January 31, 1952

MONTHLY REVIEW

FEDERAL RESERVE BANK OF ATLANTA

Volume XXXVII | Atlanta, Georgia, January 31, 1952 | Number 1

The Eye of the Hurricane

When one sets out to depict in general terms the state of the economy in some particular period of time, he is quite likely to lapse into the use of figurative language. This is especially true at the end of the year when one indulges in the customary backward glance over the preceding twelve months. Only by some figure of speech, by some analogy or metaphor, can an observer convey the total impression that such a period has made upon his mind.

Analogies drawn from the world of nature seem particularly well suited to expressing economic conditions. References to such things as the "economic climate" and the "business weather," for example, are common in this sort of writing.

Of all natural phenomena, one of the most awesome is the hurricane. Even in those who have never personally experienced such a storm, the mere thought of its spectacular violence and of the blind and indiscriminate fury with which it deals out cataclysmic destruction is enough to inspire sensations of terror.

There is one aspect of a hurricane, however, that seems very curious and, to a layman, almost incredible. This is the calm that lies at its heart. Although the wild and shrieking winds may threaten and may wreak destruction all around, in the eye of the hurricane all is peace. In that miraculously favored spot, and for a brief moment in time, at least, nothing happens. It is said that the winds that tend to rush toward the center are checked in their centripetal movement by the rotation of the earth upon its axis, and, instead, are sent spiraling around the hurricane's eye.

That a hurricane of unpredictable dimensions has been in the making throughout the world for the last six or seven years is a matter of common knowledge and of common fear. Like the variations in barometric pressure that set storm winds in motion, the cleavage of the world into two incompatible, and perhaps irreconcilable, ideological spheres has likewise raised a wind that has sucked into it the moral, political, economic, and military forces of nearly every nation. There is scarcely a man alive today, civilized or uncivilized, whose life and personal destiny is not in some measure at the mercy of the gathering storm. Nations have been shaken on their foundations, and some have fallen, or nearly fallen, before the gathering winds. Some have been coerced, cajoled, threatened, and bribed into alligning themselves with one side in the world-wide struggle. Others have managed to remain upright only by virtue of the sacrifices they have imposed upon themselves and of the unprecedented aid, economic and military, that the United States has been able to give them.

How successful all these efforts will be is still in doubt. It is questionable how much larger a burden of rearmament the economies of Western Europe can stand without collapse. In more than one country, inflation is rampant and standards of living, already low, are falling lower still. Some observers profess to see dangers ahead even for the United States—the United States, whose extremely productive economy has been the foundation upon which the whole free world has depended for support and assistance, and upon which it will continue to depend for some time to come. For this country, too, has had to bend before the storm.

Billions in wealth and over a hundred thousand casualties is the price we have paid so far for our involvement on the bleak and distant battlefields of one small corner of Asia—Korea. How much more will have to be spent on the larger tasks that lie ahead no one knows. In any case, the position of the United States in the world today has necessitated an increasing orientation of its whole economy toward the possible eventuality of war. The armed forces have had to be built up to a level of approximately three and a half million men. These forces have had to be supplied and equipped and trained. Besides increasing the current output of arms, moreover, it has been necessary to expand the productive capacity of American industry to meet any demand for end-items that might be placed upon it in the future.

All of this, of course, implies huge expenditures, not only by the Government, but also by private business. Government purchases of goods and services for national security alone, which amounted to almost 19 billion dollars in 1950, were running at a seasonally adjusted annual rate of 45 billion in the fourth quarter of 1951. Gross private domestic investment that amounted to 48.9 billion dollars in 1950 was being made at a seasonally adjusted annual rate of 55.7 billion in the third quarter of 1951.

Expenditures on such a scale for war or preparations for war, as well as expenditures incident to capital formation, are all inflationary in character. The degree of inflation accompanying them, however, depends in part upon the method by which they are financed. In both cases, there is a diversion of economic resources from production for the consuming public and a coincidental pouring of money incomes into the hands of the public. Insofar as these incomes are paid out of money newly-created through the banking system, the inflationary danger is the worse. Fear adds to the danger—fear of shortages that causes people to engage in a wild scramble for goods before they disappear from dealers' shelves; fear of higher prices yet to come that

causes them to convert rapidly depreciating dollars into goods and other property that may appreciate in value.

The Threat

At this time last year, one had every reason to view the future with alarm. The storm that had been gradually gathering ever since the end of the war had reached cyclonic proportions. War had broken out in Korea in the preceding June, and there was a threat that it might eventually engulf all of Asia and perhaps end in the holocaust of a third world war, for China had intervened in the conflict.

The public reacted as might have been expected. There was a mad rush for goods by the consumer and by businessmen. The seasonally adjusted department store sales index that had stood at 298 in June 1950, rose to 325 in December and reached its highest point in January 1951, when it touched 362. Department store inventories likewise increased, with the index rising from 276 in June 1950 to 329 in December, and continuing to rise until it reached its highest point at 377 in April 1951.

Bank loans at all commercial banks rose from 44.8 billion dollars in June 1950 to 52.2 billion dollars in December of that year. Consumer credit outstanding increased by nearly 2 billion dollars in the same period, and the privately held money supply, about 7 billion dollars. Personal income increased from an annual rate (seasonally adjusted) of 219 billion dollars in June 1950 to 244.4 billion in December. Personal consumption expenditures that ran at a seasonally adjusted annual rate of 184.7 billion dollars in the first quarter of 1950 rose to 202.5 billion in the third quarter and, after subsiding to 198.4 billion in the fourth quarter, rose to a high point of 208.2 billion in the first quarter of 1951.

As 1951 dawned, therefore, it was apparent that people had plenty of money and were disposed to spend it freely. And in the background there was always Congress considering ever larger expenditures for military and other purposes, all of which under certain circumstances could be inflationary, despite the imposition of direct control of prices and wages. The all-commodity index of wholesale prices that had stood at 157.3 in June 1950 rose to 175.3 in December, and to 184 in March 1951. The index of consumers prices rose from 170.2 in June 1950 to 178.8 in December and climbed persistently upward all through 1951. Although the rise between May and August was very moderate, it reached approximately 188 in November. The familiar spiral of inflation seemed to be rising in deadly earnest, with nothing in sight to stop it. The world-encircling storm that had swept American forces into Asia before it and that had catapulted this nation into the vanguard of European defense was now threatening to sweep through the basic economic and financial structure of the country with destructive results.

What Happened

As one looks back over 1951, however, that thing that stands out most prominently is the fact that the worst never happened, although all the ingredients for an accelerating increase in the inflationary movement continued to be present throughout the year. Personal income that had been running at a seasonally adjusted annual rate of 243.6 billion dollars in January 1951 climbed steadily throughout the year until it topped 257 billion in October. Even after paying their taxes, people had more money than ever in their pockets, for disposable income (personal income after taxes) rose from an annual rate of 216.8 billion dollars in the first quarter of the year to 224.7 billion in the third quarter. From June through November in 1950 the privately held money supply had increased by a little less than 4 billion dollars, but in the corresponding period in 1951, it increased by nearly 8 billion dollars. This is the stuff of which inflation is made.

Nevertheless, the worst never happened. In the last three quarters of the year, there came, instead, a halt in the upward spiraling of the economy; an uneasy lull; an unexpected becalming of the storm winds. It was like living in the eye of a hurricane.

Why the worst never happened will probably be a matter for dispute among economists and business analysts for a long time to come, and a completely satisfactory answer may never be forthcoming. It will be said that the economy momentarily achieved a balance at a high level. Such a statement, however, explains nothing. It merely states the fact. Figures of speech likewise explain nothing, but the figure of the hurricane may, nevertheless, convey a truthful impression of what has happened. Just as the rotation of the earth upon its axis checks the centripetal onrush of the winds and creates and area of calm in the eye of the hurricane, so, too, perhaps, has the inherent strength of the American economy held in abeyance destructive forces that have threatened it.

Why It Happened

The inherent strength of the economy, of course, is not one thing, but is a compound of many things. Some of these elements that have contributed to the halting of the inflation may be mentioned.

One of the most important elements of strength in the economy is, of course, the extraordinary productive capacity of the free capitalistic system. On more than one occasion the United States has surprised not only the world but itself by its capacity to turn out a flood of goods and services. It has done so again in the present instance. The Federal Reserve index of total production rose from 199 in June 1950, the month of the Korean outbreak, to 223 in April of 1951—an increase of approximately 12 percent. This was the highest level ever attained in peacetime. There was some decline in the index thereafter, but in November it still stood at 218. (Preliminary estimate.)

The increase in the Gross National Product tells a similar story. The Gross National Product, which consists of the total output of both goods and services valued in current dollars, rose from an annual rate of 275 billion dollars in the second quarter of 1950, the quarter in which the Korean War began, to 327.8 billion in the third quarter of 1951—an increase of 19 percent. Part of this increase, of course, was accounted for by rising prices, but since the consumers price index rose only by about 10 percent in the same period, it is evident that about half of the increase in the Gross National Product represented a real increase in goods and services.

As a result of this increase in production, the shortages of civilian goods that had been pretty generally expected did not materialize. The bitter choice between guns and butter had not yet confronted the American people. Only in a few lines where strategic materials were involved did the public suffer any inconvenience at all.

That the civilian economy did not suffer thus far during the rearmament boom was partly the result of lagging purchases for the armed services. Out of 130 billion dollars voted for the military, only about 35 billion had actually been spent towards the close of 1951. Whether or not it was good that the civilian economy be flooded with goods and services at the expense of a smaller volume going to the armed forces depends upon the correctness of military and political judgments with which we are not here concerned. In any case, only history can answer for the wisdom, or lack of wisdom, of this or any policy.

The fact remains that there has been plenty of things upon which people could spend their rising incomes, and that this very plenty has been an ameliorating influence in a potentially dangerous inflationary situation. No longer fearing shortages of goods, consumers have not repeated the excesses committed in the third quarter of 1950 and again in the first quarter of 1951. In the first wave of scare-buying after the outbreak of Korea, personal consumption expenditures jumped from a seasonally adjusted annual rate of 188.7 billion dollars in the second quarter of 1950 to 202.5 billion in the third quarter. They subsided in the fourth quarter to 198.4 billion, but leaped up to 208.2 billion dollars in the first quarter of 1951, after the Chinese intervention. This second wave of scare-buying quickly spent itself, and by the second quarter of the year, personal consumption expenditures had fallen to an annual rate of 201.7 billion dollars. In the third quarter, they were back at 202.5 billion, the same level as that prevailing in the corresponding period of 1950.

In spite of dire prophecies of greater inflationary dangers yet to be faced when the rearmament program gets into high gear, the buying public has for the moment curbed its propensity to consume. In part, this has been a voluntary reaction, but in part, it has also been the result of having checked buying on credit by Regulation W, even in its present relaxed form. The Federal Reserve's Regulation X and parallel action by other agencies have likewise put the brakes on what threatened to be a wildly speculative boom in construction.

As personal incomes continued to rise, not only did consumer buying level off, but personal savings increased greatly. The two periods of scare-buying were accompanied by declines in the percentage of disposable income that went into net savings—from 4.5 to 2.2 percent between the second and third quarters of 1950, and from 7.8 to 3.9 percent between the fourth quarter of 1950 and the first of 1951. At present, the rate of savings is running in the neighborhood of 10 percent of disposable income, the highest peacetime rate in recent times. This increase in the rate of personal savings has been an important factor in bringing about the stability that the nation enjoys at the moment.

Congress, too, has played an important role in mitigating the inflationary danger, at least for the present, by adopting vigorous tax programs. Although these programs have fallen short of what many have thought desirable, they, together with the inflationary increase in incomes, will apparently succeed in keeping Government revenues and expenditures in approximate balance in the current fiscal year, when the cash deficit will probably amount to no more than about 2 billion dollars.

No one, of course, likes taxes, and there has been much complaint about the present tax burden. It is said to be so heavy that it tends to discourage initiative. Nevertheless, it is perfectly obvious that when incomes grow faster than the output of goods and services available to the public, the excess income must either be saved in non-inflationary forms, or taxed away, else its purchasing power will evaporate by way of rising prices. Of these three alternatives, the last is by far the most dangerous and destructive to the economy. Insofar as Congress has adopted the second of these alternatives, it has lessened the danger of the third.

The banks and other lenders who have participated in the Voluntary Credit Restraint Program, sponsored by the Board of Governors of the Federal Reserve System under powers delegated to it by the President under the Defense Production Act, have also had a share in checking the force of the inflationary storm that had seemed to be brewing. The flow of credit into non-essential uses was curbed without shutting off credit from uses essential to the defense effort. Bank loans indeed, continued to expand throughout 1951, but the increase from midyear through November was less than half of what it had been in the corresponding period of 1950. There is thus tangible evidence that this program of voluntary action has achieved some measure of success in helping to curb inflation.

Ever since the end of the war, however, the most serious source of inflationary danger lay in the monetary and fiscal policies that permitted the monetization of the widely held public debt through the sale of Government securities to the Federal Reserve System at pegged prices. In this way, bank reserves could be created, against which there could occur a multiple expansion of private credit. As long as such policies persisted, the economy was caught in a vicious circle; the more the debt was monetized, the greater the expansion of credit and the upward pressure on prices; the higher prices rose, the greater became the demand for credit, and, consequently, for bank reserves that could be created by further sales of securities to the Federal Reserve.

If the intense inflationary pressures were to be allayed, it was necessary to break this vicious circle at some point. It was well enough to try to check the demand for credit, but this demand is so wide in scope and so varied in its forms that efforts directed against the demand side can at best be of only limited utility. It was obvious that the only radical solution would be a change in policy that would prevent the supply of credit from rising in such an uncontrollable fashion.

Moving in this direction, the Federal Reserve System raised rediscount rates and practically exhausted its power to increase required bank reserves. It was in March 1951, however, that a step of far-reaching importance was taken in the form of an agreement, or "accord," with the Treasury with respect to the Federal Reserve's support of the Government bond market.

Under the terms of this agreement, the Treasury offered to exchange new 2¾ percent nonmarketable bonds of limited redeemability for the two longest-term outstanding 2½ percent restricted bonds. This exchange had the effect of relieving the market from the threat of this volume of bonds hanging over it, and also it reduced the volume of potential sales of Government securities by investors. In this way, an imminent possibility of further expanding bank reserves and, hence, of private credit was checkmated.

Immediately thereafter, the Federal Reserve System took

steps to check the sale of marketable Government securities to the Reserve Banks. Purchases of short-term securities were limited to what was essential in connection with temporary money market adjustments, whereas long-term issues were allowed to adjust to levels reflecting the demand-supply situation. Transactions were still engaged in for the purpose of maintaining orderly market conditions and of creating a favorable market climate for Treasury financing, especially at refunding times. They were, however, no longer engaged in for the purpose of maintaining artificially high prices for Government securities or, conversely, low interest rates on borrowed money. It thus became more difficult for banks and other lenders to increase bank reserves at their own discretion. The recapture by the Federal Reserve of the initiative in the creation of bank reserves thus put it in a position to affect powerfully the expansion of private credit.

The rise in interest rates that accompanied this change in policy could reasonably be expected to have certain salutary results. Higher interest rates, communicated from the Government securities markets to others, could be expected to discourage some borrowing. They could also be expected to encourage investors to buy and to hold securities of higher yield. Banks and other financial institutions were discouraged from selling securities because of the risk of loss in the capital value of their interest-bearing securities arising from flexible prices. Instead, banks had become borrowers from the Federal Reserve Banks in order to adjust reserve positions. Indebtedness to the Federal Reserve Bank would in itself cause the borrowing bank to tighten up on its loans until such time as it liquidated its debt to the Federal Reserve Bank.

To what extent this change in monetary and fiscal policy has been responsible for the reduction in inflationary tension during the latter part of 1951, and to what extent the relaxation has been brought about by some of the other factors that have been discussed cannot be determined. In any situation shaped by many and sometimes conflicting forces, it is impossible to say what influence one or another of them has had in producing the final result. One never knows, indeed, what the situation would have been had this or that element been different from what it actually was. It would therefore be futile to impute praise or blame to anyone for the situation in which the country now finds itself.

We can at least be thankful that we are in the eye of the hurricane rather than being caught up in its destructive winds. For their part in contributing to this relatively stable position, we may thank the Treasury and the Federal Reserve System since they have jointly inaugurated a more realistic monetary and debt-management policy than had prevailed heretofore. We may thank Congress for having gone a considerable distance in recognizing the anti-inflationary importance of taxation. We may be glad that the American buying public is not being carried away by its fears of the future and has increased its savings rather than its consumption expenditures. We may take pride in the achievements of the nation's businessmen in increasing production and of the nation's banks and other lending institutions in discouraging undesirable uses of credit. It has taken the combined efforts of everyone—Government, monetary authorities, business, and public—to achieve this position.

Towards the Future

In these early days of 1952, one cannot escape wondering if we can maintain our present position until the storm blows itself out or if, in the end, we shall have to suffer its fury. It would be trite to say that 1952 is a critical year. Every year is critical for the one following it. But 1952 is truly critical in a very special way. Of one thing we can be certain—as certain as we can be of anything: The dangers in every field—political, military, and economic—will be greater than ever. Military spending promises to mount and the Government's cash deficit will probably be several times larger in the next fiscal year than in this. Every group in the economy—agriculture, labor, business, and all the others—will be sorely tempted to extract the highest price it can get for what it has to sell. The buying public in turn may be tempted to spend a larger fraction of its current income than it has been doing, and, perhaps, to throw past savings into the market in a scramble for goods.

Inflation, like sin, always seems evil when seen in someone else. It often looks fair when it is our own. If our own price is free to rise, we are quite willing for the other fellow's to be controlled. If many of us yield to this temptation to get higher prices for ourselves, we shall certainly be courting disaster. Safety in 1952, as in 1951, will be achieved only by the combined efforts of everyone, working together in a high spirit of social responsibility, and with a willingness to forego the immediate and temporary advantage of the individual or group for the sake of the more remote but more permanent good of all.

EARLE L. RAUBER

Bank Announcements

On January 14, the newly organized City National Bank of Dothan, Dothan, Alabama, opened for business as a member of the Federal Reserve System. This bank began operations with a capital stock of $272,000 and surplus and undivided profits of $68,000. Its officers are W. C. Faulkner, President; J. R. Morgan, Executive Vice President; R. A. Dowling, Sr., and I. Rimson, Vice Presidents; and Richard Griffin, Assistant Cashier.

The newly organized First Bank of Alabaster, Alabaster, Alabama, opened for business on January 21 as a member of the Federal Reserve System. Capital stock of this bank amounts to $50,000. Surplus and undivided profits total $25,000. George L. Scott, Jr., is president; J. A. Hines is Vice President; W. V. Hammond, Secretary; and T. L. Cox, Cashier.

On January 30, the Fort Payne Bank, Fort Payne, Alabama, a newly organized nonmember bank, opened for business and began remitting at par. The bank has paid-in capital of $100,000 and surplus and undivided profits of $25,000. Herman Watson is President; Charles W. Wikle, Executive Vice President; and J. L. Appleton, Cashier.