking differentials between yields of corporate securities and the yields of Federal issues. Plans for business and bank mergers multiplied, and an appreciable number were executed. Borrowing expanded rapidly, especially on the part of consumers. To finance the larger scale of their operations, corporations also borrowed more heavily during 1955 than in the previous year. However, a significant part of the increase in corporate obligations represented borrowing by sales finance companies to meet the growing demand for consumer loans.

Much of the newly created mortgage debt, especially in the case of veterans' new home purchases, was marked during 1954 and the early months of 1955 by a pronounced lengthening of maturities and reduction of downpayments. A similar tendency became prominent in automobile instalment loans early in 1955, and to some degree occurred also in other markets. The changes in credit terms helped to widen the dollar gap between new borrowings and repayments. Although repayments increased, newly extended credits increased more rapidly, so that the outstanding debt tended to grow at a high and increasing rate. Consumer instalment debt, which had remained steady during the greater part of 1954 and increased only slightly toward the close of the year, rose about 5½ billion dollars during 1955. The home mortgage debt, which increased by 9.7 billion dollars in 1954, rose by 13.4 billion in 1955. At the end of the year the total debt of individuals, including noncorporate businesses, stood 15 percent higher than at the beginning. However, monthly payments on the loans proceeded on schedule, and delinquencies were not only very low but even lower than in past years.

The huge demand for credit by consumers and business firms was augmented by governmental requirements despite the larger tax revenues that accompanied the expansion of the economy. The Federal budget moved toward a balance during 1955 but did not yet reach it. In the States and localities, considerable support developed both for raising taxes and for increasing debt to finance essential public improvements, such as roads, bridges, schools, water systems, and sewerage plants. The total governmental debt grew during 1955, although its rise was only a small fraction of the increase in private debt. The net borrowing by the Federal Treasury during the year was 2 billion dollars, while the States and localities added about 5 billion to their debt.

The surging demands for credit could be met from only two sources, first, an expansion of the money supply, second, current or past savings. Between mid-1954 and the end of May 1955 the money supply—that is, the sum of demand deposits and currency outside banks—increased by 5 billion dollars. This increase occurred while there was still considerable slack in the economy, and it facilitated the growth of production, employment, and real incomes. But by the late spring of 1955 the expanding demand for the products of industry, swollen by heavy borrowings, was already pressing hard against the Nation's industrial capacity. Shortages of steel, nickel, copper, paperboard, cement, plumbing fixtures, some types of lumber, and other materials developed. Unemployment was low, overtime extensive, and many types of skilled labor scarce. Wages and prices were beginning to stir. Accommodation of the pressing demands of borrowers by any substantial increase in the money supply would, in these circumstances, have served to raise prices rather than increase production.

Interest rates reflected the growing demand for credit in the face of a more slowly growing supply of loan capital. They began rising gradually in the principal money centers toward the end of 1954, then rose more rapidly as the excess reserves of commercial banks kept declining and their borrowings at Federal Reserve Banks increasing. Beyond meeting seasonal requirements, there was little increase in the money supply between May 1955 and the end of the year. Borrowing continued on an extensive scale, but it was largely confined to the loan funds available from the savings of individuals, businesses, and the various private and governmental trust funds. This process of confining credit to available savings, which is a protection against inflation in the future, was obscured by the continued and rapid increase of loans by commercial banks. These loans were made possible principally by the sale of government securities; in other words, the buyers of government securities indirectly provided the funds that financed borrowers from banks. The process of confining credit to available savings was much plainer in the case of mortgage-lending institutions, many of whom found that their supply of savings available for mortgage loans was smaller than the amounts they needed to accommodate customers. Interbank borrowings smoothed these and other necessary financial adjustments, and so too did higher interest rates, more selective screening of credit demands by lenders, and reduced credit commitments by financial institutions.

Despite elements of strain in the money and capital markets, the demand for commodities and services continued to grow as the year advanced. Their supply also kept growing, although many businesses encountered obstacles in increasing production—in certain cases because their available plant was already operating at or close to capacity, in others because some essential materials or skilled labor were in short supply, in still others because credit had become harder to obtain. Orders received by business firms generally multiplied faster than sales, backlogs grew, and delivery periods lengthened. Despite the growing pressure of demand on the Nation's physical resources, production as a whole continued to increase, albeit at a reduced rate. And despite the boom atmosphere that to some degree accompanied these developments, the over-all level of prices in both consumer and wholesale markets did not change appreciably. The index of consumer prices, which stood at 115.2 in July 1954, moved to 114.3 in January 1955 and 114.7 in December 1955. The index of wholesale prices moved from 110.4 in July 1954 to 110.1 the following January and 111.3 in December 1955. When the year ended the scope of the expansion had narrowed and its pace had slackened. The Nation had practically reached full employment, and was accommodating itself to a necessarily slower rate of advance.

II. Governmental Policy in a Time of Expansion

The preceding sketch of recent economic experience is amplified in Appendix B and documented by the charts and tables in this Report. But even this brief summary has sufficed to suggest how the unfolding of prosperity generated a degree of exuberance which, if left to itself, could have led to widespread increases in prices, speculative buying, new price increases, and eventual economic recession. The Federal Government, keenly aware of its responsibilities under the Employment Act, moved resolutely to prevent such developments.

That conditions in 1955 might require a different emphasis in economic policy was foreshadowed in last year's Economic Report. It noted that in the course of resolving old problems, expansion "often brings new ones in its train." It called attention to the danger of excesses in periods of expansion, particularly in activities which involve the discounting of a long future, as in the case of home purchases or the pricing of corporate shares. It warned that "continued economic recovery must not be jeopardized by overemphasis of speculative activity." And it urged concentration of governmental policy on facilitating long-term growth, rather than on measures for imparting an immediate upward thrust to the economy.

Thus, the Government was prepared for the problems that confronted our economy in the year just ended, and policies to restrain undue expansion were evolved to meet threats to stability as they emerged. It is well to recall that the expansion which got under way in the late summer of 1954 started from a high level of economic activity. Since the Nation's financial and commercial markets reflected that fact, as well as the promise of a still better future, the Government deemed it prudent to restrain incipient inflationary tendencies even at an early stage of the expansion. As a Nation, we are committed to the principle that our economy of free and competitive enterprise must continue to grow. But we do not wish to realize this objective at the price of inflation, which not only creates inequities, but is likely, sooner or later, to be followed by depression. On the other hand, it is necessary to exercise great care that a policy of avoiding inflation does not interfere with attaining a satisfactory rate of economic growth. Premature measures and restraints which are too potent may bring on or hasten the very reactions that the restraining policies are intended to prevent, just as excessively delayed action would fail of its purpose.

Moreover, market forces themselves tend to correct many maladjustments, and governmental policy must take account of the direction and strength of these forces. The rise in interest rates during 1955, for example, was to a significant degree a result of market developments, tending to restore balance between the vigorous demand for investment funds and the limited supply of savings available for investment. In such a situation it is essential to appraise with care the speed and strength of market adjustments so that they, together with the governmental measures that are being contemplated, may exercise an effective yet not overpowering corrective influence. This type of appraisal is often difficult and it is always subject to the fallibility of human judgment. The following review of recent monetary and fiscal policies will show how the Government went about the delicate task of preventing inflation without impeding economic growth.

III. Adjustment of Monetary and Fiscal Policies to the Needs of the Economy

The first departure from the vigorous expansionary policies pursued during much of 1953 and 1954 occurred toward the end of the latter year. As we have seen, economic expansion was well under way by the late summer of 1954. This development was accompanied by a brisk demand for credit, which the commercial banks and other financial institutions were able to meet as a result of the ample lending power that the policy of active credit ease, which then prevailed, had helped to create and maintain.

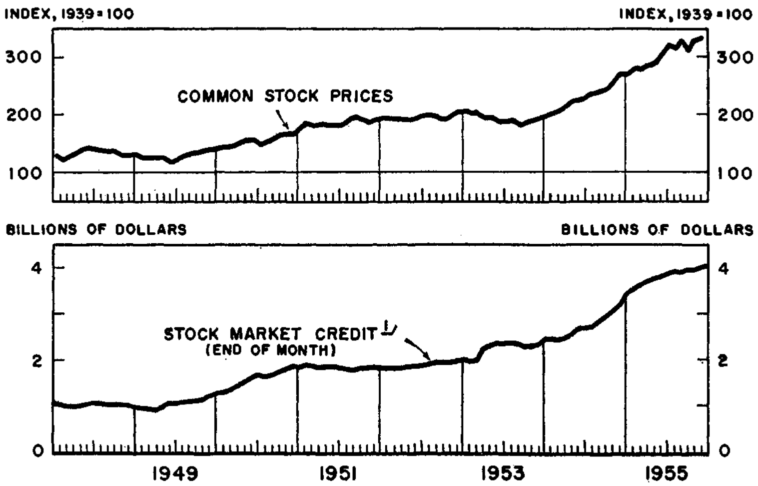
Although conditions in the latter part of 1954 did not call for a policy of restraint, a mild change in the degree of credit ease seemed desirable in the light of the unfolding economic situation. Accordingly, the Federal Reserve System restricted its purchases of government securities in December 1954. This action made it necessary for commercial banks to increase their borrowings to meet the unusually large increase in year-end currency and credit demands. It also placed the monetary authorities in a better position to move toward a policy of restraint if economic conditions should warrant it. The move exemplified one of the advantages of general monetary and credit policies: they can be adjusted gradually, and if need be promptly reversed, to meet changing economic conditions.

Holding the Tax Line

As the year 1955 opened, the economic expansion was proceeding vigorously on a widening front. In keeping with this fact, the Administration recommended in January a budget which brought expenditures and receipts of the Federal Government into balance, on a cash basis, over the coming year. This required a tight rein on expenditures and the avoidance

CHART 16

Stock Prices and Credit

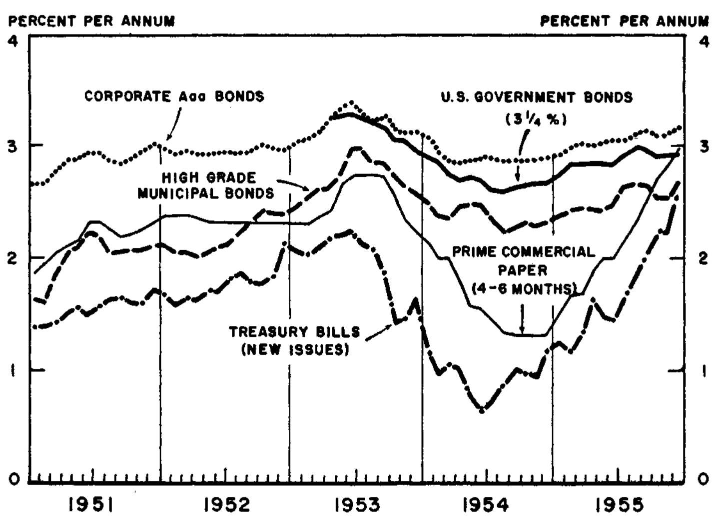


1/ CUSTOMERS' NET DEBIT BALANCES AND BANK LOANS TO OTHERS THAN BROKERS AND DEALERS. EXCLUDES U.S. GOVERNMENT SECURITIES.

SOURCES: SECURITIES AND EXCHANGE COMMISSION, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, AND NEW YORK STOCK EXCHANGE.

CHART 17

Money Rates and Bond Yields



SOURCES: TREASURY DEPARTMENT, BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, MOODY'S, AND STANDARD & POOR'S.

of drains on revenue through any reduction of tax rates. Consequently, the Congress was urged to postpone the tax reductions which were scheduled to take effect on April 1, 1955.

Without such affirmative action, Federal taxes would have decreased by approximately 3 billion dollars in a full year. The corporate tax rate would have declined 5 percentage points, involving a loss to the Treasury of about 2 billion dollars. The revenue from excise taxes would have been cut by approximately 1 billion dollars. These tax reductions did not seem appropriate at a time when aggregate economic activity was at a high level and expanding rapidly, while the budget was still unbalanced. However desirable tax adjustments may be to facilitate the long-run expansion of the economy, it is imprudent to initiate them when the budget shows a deficit and when they may interfere with the objective of maintaining balanced economic growth.

Although a bill to reduce individual income taxes was passed by the House, the Congress in the end accepted the President's tax program. The recommendation to defer the scheduled tax reductions was adopted on March 30, 1955.

Containing the Rise in Stock Market Credit

The proposal of early January to hold the tax line was preceded by a step that dealt with specific credit excesses. A few days earlier, the Federal Reserve authorities had acted to restrain the use of credit in the stock market, where speculative tendencies had become clearly evident.

The rise in stock prices, which began in September 1953 and continued almost without interruption through 1954, was accompanied by a significant increase in the amount of credit used for financing stock purchases. Customers' debit balances with member firms of the New York Stock Exchange rose over 700 million dollars in 1954 or almost 45 percent, and more than three-quarters of the rise was concentrated in the last six months of the year. Loans by banks to individuals for purchasing or carrying stocks also increased. The volume of security trading on margin had grown noticeably during 1954.

Experience provides ample evidence that excesses in the stock market can be transmitted quickly to other markets and eventually create economic trouble. It is important to prevent such developments. Hence, the Federal Reserve authorities moved in January to restrain the use of credit in security speculation, by increasing margin requirements on loans for the purchase of securities from 50 to 60 percent. Since the borrowing from brokers and banks, in connection with security transactions of individuals, continued to increase fairly rapidly in the next three months, margin requirements were again raised in April—this time to 70 percent. Stock prices, especially of the largest and best known industrials, continued upward through much of the rest of the year, but the rate of increase of stock market credit declined substantially soon after this second action was taken.

From Active Credit Ease to Moderate Restraints

Besides taking steps to contain stock market excesses, the general credit policy of the Federal Reserve System was modified early in 1955 in the direction of restraint. In January and February, the Reserve Banks reduced their holdings of government securities by about 1.3 billion dollars. This reduction was designed to absorb funds that normally become available to commercial banks as a result of the seasonal return of currency and the seasonal decline in loans. But in view of the continuing strong demand for bank credit, the sales and redemptions by the Reserve Banks had the effect of tightening the reserves of their members. The commercial banks responded by selling securities to meet the growing demand for loans. Simultaneously, they increased their borrowings from the Reserve Banks.

The Treasury also adjusted its financing programs to the change in economic conditions. Treasury financing in 1954 was carried out with short- and intermediate-term securities, many of which were bought by commercial banks and served to increase the money supply. In early 1955 there was no longer much reason for avoiding competition with other borrowers in the long-term capital market. Nor was there any special need to stimulate the expansion of the money supply. Hence the Treasury issued almost 2 billion dollars of 3 percent, 40-year bonds in February. Besides absorbing funds from the long-term market, the new issue helped to meet the needs of long-term investors, such as pensions and trust funds, insurance companies, and endowment funds. An additional 800 million dollars of these long-term bonds were issued later.

The policy of restraint of early 1955 was extended as the expansion of credit continued. Loans to business firms, automobile purchasers, and homeowners—the three groups which provided the major impetus to economic expansion—rose sharply during the spring. Business loans of commercial banks, which normally decline in the first half of the year, increased by 2 billion dollars in the first six months of 1955. The outstanding instalment debt of consumers expanded nearly 2 billion dollars in the second quarter, the largest increase on record over so brief a period. The value of home mortgage loans recorded during the first six months of 1955 exceeded recordings in the corresponding period of 1954 by a third, if not more. Although interest rates stiffened, other credit terms, such as the required downpayment and length of maturity, became more liberal, particularly for automobile and home purchases. In view of these credit and business developments, the Federal Reserve discount rate was raised in April from 1½ to 1¾ percent. This action brought the discount rate in line with the market level of short-term rates and made borrowings from the Reserve Banks more costly.

During the summer, employment reached a new peak of about 65 million. Although pockets of unemployment persisted in some local areas, unemployment generally was close to a practical minimum. Total output broke all previous records. Upward pressures on wages and prices became more

CHART 18

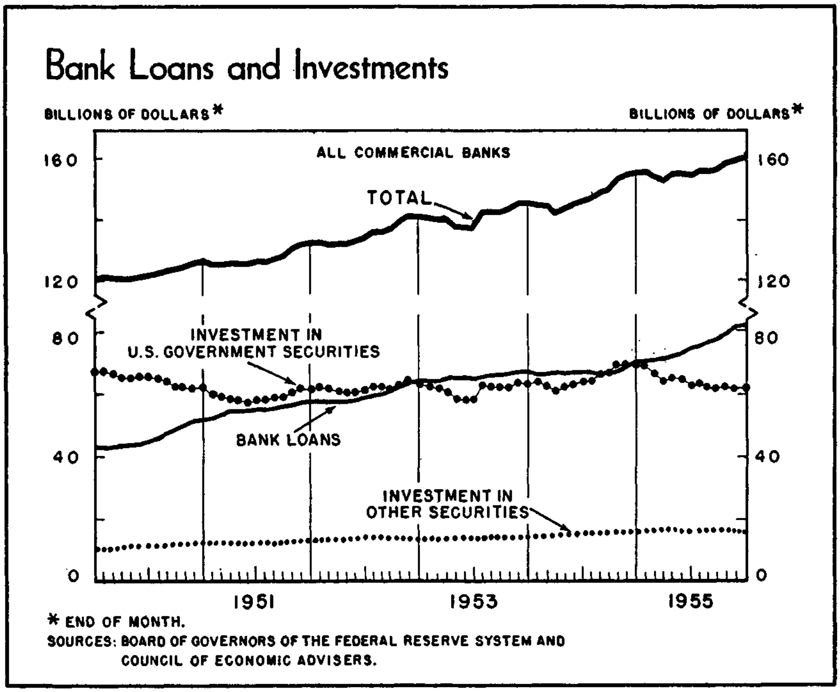


CHART 19

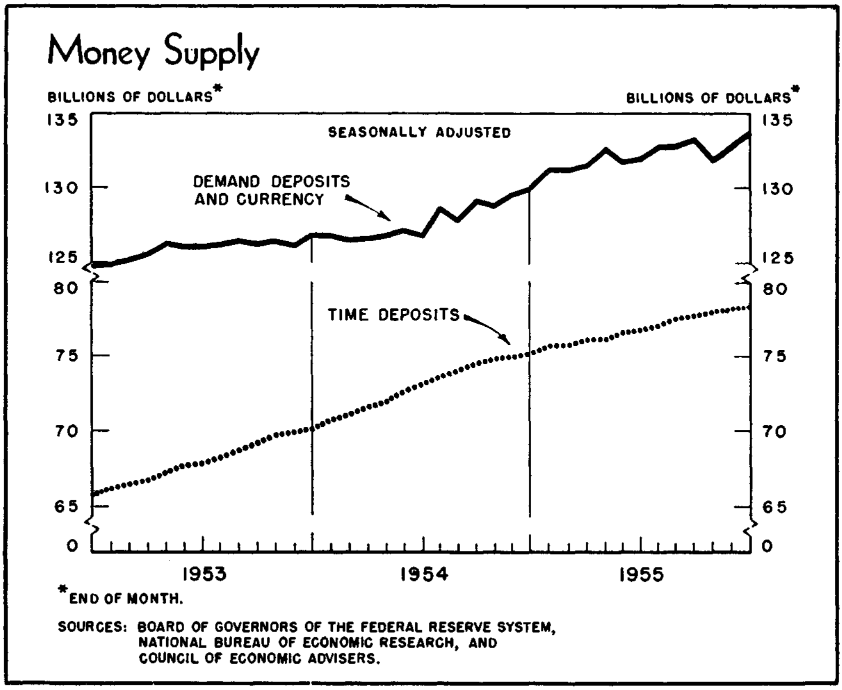
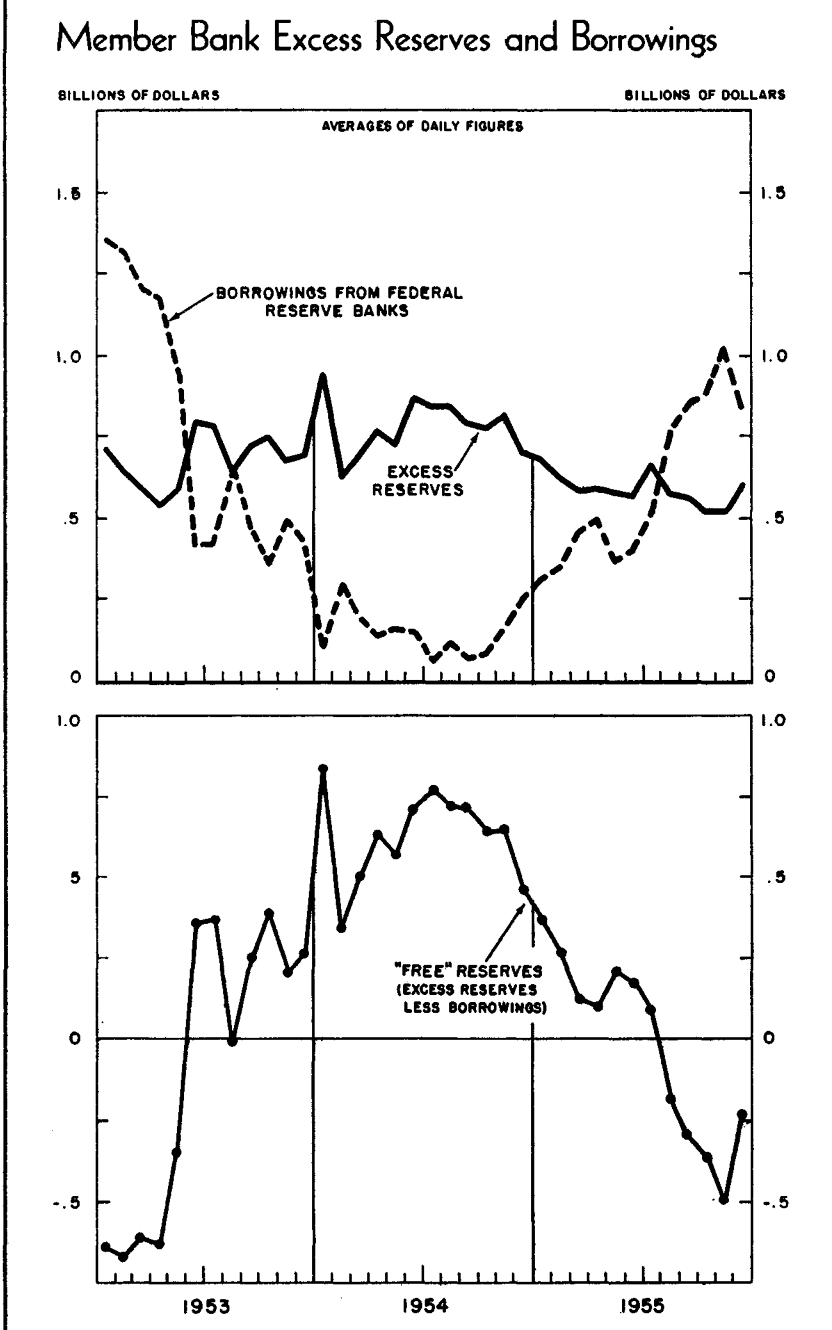


CHART 20



SOURCE: BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM.

intense. New collective bargaining agreements in major industries called for substantial wage increases, which in some cases were followed by substantial price advances. Shortages of steel, copper, aluminum, and of a variety of building materials developed or became more acute. The credit expansion supporting the high level of demand in practically all sectors of the economy reached a pace which, if continued for long, would threaten the stability of the economy.

To help avert this threat the Federal Reserve Banks reduced their holdings of government securities on a considerable scale between late July and mid-September. The effect of this policy was to put added pressure on bank reserves at a time when the demand for loans was piling up. To bolster their reserve position and continue lending, the commercial banks further reduced their own holdings of government securities and also increased their borrowing at the Reserve Banks. But when they borrowed money, they had to pay a higher price for it. Early in August, the discount rate was increased by one Reserve Bank to 2¼ percent and by the others to 2 percent. By mid-September, discount rates were raised to 2¼ percent by all Reserve Banks.

The pace of economic expansion slowed down somewhat during the fall, but incomes continued to increase and demand remained at a high level. When stock prices declined in late September and early October, a note of uncertainty crept into the thinking of some people. Within a few weeks, however, the averages of stock prices returned to their prior peaks. It became evident that business firms were laying plans for further increases in investment outlays, and that business and consumer demands for credit showed few signs of slackening. In view of this situation, the monetary authorities maintained pressure on the reserves of commercial banks. Although the Reserve Banks purchased a sizable amount of government securities toward the end of September and the following weeks, the amount fell short of meeting the seasonal requirements of commercial banks before the Christmas season. In November, the discount rate was raised to 2½ percent—the fourth increase of the year. In December, the reserve position of the banks eased somewhat, but pressure in the credit markets continued.

As the pressure on bank reserves increased during the year, the commercial banks took care of their customers' requirements by huge sales of government securities and by borrowing at the Reserve Banks. However, increasing tightness in the credit markets in time led both the commercial banks and other financial institutions to screen their loans more carefully. Mortgage money, in particular, became less plentiful. Simultaneously, the increased cost of borrowing moderated the demand for long-term credit by some borrowers. This effect became noticeable during the summer, when a number of State and local governments and turnpike authorities deferred their scheduled financing. The restricted supply of loan funds made its influence felt also in the short-term credit market, though to a smaller degree. The net result was some restraint of private and public expenditures, which was salutary in an environment in which excessive demand could well have resulted in sharply rising prices.

Consumer Credit Policies

To supplement the general monetary policy of reducing the ease of borrowing, specific actions were taken during the spring and summer in two areas which, in addition to the stock market, caused some concern. One of these areas was consumer credit.

Most of the expansion of consumer credit occurred in connection with automobile loans, which in the early months of 1955 were being made on increasingly liberal terms. In the case of new car purchases, instalment contracts with maturities as long as 30 and 36 months became more prevalent. Downpayments of less than a third became fairly common, and they were sometimes nominal because of the tendency to overvalue trade-ins. The frequent combination of low downpayments and lengthy maturities meant that the outstanding debt on many instalment contracts exceeded the market value of the car for appreciable periods. In the case of used cars, downpayments also declined, though there was little change in maturities.

The authority of the Board of Governors of the Federal Reserve System to establish maximum terms on consumer credit had ceased in 1952. Consequently, apart from general monetary policies, the means of influencing consumer credit were limited to what could be accomplished by moral suasion and bank supervision. Government officials met repeatedly with representatives of financial institutions and noted the hazards that may attach to excessively liberal credit terms. In July the Federal bank supervisory authorities—that is, the Comptroller of the Currency, the Federal Reserve Board, and the Federal Deposit Insurance Corporation—added a section on consumer credit to their regular examination reports, with a view to providing a better basis for evaluating the quality of consumer loans extended by banks. Partly in response to these measures, but mainly in response to the general tightening of the money market, many lenders put a halt to further liberalization of terms and some began to stiffen terms. However, maturities and downpayments generally remained liberal by contrast with those of prior years.

Housing Credit Policies

Several steps were taken by the Government to help cope also with the threat of overexpansion of housing credit. We have already noted the great upsurge in residential construction between the fall of 1954 and the spring of 1955. This was stimulated by increasingly easy credit during 1954, and the eagerness of financial institutions to acquire, and make forward commitments for, mortgage loans at a time when rates of return on other investments were less attractive. The demand for new housing generally remained strong during this period. Nevertheless, by the spring of 1955 a surplus of housing became evident in some scattered localities.

CHART 21

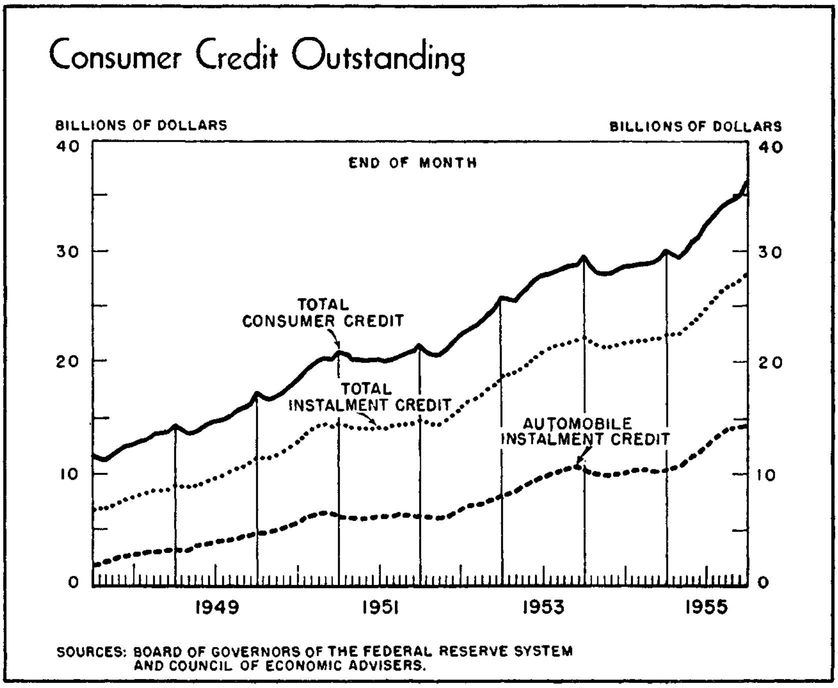
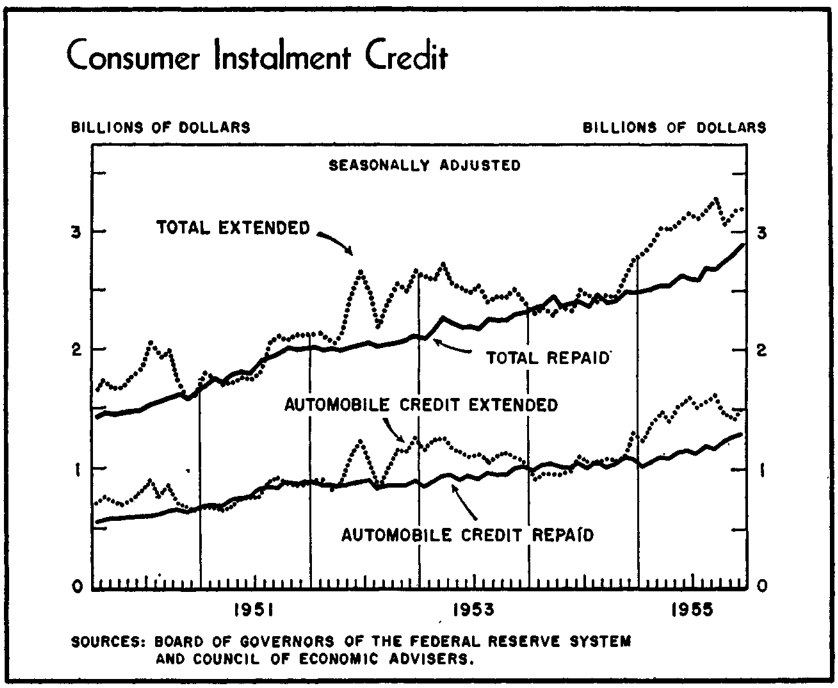


CHART 22



Easy mortgage credit manifested itself most conspicuously in the terms offered on government-guaranteed loans for veterans, although it was by no means limited to this segment of the market. In the spring of 1955, mortgage loans with maturities of 26 to 30 years represented nearly two-thirds of the total number of veterans' loans on new homes, compared with about one-third a year earlier. The like was true of no-downpayment mortgages. The extensive and growing resort to mortgages requiring no downpayment raised the serious question whether such loans were in the best interest of many of the veterans attracted into home purchase, and whether the sale of homes on increasingly easy terms could be maintained without deterioration of credit standards and unsettling effects on home building activity in the future.

In addition, strains in the mortgage market began to be evident in the spring and summer of 1955. Finding it difficult to handle the record volume of mortgage loans and commitments, mortgage lenders resorted increasingly to short-term credit. Savings and loan associations stepped up sharply their borrowing from the Federal Home Loan Banks. Other mortgage lenders arranged for temporary financing by "warehousing" large amounts of mortgages with commercial banks—a development which led the Federal Reserve Bank of New York to advise caution in the extension of this type of credit. Advances by Home Loan Banks to savings and loan associations, together with mortgage "warehousing" loans by commercial banks in major cities, increased by 1.3 billion dollars between August 1954 and August 1955.

The strains on the financial system were paralleled by pressures on the resources available to the construction industry. Building materials, such as cement, steel, copper and brass products, gypsum board, hardwood flooring, even bricks and nails, were reported in short supply in more and more areas. Wages were rising generally. The price of land for residential developments was increasing rapidly, as were prices of building materials.

In view of these developments, the Federal Housing Administration and the Veterans Administration issued regulations in late April, which required the home purchaser who obtained a mortgage underwritten by the Government to pay legal, recording, and related fees in cash. The inclusion of such costs in mortgage loans was one of the unsound, though not widespread, practices that had developed under competitive pressures. At about the same time, the field offices of both agencies were instructed to intensify their surveys of local housing markets, and to take coordinated steps to restrain Federal underwriting of mortgages in localities where housing surpluses were found to exist. In July both agencies reduced from 30 to 25 years the maximum maturity of mortgages that could henceforth be insured or guaranteed by the Government. Simultaneously, the minimum downpayment on homes bought under the veterans' program was raised from zero to 2 percent of the purchase price, while minimum down-

CHART 23

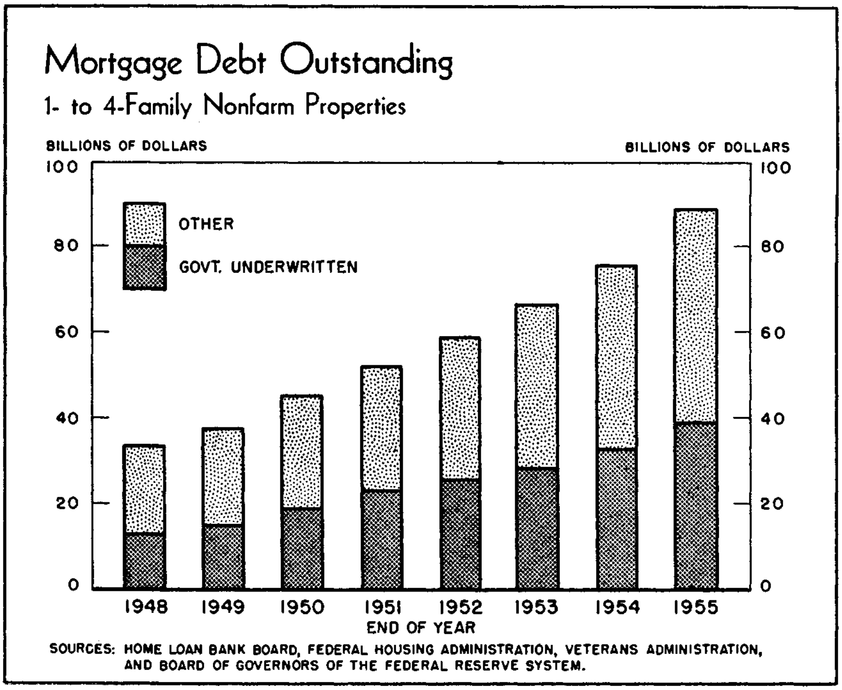
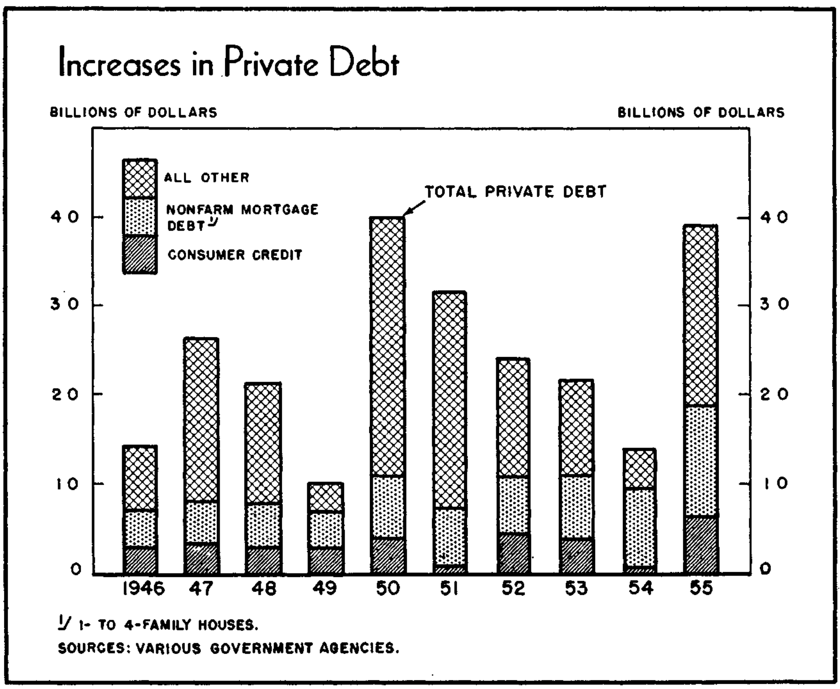


CHART 24



payments on homes purchased under the program of the Federal Housing Administration were increased correspondingly. In line with these measures, the Federal Home Loan Bank Board took steps in the summer and fall to restrain the rapid growth of lending by the Home Loan Banks.

All these steps were parts of a general and concerted credit policy. Housing loans insured or guaranteed by the Federal Government now represent over two-fifths of the entire home mortgage debt. For this reason, if for no other, the Government has a direct responsibility in helping to maintain a sound housing and mortgage market. It has a corresponding duty to use its own programs wisely, so as to promote stable economic growth as well as progress toward better housing. The objective of stable growth is clearly in the national interest. It is also in the long-term interest of those who have so greatly benefited from the Federal housing programs—the millions of consumers with a stake in their homes, jobs, and debt obligations, the hundreds of thousands of workmen in the construction industry, and the thousands of enterprises engaged in home building and mortgage lending.

Adjusting the Stockpiling Program

After the basic decision of January to hold the tax line, monetary and credit policies were largely relied on to keep the excesses that tend to arise during prosperity from cumulating. However, the Government's housekeeping operations were also managed so as to relieve the pressures of an expanding economy. Among other things, the stockpiling program was adjusted during the past year, within the limits permitted by law, to avoid undue hardship to the civilian economy. Quantities of copper, aluminum, and nickel under contract for delivery to the Government were diverted to industrial use, and in the case of copper some holdings outside the stockpile were sold for essential industrial uses. It was possible to do this without injury to the defense program because of the substantial progress that had previously been made in stockpile accumulations. Also, the expansion of capacity in some major industries, notably of aluminum, is now contributing to domestic mobilization potentials and is decreasing correspondingly the need for stockpiles.

IV. Effectiveness of Monetary and Fiscal Policies

Monetary and fiscal policies influence different activities in varying degree, and these effects have varying time dimensions. Thus, financial developments during 1955 reflected not only the restraints placed on borrowing in that year, but also the credit ease of the preceding year. In addition, they mirrored the strength of credit demands accompanying the rapid business expansion of 1955 as well as the efforts to moderate these demands. Final evidence of the effectiveness of recent governmental policies must therefore be sought in the economic annals that are yet to come as well as those for 1955. Even now, however, it can be said with confidence that the early recognition of a need for monetary and fiscal caution, and the gradual but persistent application of a policy of restraint during the greater part of 1955, contributed in no small degree to the achievement and maintenance of prosperity without price inflation.

The vigorous expansion of economic activity during 1955 was accompanied by little change in the average level of wholesale or consumer prices. To be sure, the substantial stability of the price level reflected in some degree the opposite movements of industrial and farm prices in wholesale markets. However, the increase even in the average level of industrial prices was not large for a period of high prosperity. Because the over-all change in prices was small, speculative accumulation of business inventories, such as has often led to economic recession in the past, was largely avoided last year. And since consumer prices remained virtually stable, higher earnings due to increased basic rates of pay and longer or more regular hours of work were not dissipated, but resulted in rapidly rising real incomes for wage earners. The advances occurred in a general atmosphere of industrial peace.

Although we have not entirely escaped the financial excesses that commonly develop in a time of economic exuberance, the policies of restraint pursued by the Government helped to moderate the growth of debt and to protect its quality. A balanced Federal budget is now definitely within

CHART 25

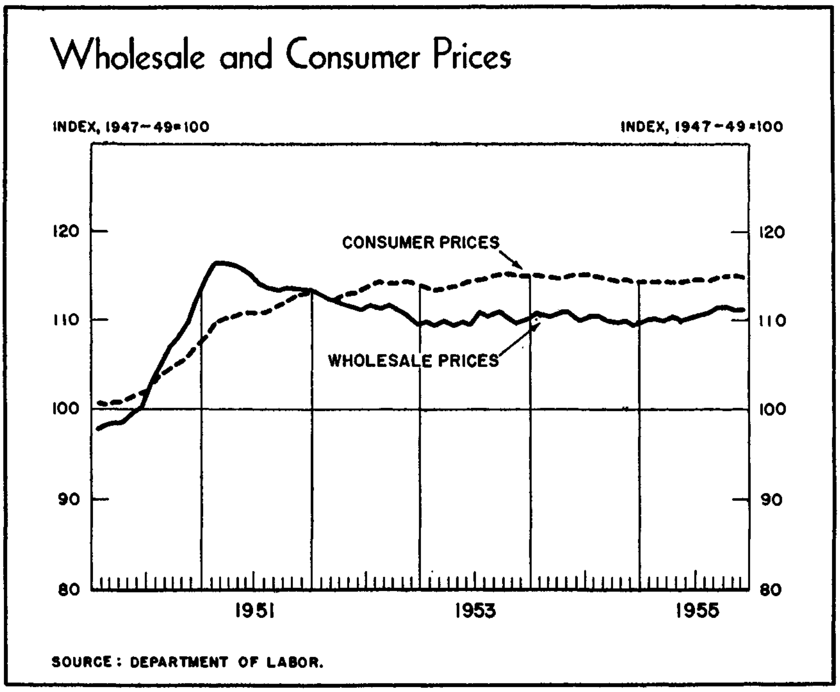


TABLE 4.—*Changes in average gross and net spendable weekly earnings of production workers in manufacturing, constant prices, 1946–55* [1]

Period	Gross average weekly earnings	Net spendable average weekly earnings [2]	
		Workers with no dependents	Workers with three dependents
Percentage change:			
1946 to 1947	−0.4	−1.0	−2.5
1947 to 1948	.7	3.1	2.4
1948 to 1949	2.4	2.4	2.2
1949 to 1950	7.0	5.2	5.2
1950 to 1951	1.0	−2.1	−.8
1951 to 1952	2.7	.7	1.5
1952 to 1953	4.6	4.3	3.8
1953 to 1954	−.1	1.4	−.1
1954 to 1955 [3]	6.8	6.5	5.9

[1] Earnings in constant prices are obtained by dividing earnings in current prices by the consumer price index.
[2] Gross weekly earnings less Federal social security and income taxes.
[3] Based on preliminary data for 1955.

Source: Department of Labor.

TABLE 5.—*Changes in average gross weekly earnings in selected industries, constant prices, 1946–55* [1]

Period	Manufacturing		Building construction	Retail trade	Wholesale trade	Class I railroads	Telephone	Laundries	Bituminous coal mining
	Durable goods	Nondurable goods							
Percentage change:									
1946 to 1947	−1.5	−0.3	−1.7	−2.3	−4.9	−3.9	−11.7	−5.4	0.2
1947 to 1948	1.1	.1	1.0	.2	−.7	1.5	1.5	−2.8	.6
1948 to 1949	2.6	2.6	4.1	5.8	4.5	4.8	6.9	3.2	−11.4
1949 to 1950	8.1	5.4	2.9	2.7	3.9	1.8	4.0	.4	10.1
1950 to 1951	1.6	−1.0	2.3	−1.5	−1.3	2.4	−.8	−1.3	2.4
1951 to 1952	3.4	2.0	5.6	1.7	3.1	2.4	2.8	−.1	−1.8
1952 to 1953	4.3	3.5	3.4	3.4	4.9	1.9	5.4	1.9	8.4
1953 to 1954	−.4	1.4	2.2	3.2	2.8	2.8	4.9	.7	−5.6
1954 to 1955 [2]	8.1	5.4	2.1	3.5	4.9	3.8	5.6	1.8	18.0

[1] For production workers or nonsupervisory employees. Earnings in constant prices are obtained by dividing earnings in current prices by the consumer price index.
[2] Based on preliminary data for 1955.

Source: Department of Labor.

reach. There has been little change in the amount of stock market credit outstanding since last June, and its quality has improved. The tendency toward increasingly liberal terms on consumer instalment loans has been arrested. Mortgage lending is proceeding on a more prudent basis. For some months now, the expansion of borrowing has in the aggregate been largely restricted to the loan funds made available from past or current savings. Because the creation of new money has been kept down, the recurring problem of preventing inflation should be less difficult in the future.

While the monetary and fiscal restraints of last year contributed significantly to economic stability, they did not interfere with the attainment of a very high rate of economic growth. Expansion continued throughout the year, and the rate of growth slowed down only when output began pressing against the ceiling of physical resources. On the whole, then, the performance of the economy in the year just ended indicates considerable success of the Government's stabilizing efforts, just as the annals of 1954 demonstrated that the Government helped to overcome the forces of economic contraction and facilitate recovery.

In some ways, the lesson of 1955 is perhaps the more significant one. Success in preventing depression depends in large part upon a willingness to avoid the excesses that can so easily develop during prosperity and upon skill in doing this. Governmental measures of monetary and fiscal restraint are not as readily accepted as are measures of economic stimulation. The manufacturer who sees an opportunity to expand his activities by borrowing cannot always understand why his bank is so short of funds that he must put up with a smaller loan than he requested. Nor can the homebuilder or merchant or consumer. Nor, for that matter, can the banker. To each participant in the economic process a shortage of credit may appear as a restriction on his own opportunities. But the basic shortage under conditions of high prosperity is on the side of physical resources, not on the side of money or credit. If credit on easy terms were available to everyone at a time when the economy is already working close to capacity, the consequence would be a scramble for limited resources and a cumulative bidding up of prices. If taxes were simultaneously reduced, this inflationary process would only be speeded up. A government that sought to prolong prosperity by such devices would be taking a road that all too often has ended in disaster.

Prompt and resolute governmental action to contain undue expansion requires courage and a willingness to focus on the less apparent and the longer-term interests of the economy. The fact that the Government during 1955 acted in this fashion, and the degree to which people accepted and approved the program of fiscal and monetary restraints as the better part of wisdom, testify to our increasing maturity as a Nation in dealing with the problem of economic instability. Another challenge to meeting the objectives of the Employment Act was met as the first decade of operations under this novel legislation came to a close.

V. The Current Economic Situation

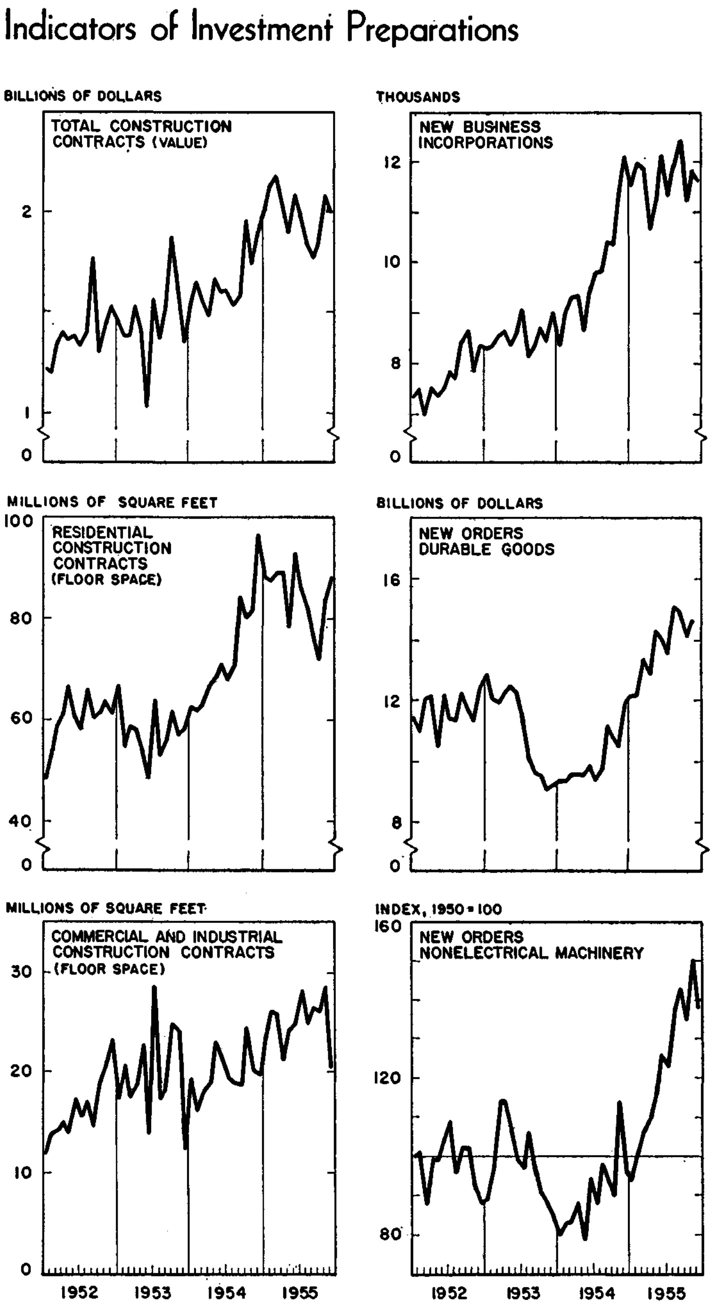
Once an economy operates close to full capacity, further expansion of economic activity is bound to proceed at a slower rate. At such a time, moreover, crosscurrents multiply and become more prominent. As was to be expected, the scope of the economic expansion has narrowed in recent months and its pace has slackened. Declines have lately been under way in housing starts, automobile production, and other activities, but they are being amply offset by increases elsewhere. The flow of orders to business firms remains high and, in the aggregate, continues to exceed current production and sales. Many shortages, particularly of metals, persist. In short, the rapid expansion of six or twelve months back has given way to a tamer movement, but the underlying trend still appears to be upward.

The economy is starting the new year from a strong financial as well as a strong industrial position. Although stock prices are substantially higher than a year or two ago, credit is not a very large factor in today's stock market. Although consumers have recently added heavily to their debts, they also have added substantially to their liquid assets and earning power. The current liabilities of business firms have risen, but their current assets have risen still more. Agricultural inventories are very high, but they are largely held by the Government and their disposal will not be permitted to disrupt markets. The recent expansion of industrial production has been accompanied by an increase in business inventories, but a preponderant part of the increase has been in goods locked up in the productive process. Apart from the automobile industry, which is now bringing its production into better adjustment with market demand, there is little evidence in the business world of excess or speculative inventory holdings. Taking recent years as a standard, the current ratio of inventories to sales is generally low for both manufacturers and distributors. The increase of inventory investment in the fourth quarter of 1955, which stands out prominently in the most recent statistical summary of the gross national product, is largely attributable to automobiles and does not have a more general significance.

As just noted, housing starts have recently been declining. Such indicators as we have of proposed home construction are also pointing downward. These movements largely reflect the limited supply of mortgage money in the recent past, rather than a slackening demand for new homes. Basic conditions of the home-building industry are, on the whole, satisfactory. In good part because of the governmental steps taken during 1955 to avoid overbuilding, local housing surpluses are now fewer than last spring. In the Nation as a whole, the vacancies currently available are only about 2.3 percent of the total stock of dwellings. Although that figure is somewhat higher than in recent years, vacancies still fall short of the reserves that people need in order to shift their housing accommodations without excessive delays.

The demand for new dwellings remains strong, and there are some signs also of improvement in the conditions affecting their supply. Shortages of building materials have been reduced somewhat in recent weeks. More-

CHART 26



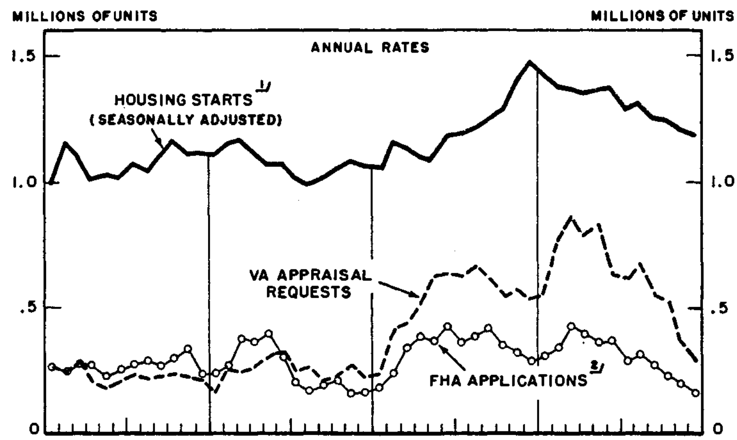
NOTE: ALL DATA ARE SEASONALLY ADJUSTED.

SOURCES: F.W. DODGE, DUN & BRADSTREET, DEPARTMENT OF COMMERCE, Mc GRAW-HILL, AND NATIONAL BUREAU OF ECONOMIC RESEARCH.

over, the condition of the mortgage market is beginning to improve. Quotations on government-underwritten mortgages have stabilized of late. Commitments by life insurance companies for making home mortgages seem to have turned up. By last December, the savings and loan associations had already succeeded in bringing their commitments into reasonable adjustment with their inflows of cash, and the Federal Home Loan Bank Board therefore relaxed the restraints on borrowing from the Home Loan Banks. More recently, in view of the adjustments that have already taken place in the home-building and home-financing industries, the maximum permissible term of governmentally underwritten mortgages has been restored to 30 years. All these developments favor a good rate of residential building

CHART 27

Housing Starts and Applications for Financing



1/ NEW PRIVATE NONFARM HOUSING STARTS.
2/ UNITS IN MORTGAGE APPLICATIONS FOR NEW HOME CONSTRUCTION.
SOURCES: DEPARTMENT OF LABOR, VETERANS ADMINISTRATION (VA), AND FEDERAL HOUSING ADMINISTRATION (FHA).

during 1956, although it seems unlikely that the exceptionally high volume of the past year will be attained.

On the other hand, business investment has been rising vigorously in recent months, and the indications are that the increase will be extended in the months immediately ahead. Orders for machine tools, freight cars, engines and turbines, and durable goods generally have been expanding. The excess of orders over sales of durable goods in the past twelve months has built up a large backlog of unfilled orders. New business incorporations

CHART 28

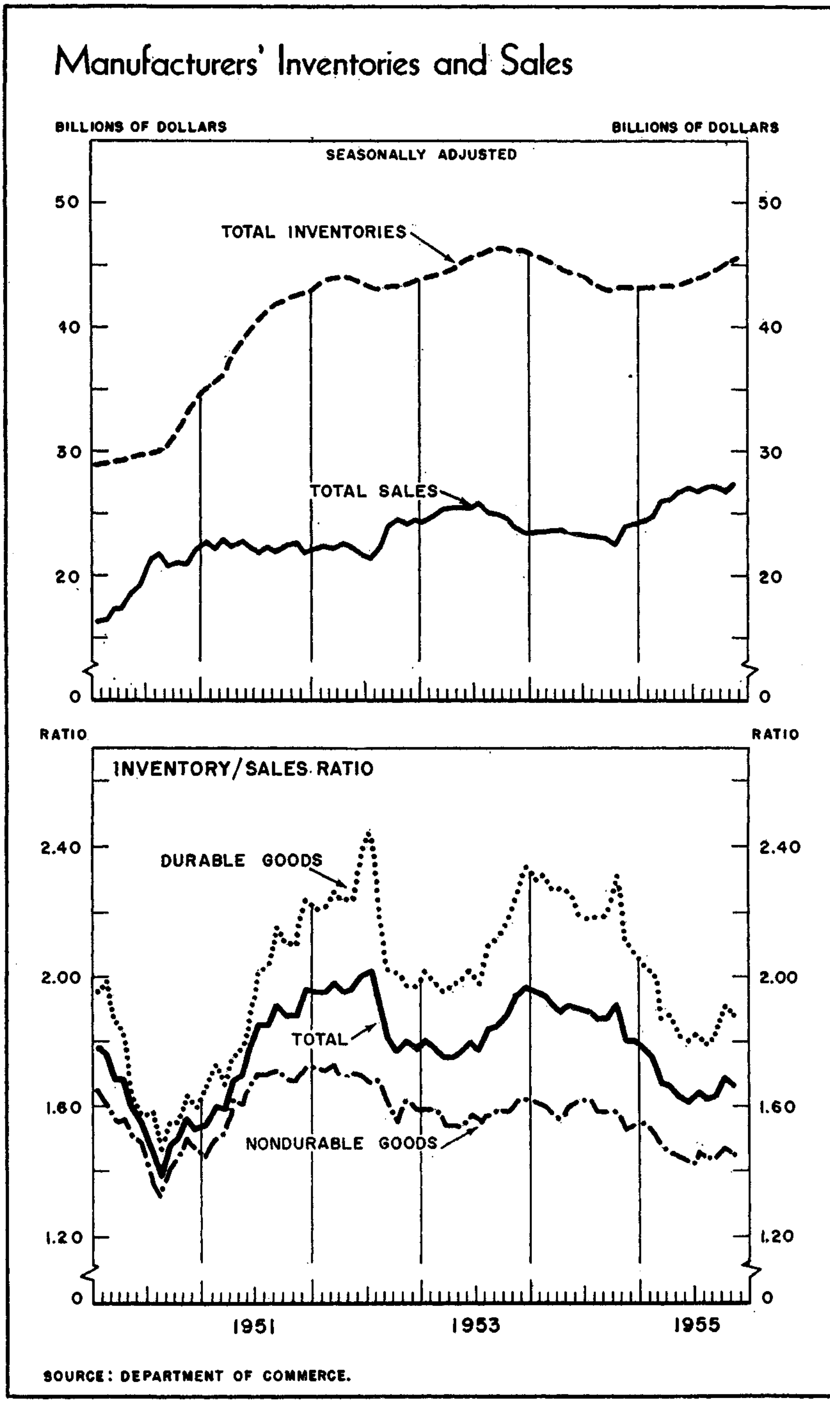
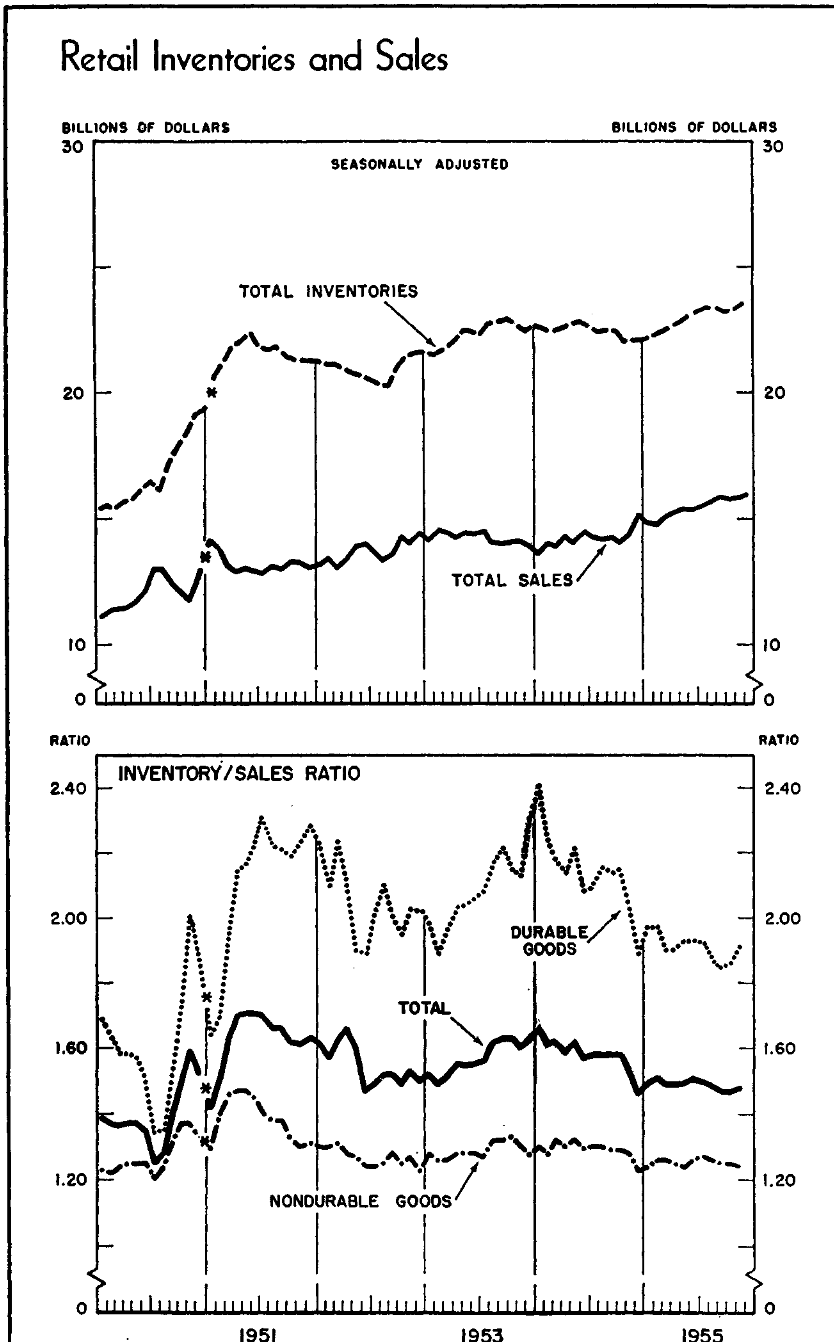

Manufacturers' Inventories and Sales
BILLIONS OF DOLLARS
BILLIONS OF DOLLARS
SEASONALLY ADJUSTED
50
40
30
20
0
TOTAL INVENTORIES
TOTAL SALES
RATIO
RATIO
INVENTORY/SALES RATIO
2.40
2.00
1.60
1.20
0
DURABLE GOODS
TOTAL
NONDURABLE GOODS
1951
1953
1955
SOURCE: DEPARTMENT OF COMMERCE.

CHART 29



* DATA BEGINNING JANUARY 1951 NOT COMPARABLE WITH DATA FOR EARLIER PERIODS.
SOURCE: DEPARTMENT OF COMMERCE.

have been proceeding at a high rate. When allowance is made for the erratic movements intrinsic in monthly records, it is clear that construction contracts for commercial and industrial structures have been moving to higher levels. Surveys of business plans for capital spending, many of which represent firm commitments for 1956, likewise suggest a rising volume of business outlays on plant and equipment. In view of the investments that are projected or already under way, the outlook for business capital expenditures in coming months is good.

The prospective high volume of private investment in fixed capital—that is, business investment in plant and equipment together with residential construction—is likely to be supplemented over coming months by further expansion of State and local spending. The pressures for local improvements are continuing to mount over the country, and the scale on which construction contracts are proceeding strengthens the expectation of a higher rate of State and local outlays. Federal expenditure on goods and services may also move a little higher over coming months.

The basis for judging other parts of the economy is less clear at present. However, foreign trade probably will continue at a high level, at least over the months immediately ahead. How soon and in what degree the decline of farm incomes and farm spending is checked will largely depend on how promptly the Congress acts on the Administration's newly proposed farm program. The future course of consumer spending is always shrouded in uncertainty, but it is well to note that retail sales last quarter were at their highest level of the year, and that retail sales in December—quite apart from the normal seasonal bulge—were at the highest level of the quarter. Thus, the trend of aggregate consumer spending continues to be upward, despite the recent decline of expenditures on durables. If it is unlikely that consumers will buy automobiles in 1956 at last year's extraordinary rate, they may spend more freely on home improvements, home furnishings, and nondurables. The urge to maintain and improve living standards is so strong nowadays that continuation of a high level of consumer spending can be reasonably anticipated.

Under current conditions, the economic growth of our Nation is limited by industrial capacity and accretions to the labor force. When the economy has reached so high a level its near-term course is inevitably surrounded by a margin of uncertainty, and minor movements can occur without involving a change in general trend. Taking recent developments all together, it is reasonable to expect that high levels of production, employment, and income will be broadly sustained during the coming year, and that underlying conditions will remain favorable to further economic growth.

The clearest lesson of recent economic history is the need for alertness to economic change and for prompt adaptation of economic policies to changing business conditions. It is important to avoid complacency and to bear in mind the uncertainties that always surround the future. But it is no less important to recognize that the opportunities which lie ahead for American businessmen, consumers, workers, farmers, and investors are much greater than the uncertainties. The basic objective of governmental policy in the economic sphere during the coming year should be to help in the realization of these opportunities. The following chapters present for the consideration of the Congress a program to help widen the scope of our current prosperity and to help extend it into the future.