

PART I

THE GENERAL ECONOMIC SITUATION\*

Background of Regulation W

The role of consumer credit controls must be evaluated in terms of the unusually strong inflationary forces of the past three years. Demand for consumer durables has been at record levels as a consequence of the wartime years of sharply reduced production coupled with large holdings of liquid assets and high current incomes. At the same time, production of many major consumer durables has been restricted because of the equal urgency of demand for durable producer goods and the limited amount of steel available to satisfy the unprecedented total demand.

Under these circumstances, restrictions on the use of consumer credit have served to lessen the intensity of demand for scarce consumer durables and thereby to temper somewhat the consequent price increases. Nevertheless, the instalment credit controls exercised by the Board became inoperative after November 1, 1947, in accordance with the resolution of Congress approved on August 8, 1947.

After a sharp decline in prices of farm products and foods in February of 1948, inflationary pressures were again reasserted and by mid-summer appeared to be clearly dominant for the near future, particularly since average prices at both wholesale and retail had been rising sharply in the preceding months. Enlarged defense expenditures arising out of the tense international situation, the adoption of the European Recovery Program, and a substantial reduction in personal income taxes combined with previously existing factors of strength to give a strong upward lift to the economy in the second and third quarters.

During the middle months of the year, personal income rose very sharply, in part because of higher employment and in part because of higher wages resulting from wage contracts negotiated in the mass production industries. Gross national product increased at an annual rate of 11 billion dollars from the first to the third quarters reflecting increases in both prices and output. Corporate profits both before and after tax reached new peaks in the third quarter. During this period, the most important apparent anti-inflationary factor was the bumper harvest of 1948, as a result of which prices of important crops declined to about support levels.

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In the light of strongly inflationary developments in both the postwar period as a whole and in the immediately preceding months, the Board of Governors on August 19, 1948 issued Regulation V; to become effective on September 20, thereby reinstating consumer credit regulation. This action was taken under Public Law 905 which the President signed on August 16.

#### Recent economic developments

More recently a less inflationary pattern of economic tendencies has begun to emerge. (Contributing somewhat to this tempering of inflationary pressures were the reimposition of Regulation W and the raising of member bank reserve requirements in September.) Signs have recently appeared that in an increasing number of areas supplies had caught up with or even exceeded demand at current prices.

Average wholesale and consumer prices have receded from their August peaks. In fact, at the end of December, average wholesale prices were just below those of December 1947, while average consumer prices were moderately higher. These broad averages, however, obscure the fact that changing cost, demand and supply situations in various markets have been reflected in an increasing divergency in price movements, with wholesale prices of many commodities, particularly nondurables, lower at the end of the year than at the beginning. Of the ten major groups in the wholesale price index, only metals and metal products, fuels and lighting materials, housefurnishings and building materials are at higher levels than a year ago. Prices of metals and metal products, however, increased almost 15 per cent in 1948--a larger increase than in 1947--and such prices are still moving up.

While wholesale price declines since August are mainly the result of lower prices for farm products and foods, it is significant that prices of all other commodities have been virtually unchanged on the average since mid-August, although they are still moderately higher than at the end of 1947. Prices of nonmetallic raw materials have been drifting down, while metals have continued to edge up.

Following an increase in reserve requirements at member banks, expansion of loans at commercial banks, which had been at about the same rate in the July-September period as in the same months of last year, slackened considerably in the fourth quarter. Bank lending to businesses, real estate buyers, and consumers was generally curtailed and showed little growth in the last quarter of the year compared with a very large expansion during the same period in 1947. In part, slackening of business demand for bank loans is the result of the increased volume of funds obtained from other sources, including retained earnings out of record profits and funds from nonbank sources, including insurance companies. Reduced expansion in total consumer instalment credit in October and November reflected in part the reimposition by the Board of Governors of controls on the terms of such loans, effective September 20.

New residential units started have declined steadily from the peak reached in May, in contrast to experience in 1947 when they rose steadily to October. In recent months, the volume of such starts has been well below the levels of the corresponding months of last year.

Expectations of deflationary developments have been supported by the widespread reporting of pre-Christmas sales and by a host of reports on layoffs and shortened hours in many industries, including consumer durables. Quantitatively, these layoffs have not yet added up to much, but as indications of slackening demand they have been disquieting. Contrary to the usual pre-holiday seasonal advance between October and November, employment in nonagricultural establishments declined by 170,000 this year, according to estimates of the Bureau of Labor Statistics. Total nonfarm employment, at 45,700,000 persons in November, was 780,000 above the same month of last year. However, this was the first time in 1948 that the year-over-year differential has fallen below a million.

The curtailment of operations in textile, leather, and apparel groups, along with scattered layoffs in some other industries, resulted in some increases in unemployment. In December, according to the Census Bureau estimates, unemployment rose to 1.9 million persons, about 300,000 more than at the lowpoint reached in October and also about 300,000 more than in December 1947. Furthermore, sharp reductions in the work week have taken place in those soft goods industries which have been curtailing employment.

A trend of small increases in unemployment is also indicated by the number of persons filing claims for unemployment compensation under the State programs (exclusive of the veterans program). The number of initial claims filed increased from about 160,000 a week at the end of September to 280,000 a week in late December, and claims filed for continued unemployment rose in the same period from a level of about 800,000 to 1.2 million. By contrast, there was virtually no change in the number of claims filed during the same period last year. For the week ending December 25, 1948, about 130,000 more initial claims were filed and there were about 440,000 more continued claims than in the same week last year.

Consumers have been exercising a surprising amount of caution in making retail purchases, in view of the record levels of personal income and the large and fairly well distributed volume of outstanding liquid assets. Throughout November and early December, department store sales were below those of the corresponding months of 1947. Sales in December, however, are now estimated to have been about 1 per cent higher than in December 1947. For November and December combined, such sales did not quite equal those of last year. Particularly hard hit in department stores were sales of major household appliances. To some extent, however, this may represent a loss of such business to other types of retail outlet, but this would generally reflect a sharp intensifying of competitive activity in this merchandising area. Sales of all retail stores dropped slightly

in October, and by November they were 2 per cent below those of September on a seasonally adjusted basis. Sales of stores in the housefurnishings group showed a decline of almost 12 per cent from September to November and a decline of 4 per cent from November 1947.

After sharp rises in the middle months of 1948, personal income has been fairly constant at record levels since August in contrast to experience in 1946 and 1947, when it increased sharply in the closing months of the year. In part, this is due to the fact that wage and salary income has leveled off in recent months.

The ratio of personal saving to disposable income has shown a tendency to increase moderately since the second quarter of 1947. In part, this upward drift has represented a relative shift in the disposition of personal incomes from consumption type objects toward nonconsumption categories, such as noncorporate business investment, farm inventories, and purchases of new homes which are included in saving rather than in consumption expenditures. Nevertheless, insofar as the rise reflects increased consumer savings in liquid form and an increased volume of debt repayments, it has served to relax inflationary pressures generally in the economy. Available data through the end of 1948 are not adequate to evaluate properly the relative importance in aggregate consumer demand of these two factors. In view of the slackening becoming evident in purchases of new homes and in retail sales generally and the declines in prices of farm products, however, increases in the rate of personal savings at this time suggest growing weakness rather than continuing strength in such demand.

On the basis of the limited data now available, it is probable that the median liquid asset holding and the proportion of units with some liquid assets declined slightly during 1948. Total individuals' holdings of liquid assets remain about as large as at the end of 1947 and fairly widely distributed.

#### The outlook for the first half of 1949

There have been several occasions in the postwar years when it appeared that inflationary pressures were receding. Although major factors of strength remain in the economy, there are several reasons for believing that the current period actually is at least a temporary period of change from a condition of generally rising prices to one of relative price stability at generally high levels of production and employment.

Three years of high-level production of houses and consumer and producer durables have succeeded in reducing the intensity of demand for many commodities at current prices. This situation has been reflected in the divergence of price movements this year, in the moderate slackening in the rate of investment in producers' goods and inventories, in the reduced rate at which new housing units are being started, and in increasing consumer

resistance and selectivity with respect to consumer durable goods as well as nondurable goods and services. To a minor extent, this relative weakening of demand is being reflected in declines in employment and output as well as in prices.

The bumper crops of 1948--in contrast to short crops in 1947--coupled with improvement in the agricultural situation abroad have resulted in marked price declines of such commodities, and serve to relax upward price pressures on foods and other finished commodities and to moderate pressure on wages arising from high living costs. Furthermore, industrial recovery in Western Europe has served to reduce demands for such commodities as coal and textiles which are normally not imported in large quantities from the United States, thereby considerably easing the supply position here for these commodities. In other areas, such as petroleum products, the large scale investment of recent years is resulting in increased domestic supplies.

Under these circumstances, it appears that further inflation is not likely to develop in the first half of 1949, if it is assumed that actual and prospective defense spending is not increased substantially more than the rise indicated by present schedules based upon the fiscal 1949 budget. A defense budget of well over 15 billion dollars for fiscal 1950 is not likely to affect materially developments in the first half of 1949, in view of the fact that appropriations are not ordinarily passed upon much before the adjournment of Congress although anticipatory effects upon consumer and business expenditure policies might be of some importance.

The major uncertainty, then, for the first half of 1949 relates not to whether there will be further inflation but rather whether there will be sharp price deflation with accompanying widespread reductions in output and employment or whether moderate downward price adjustments can be effected with generally high levels of employment. The cumulative evidence of slackening of demand in many markets at current prices must be considered in the light of the remaining factors of strength in the economy, including record levels of personal income, large and fairly widely distributed holdings of liquid assets, still rising State and local expenditures on greatly needed public works, large and still rising Federal expenditures particularly for defense and foreign aid.

The limitation placed on the money supply by a large Federal cash surplus in fiscal 1948 has been substantially reduced this year as a result of increasing expenditures and the reduction of personal income tax rates last spring. Thus, in the first half of calendar 1948, the Federal cash surplus was 7.6 billion dollars; in the same period of 1949 it is estimated at 2.1 billion. A further reduction in the cash surplus or even a deficit is likely in fiscal 1950 in view of the probably large increase in expenditures, unless tax rates are increased. Meanwhile, state and local

governments, which showed a cash surplus of 1 billion dollars in 1947, have shown an increasing cash deficit throughout 1948. In view of increasing demands placed on such governments for education, construction of public buildings and roads, it is likely that this deficit will be larger in calendar 1949 and that borrowing by these governmental units will continue to expand.

Large programs of private investment in plant and equipment, especially on the part of public utilities and railroads, are still a long way from completion. In this connection, the most recent Commerce-SEC Survey of Plant and Equipment Expenditures (conducted after the election) indicates that planned expenditures in the first quarter of 1949 are about 5 per cent above actual expenditures in the first quarter of 1948. In view of price increases for capital goods since early 1948, this probably represents a small decline in the physical volume of such investment, but the planned level of investment is nonetheless high,

Another favorable factor in the economy is the fairly cautious policy of inventory accumulation which business has followed since the end of the war. There is no evidence in recent months of any shift to speculative accumulation. While excessive inventories have been accumulated in some lines--in some cases involuntarily--there is no statistical evidence that the over-all holdings of business inventories are seriously excessive in relation to business in the second half of 1948. It should be pointed out, however, that declining levels of business always make it appear that pre-existing inventories have been too high.

Another source of strength in the first part of 1949 arises out of the fact that Federal refunds on personal income taxes are likely to be about 1 billion dollars larger than in the first part of 1948 because of the fact that reduced withholdings did not go into effect until May 1, 1948.