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THE CURRENT ECONOMIC SITUATION AND OUTLOOK*

The great boom of the Forties, it now appears, has largely run its course. Originating as a typical business upswing following the sharp recession of 1937-38, the boom gathered strong upward impetus after the outbreak of war in Europe, and mounting national defense expenditures. It was converted into a "controlled war inflation" expansion by our entry into world conflict. After four years of total war and removal of wartime controls, the boom received a final inflationary stimulus from the huge overhang of war-created liquid resources and from an exceptionally large reequipment backlog and heavy restocking needs for consumers as well as for producers and distributors. Pressures on domestic output were also heavily taxed by demands from abroad where production and trade had been disrupted by war much more than in this country.

The boom had many extraordinary features. The average per annum increment in physical output probably reached an all-time rate. Unprecedented sums were spent on war, armaments, and international aid. Additions to productive facilities and advances in technology were unparalleled in this country's annals. A whole new frontier of economic power and technology was discovered for exploitation by future generations. Throughout the entire boom period and for the first time in the records of capitalism, interest rates were relatively stable at an exceptionally low level.

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*Statement by Ralph A. Young, Associate Director, Division of Research and Statistics, Board of Governors of the Federal Reserve System, before the Conference of Federal Reserve Bank Chairmen, White Sulphur Springs, West Virginia, May 30, 1949.

The real income of American consumers during the boom rose by some 30 per cent. Incomes became much more evenly distributed than ever before in our history. Probably a higher proportion of consumers held some liquid assets and had sizable secondary financial reserves in the form of life insurance, houses, and corporate securities than at the peak of any previous period of long-sustained business boom.

Considering the inevitable prodigality of our war finance and the enormous carry-over of spendable resources which it left us, the real wonder of the recent period is not that we had so much inflation, but that we had so little. Perhaps the ultimate credit for this achievement should go to progress in economic democracy. Had we not experienced considerable broadening of the average citizen's economic knowledge, our inflationary excesses might have had no bounds.

The composite of current indications, as my opening comment implied, is that this extraordinary boom period has now been succeeded by a period of readjustment. What are these indications and what importance is to be attached to them? For purposes of summary analysis we may divide them into two broad groups: certain current economic tendencies -- straws in the wind -- and certain underlying forces and structural conditions.

Certain Current Economic Tendencies

Consider first some of the more striking current economic tendencies:

1. Since last fall, declines in industrial production, in factory man-hours and employment, and in prices have been very widespread and much more general than in any preceding soft phase of the boom period.

2. While declines in many areas have thus far been moderate, the more sensitive areas have shown large, and even very large, declines. Some declines -- for example, in basic prices -- have rivaled the sharp and drastic declines of past periods of major business readjustment.

3. Metal and metal products industries have recently shown considerable evidence of weakness. Steel consumption has been declining, with the likelihood that the current rate of steel output, which is already 7 per cent below its level in middle March, is probably still in excess of consumption.

4. Inventory accumulation has slowed down, with inventory of finished goods continuing to rise and inventory of materials and goods in process tending to fall. Differentials between product prices and material costs, in some instances wide differentials, are keeping new orders at low levels in a growing number of industrial areas.

5. After the middle of 1948 residential building declined and, despite a marked seasonal expansion this spring in new starts, is still below year-ago levels. Business construction also is down moderately and, notwithstanding a marked increase in public construction, total activity in the construction industry is no higher than a year ago.

6. Total business expenditures for plant and equipment have leveled off, with expenditure plans indicating declines in the second half year. Farmers also seem to be paring expenditures for equipment and land and current farm influences appear to favor some decline in farm investment.

7. Consumer spending, excepting expenditures for services, food, and automobiles, has been drifting downward much of the time since last September, while personal saving in relation to disposable income has been rising. Accompanying the rise in personal saving has been a tendency towards larger consumer holdings of liquid assets.

8. Business financial positions show signs of decreasing liquidity, and the distribution of financial strength and liquidity is less widespread than a year ago. In addition, factors sustaining profit levels have weakened significantly, particularly in the case of medium-size and smaller enterprises. The rate of business failures has also been creeping up for some months.

9. Credit demand at banks has tapered off and, together with a reluctant lender attitude apparently assumed by many bankers, has resulted in a sharp reduction in the volume of outstanding bank loans, especially of loans to business enterprises. New security financing, corporate profits, and undistributed earnings are all somewhat lower than in the second half of last year.

Certain Basic Forces and Conditions

Characteristic symptoms of the tapering off phase of a boom are impressive enough in themselves. They need, however, to be related to various forces and structural conditions of more basic importance:

1. Sustained high levels of postwar output have gone a long way toward satisfying the more urgent deferred demands for many consumer goods, including automobiles and houses. No doubt many consumers have exhausted their savings or credit, or both, and consumers generally show more choosiness and disinclination to buy because they expect lower prices.

2. Inventories have been replenished at all stages of production and business expenditures for building up inventories and customer receivables have ceased to provide a significant financial stimulus. Declining prices, for example, reduce the dollar investment needed to maintain necessary holdings of inventory and customer debt, and in many fields lower current asset investment is becoming an important contractive influence.

3. Business has invested huge sums in plant and equipment since the war in order to meet a combination of backlog and currently arising demand. With backlog demand largely satisfied, capacity in many industries is not only excessive at current prices, but in some industries may turn out to be excessive even at materially lower prices.

4. While the average age of passenger automobiles is quite high compared with prewar, suggesting a continuing backlog of automobile demand, the industry is producing a much larger proportion of medium and high-priced cars of greater durability than prewar. Signs of some narrowing in the market for medium and high-priced cars have been evident for several months, and premiums have been greatly reduced or eliminated even for low-priced cars.

5. Concurrently with the substantial satisfaction of backlog housing demand, the housing market is commencing to feel a gradual tapering off in such basic forces as a rising rate of marriages and births and boom period migration and shifts of population. The impact of these forces is, of course, cumulative. It should be remembered, moreover, that spending for housing has a large secondary effect in consumer, business, and public investment that is not associated in the same degree with other forms of construction. The effect on the economic situation of declining construction of new housing is not fully absorbed by an offsetting expansion in other types of construction.

6. Farm prospects, assuming favorable growing and harvesting conditions, are for large crops and continuing pressure of supply on farm and related prices.

7. Foreign demands for American industrial goods and foods are less urgent than earlier and are tending to soften. Foreign supplies of materials and other goods are more ample and more generally available, and hence a more active supply influence in domestic markets.

8. Examination of the current structure of commodity prices discloses many conspicuous price rigidities and disparities between prices. Some groups continue at exceptionally high levels relative to prewar. Prices of used cars and houses are still high relative to new car and new house prices; metal prices are high relative to scrap. Wide price disparities feature many materials that are substitutes for one another in many uses. For the most part, declines in consumer prices so far have been very moderate in relation to those in wholesale markets.

Continuing Strengths and Cushions

The American economy has often been stigmatized as a "boom and bust" economy. This characterization finds much support in historical record, and the very fact of the record makes for apprehension about the near-term future. We have had the boom. Does the emergence of a readjustment process mean that we must, of necessity, have the "bust"? In terms of our recently attained peak level of national product, this is truly a 100 billion dollar question.

We are all aware from experience that each force such as falling prices, price disparities, curtailed orders, liquidation of inventory, reduced consumer spending, declining income, lower investment, contributes something to economic contraction and together tend to make for a downward spiral effect, the essence in short of a "bust". Whether a cumulative downward spiral, resulting in severe and prolonged depression will eventuate, is impossible to foretell at this juncture. Developments to date do not warrant so pessimistic a view. They do support, however, an expectation of continuing moderate contraction in activity.

In considering this possibility, it is vitally important to keep in perspective the various strengths and cushions that are present in the current situation. For the most part, these strengths and cushions are without parallel in past culminations of extended periods of inflationary economic expansion. We can undertake here only to mention the more important ones:

1. As employment declines the Government automatically pays out unemployment compensation benefits which partially maintain the income and expenditures of the unemployed.

2. Payments under the farm support program similarly help to maintain income and reduce the dangers of unlimited farm price declines.

3. Federal expenditures on goods and services are in record peace-time volume and some further increase is probable. State and local government expenditures are expected to expand considerably because of pressing needs for schools, hospitals, other public buildings, and roads.

4. Consumer financial positions are strong as a result of prevailing high incomes and large and widely distributed liquid asset holdings. Many more consumers than ever before have substantial secondary reserves in the form of life insurance, corporate securities, and equities in homes.

5. From the standpoint of providing a mass market for our mass production system, current income also is probably better distributed than at any prior time.

6. Labor is more widely organized than ever before to resist severe cuts in wage incomes.

7. The Board's annual Survey of Consumer Finances, just completed, shows that there continues to be a large demand for automobiles, household appliances, furniture, and houses. At lower prices, potential demands for goods and services would seem to be very great. Where substantial price reductions have occurred recently, increased buying has tended to absorb previously excessive stocks. Survey data reflecting consumer attitudes and expectations show that, while the preponderant expectation is for price declines this year, few consumers expect large declines.

8. Ten years of an inflationary buyers market have rusted the merchandising skills of industry and trade. Putting these skills again to work so that our mass production system becomes fully reconverted to a mass merchandising-production system can help reestablish sensitive contact between consumption and production.

9. Business financial positions over-all are strong in comparison with prewar, and lower material costs together with increased productivity are providing additional flexibility to financial management.

10. A high level consumption economy will continue to require large capital expenditures by business and farming. Substantial programs of capital expenditure doubtless await lower construction and equipment costs. In addition, many new expenditure programs may be stimulated by narrowing margins between costs and prices.

11. While a reduction in personal incomes and housing prices may make part of our large mortgage debt vulnerable from the standpoint of the borrower (who enjoys lower interest rates than prevailed, for instance, in the late Twenties), widespread use of mortgage amortization and of Government guarantees provides the lender with important protections.

12. The fact that the postwar period has been free of speculative excesses in the securities markets, the generally strong financial position of industry, and the great strength of the banking system are factors that make a prolonged and drastic liquidation less likely than in other periods of decline.

13. It seems quite unlikely that the money supply will contract over the months ahead. On the contrary, it appears probable that Treasury deficit financing through the banks will more than offset any loan contraction which might occur, thus having an expansive impact on the money supply.

14. The credit supply is large and elastic and the cost of credit -- short and long-term -- continues to be low.

15. The Employment Act of 1946 establishes maintenance of economic stability as the objective of national policy. This objective implicitly recognizes a governmental responsibility for interceding in economic readjustment to prevent a "bust".

Business Policies and Government Policies to Cope with Economic Contraction

These are sturdy underpinnings and their capacity to absorb considerable economic readjustment without straining the limits of social tolerance should not be underestimated. We should recognize that they are reenforced in many areas of activity by able and well-informed managements, alert to the pitfalls of a changing economic situation and aggressive in coping with its problems.

Now that postwar restocking needs are satisfied and the economy is adapting to sustainable peacetime requirements, substantial economic readjustments are highly desirable and necessary to attain a balance in relationships between production and consumption, among prices, and in the structure of production. If these internal adjustments are made as the need for them arises and at a time when total demand is generally strong, reductions in over-all activity may be moderate. If essential readjustments are delayed and allowed to accumulate, recession in general activity may be serious. In view of the notable strengths that abound, our present recession should be moderate, even though sharp declines may be experienced in some lines. Whether recession will turn out to be moderate will depend, of course, on the appropriateness and timing of business, financial, labor, and Government policies.

It is an easy temptation in a period of readjustment such as this to place the blame on public policies and to look to public policies as the cure. Readjustment in a free enterprise economy is in the first instance a matter of private policies. Flexible adaptation of merchandising programs -- i.e., of prices, marketing policies, and costs -- and the wise administration of private debt, is at the heart of the readjustment process. If business responds promptly and decisively in its problem area while maintaining as fully as possible its volume of output, and if bankers and other lenders fill their obligations as far-sighted creditors, then the prospect of moderate economic contraction will not only be realizable, but realized.

Government can make its most important contribution to readjustment at this early juncture by following policies that encourage business and consumer expenditures or remove impediments to such expenditures; that maintain public expenditures on a prudent basis; that assure the continued availability of an ample supply of low-cost credit to worthy borrowers; and that improve the economy's fiscal and financial structure. Tax revenues will decline as readjustment proceeds, and Government may confront substantial deficits. Readjustment deficits, however, should not be a source of undue concern to the informed citizen. If there is one lesson of fiscal policy that has been well taught by history, it is that Government can neither tax an economy out of a depression nor can it restore prosperity by drastically slashing its own expenditures.

We have not, in this century anyway, solved the problem of distributing all that our technical genius enables us to produce -- except through the stimulus of world war and the inflationary after effects. To my mind this does not mean that we lack the will and the wit to find reasonably satisfactory solutions. From practical experience, we know a great deal more today of techniques -- of ways and means -- of moderating extreme swings of the business cycle. We need to perfect them, to time them better, and to clear away the fogs of ignorance and prejudice that are the greatest danger in perpetuating democratic capitalism.