

THE ECONOMIC OUTLOOK FOR 1951

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Three months ago when Mr. Schultheis asked me to speak to this Conference on the topic "The Economic Outlook for 1951", I presume he had in mind the international situation and its probable effect on our domestic economy-- particularly banking and finance. For obviously it is necessary to appraise the current international situation before making observations about the future.

You will recall the events during the second half of 1950. When the Red forces of North Korea invaded South Korea last June, it was decided that the United Nations could not permit this unprovoked act of aggression to go unchallenged. Soon American Soldiers, under the banner of the United Nations, were fighting side by side with the South Koreans. After five months of bitter battle, it appeared that the struggle in Korea was drawing to a successful conclusion. Then the Chinese communists struck in force across the Manchurian border, and world peace now seems farther away than ever.

The Korean episode has confirmed the fear that has been growing since the end of World War II. The ruthless men of the Kremlin are determined to extend their domination over the free nations of the world. By common consent, the United States has been chosen as the chief defender against them. For our own self protection, to say nothing about the rest of the world, we must accept this responsibility. We must transform our country into a garrison state and prepare to defend ourselves and our friends against communism. To a traditionally free nation like ours, this will be an almost intolerable burden. What can we

do to mitigate the evil and to fortify our strength? The way we answer this question will in a large measure determine the outlook for 1951.

The nature of the conflict. This worldwide conflict in which we are now engaged has two important phases. In part it results from an attempt by one nation to extend its domination over the rest of the globe. History teaches us that this is not the first time such an attempt has been made. However, all previous conquests of this sort have eventually failed, although some of them have been successful over wide areas and for substantial periods of time. The other aspect of this great struggle is a conflict between two contrasting types of economic organization--the free enterprise system of the United States and Western Europe on the one hand and the centralized totalitarian system of communism on the other.

If this worldwide conflict were solely a question of determining which nation is to become the dominant power of the globe, the result would depend upon military planning and strategy and the ability to provide the implements of war. But in view of the fact that the struggle involves far more than military dominance, the final outcome will depend upon the question of whether our system of private business enterprise or the communist system of centralized governmental authority proves to be the more acceptable method of organizing economic activity. That is to say, our economic system must be made to work under any and all conditions. Whether we have a hot war or a cold one, a combination of both as we are having now, or no war at all, our system must continue to demonstrate its superiority.

The leaders of the communist block of nations are convinced that the private enterprise system is inherently weak because of its instability. They

believe the economy of the United States will be so weakened by recurrent periods of feverish business activity followed by depression and stagnation that it will inevitably collapse. It has been my judgment that, because of this belief, the Soviet leaders were not likely to initiate a worldwide hot war in the immediate future. However, the events of the last two weeks have made me wonder if I might be wrong.

The record of business instability. The belief that capitalism is inherently unstable and subject to alternating periods of depression and prosperity is held not only by communists but also by most Americans who abhor communism. There are two important reasons for this belief. One of these is the historical fact that during the past two centuries our economy has been subject to frequent breakdowns. All of us recall the early 1930's when millions of people were without work in the midst of vast productive powers and unused resources. We had what appeared to be an anomalous situation of people going hungry because too much food was produced and going cold because too much coal was mined, too many clothes were manufactured, and too many houses were built. Because some economists called it an "over production-under consumption depression", we tried to cure it by paying farmers to plow under every third row of cotton and by butchering the sows that were about to farrow a litter of pigs.

It sometimes seems to me that we actually enjoy recalling the great depressions of the past. We discuss them with nostalgia, like a gossip describing her operation in all its lurid details. We have a business cycle chart under the glass top of our desk or framed and hanging in a prominent place in our office.

It shows primary post war depression, secondary post war depression, debt repudiation depression, the rich man's panic, and the long depression of the 70's. Moreover, almost all of us are guilty of the fatalistic belief that depressions are inevitable. Professional economists, business men, bankers, and government officials are in general accord on this point, even though they may disagree on everything else. I dare say that if I were to call for a show of hands, everyone present would indicate his belief that depressions are unavoidable in a peace time capitalistic economy. If we have so little faith in our own ability to avoid depression, is it any wonder that the disciples of communism also believe our system will wreck itself--particularly if they give it a push or two to help it on its way?

The function of prices. The other reason for the belief that capitalism is inherently unstable has its roots in the very nature of the economy, with its apparent lack of coordination, direction, and control. In a totalitarian state, basic plans and decisions are made by a few people, and these plans and decisions are directed and controlled by governmental machinery. In a competitive private enterprise economy, the government exercises very little conscious direction and control. Decisions regarding production plans and the operations of factories and other types of producing enterprises are made by a multitude of persons, either on their own account as individual businessmen or as officers of business enterprises. Isn't it inevitable, some people ask, that these plans and decisions will be poorly coordinated and will result from time to time in the kind of a mess we call a business depression?

The question does indeed arise as to how the multitude of decisions by hundreds of thousands of separate business enterprises are coordinated so

that there is a reasonable degree of order in the economic system. To see how this coordination takes place we need to look at business arrangements for the purchase of materials, the hiring of labor, and the sale of goods and services. Those arrangements, or contracts, are made in terms of prices and promises to make payments in money. The prices represent the number of units of money, in the form of currency or of checks on a bank account, which will be paid for a given amount of materials or labor or a given quantity of goods or services. The system of prices which these contracts produce becomes a kind of impersonal central regulator of the economy. If businessmen make inappropriate decisions and base their contracts upon them, they find that their goods remain unsold or can be sold only at a loss. They discover that other types of goods which are comparatively scarce command relatively high prices. Consequently the prospect of making profits as a result of producing such goods acts as a force inducing businessmen to shift labor and materials to their production and away from making those types of goods which are relatively abundant and have been found to be unprofitable.

The prices which eventually govern these decisions of businessmen are those which individuals are willing to pay for the final products of the economy. As economists have often remarked, consumers cast their votes for some goods and services and against others as they go shopping every day in the market places. Thus the choices and decisions not merely of business enterprises but of all the people, expressed as preferences in the market, produce a price system which becomes the governor or regulator of production. Professor Wallis of the University of Chicago in a talk before the Citizens Board of the University of Chicago made this statement:

"The price system has two outstanding features. First it is by all odds the most efficient system of social organization ever conceived. It makes it possible for huge multitudes to cooperate effectively, multitudes who may hardly know of each other's existence, or whose personal attitudes towards one another may be indifference or hostility. Second, it affords a maximum of individual freedom and a minimum of coercion. And since people can cooperate effectively in production even when their attitudes on other issues are hostile, there is no need for unity and conformity in religion, politics, recreation, and language--or even in patriotism and good-will except in the very broadest senses." 1/

Instead of calling this economic order "Capitalism" or "Individualism" or "The American Way of Life" it is much more appropriate to call it the "Prices and Profits" system.

The supply of money. As we think about the importance of prices in this economic system, the question arises in our minds as to why they sometimes get out of order. We know from experience that in depression, as in time of inflation, prices do not seem to function well as a regulator of our economic activity. Why not? Could it be that there is something wrong with our monetary system rather than with the price system itself? That is to say, is the well-known erraticism in the quantity of money the cause rather than the result of business instability? Certainly it is worthwhile to examine this hypothesis.

In making an examination of this hypothesis we may start with the fundamental economic principle, the law of supply and demand, and ask the question: Is this principle applicable only to the various types of goods and services which are bought and sold in the economy, or is it applicable also to the circulating medium or money which is used in making payments and

1/ W. Allan Wallis, "The Mechanism of a Free Enterprise Economy," Marquette Memo, Sept., 1950.

fulfilling contracts? The answer to the latter question is yes. When money is in great supply relative to the need for it, as measured in an appropriate manner, it tends to fall in value and each unit becomes worth less and less in buying goods and services; if money becomes scarce relative to the need, it tends to rise in value and fewer units will be required to buy a suit of clothes, an automobile, or a television set. That is to say, a decline in the value of money due to an excessive increase in its quantity is the same as a general rise in prices. This is what we call inflation. Similarly, a rise in the value of money due to a decrease in its quantity is simply another way of describing a general fall or deflation of prices.

Neither inflation or deflation occurs instantaneously. In each case some prices go up or down and this produces pressure on other prices. Moreover, many prices are fixed by contract or custom or for other reasons are rigid and do not move readily. This creates distortions in the price structure. Generally speaking, in inflation these distortions are such as to make business unusually profitable and thereby to stimulate businessmen to feverish activity. Likewise, the distortions of the price structure during deflation tend to make business unprofitable, whereupon businessmen find it necessary or at least expedient to reduce their working forces, thus producing unemployment.

These remarks on the role of the price system as a governor or regulator of a private enterprise economy, and on the character and impact of inflation and deflation, lead us back to the problem of business instability. If the money supply, which nowadays consists primarily of bank deposits but also includes the currency which we carry around in our pockets, does not remain stable in quantity with a reasonable increase in line with the growth of the economy, occasional periods of inflation and boom on the one hand, and of deflation and depression on the other, appear to be inevitable. Some economists

who have studied the operations of our banking and monetary system have concluded that the banking system has been responsible in the past for many erratic changes in the money supply, and that those changes in the quantity of money have been the basic cause of business instability. Consequently, they have concluded that maintenance of monetary stability with a reasonable rate of growth is the key to economic stability. I would like to quote here from two books published during the past few months.

Professor Lloyd W. Mints of the University of Chicago is the author of a recent book dealing specifically with the problem of monetary policy for a competitive society. Professor Mints says:

"Monetary stabilization is needed as one of the rules of a competitive society. It is needed to prevent undue fluctuations in the expectations of the business community. For this purpose stability in the general level of prices is the essential requirement." 2/

Mr. Ralph G. Hawtrey is probably the foremost English economist who has studied the relation of banking and monetary policy to business instability. He has written several books dealing with this problem, and has recently re-written a book on currency and credit which was first published more than thirty years ago. He closes the new edition of this book with these remarks:

"Monetary stability is an essential condition of the survival of competitive private enterprise. Nowadays that economic system is challenged. The challenge ought to be met on its merits. It would be regrettable, not to say, contemptible, if the case for capitalism went by default because the monetary authorities of the world do not know how to rise to their responsibilities or to take advantage of their opportunities." 3/

2/ Lloyd W. Mints, Monetary Policy for a Competitive Society (McGraw-Hill Book Co., 1950), page 171.

3/ R. G. Hawtrey, Currency and Credit, fourth edition, (Longmans, Green and Co., Ltd., 1950), page 435.

Bank reserves. If an unstable quantity of money is the leading factor in producing business fluctuations, what forces initiate changes in the quantity of money? Since bank deposits form the bulk of the money supply, this is a question of what forces affect bank operations and result in fluctuations in the amount of bank deposits. Without taking time to go into a detailed examination of this question, I will simply say that banks find it profitable to maintain their operations close to the limit permitted by their reserve position. When banks have excess reserves, they can acquire additional assets and increase their incomes; when they have insufficient reserves, they have to dispose of assets even though income is lost in doing so. When banks increase their assets, they automatically increase their deposits; and when they dispose of assets, they thereby decrease their deposits. That is to say, the quantity of bank deposits depends almost exclusively on the quantity of reserves available to banks. The only exception to this is when reserves expand with great rapidity, as in the latter half of the 1930's, and the sequential expansion by the banks is at a slower pace.

Since 1917, Federal Reserve policies have largely determined the amount of reserves available to banks. When the Federal Reserve banks acquire additional assets, the reserve balances of member banks are thereby increased; and when they dispose of assets, member bank reserve balances are decreased. Moreover, the Federal Reserve banks have enormous powers of acquiring additional assets, or of relinquishing assets which they hold; and the amount of assets actually acquired or relinquished is dominantly influenced by the terms set by the Federal Reserve authorities themselves. If the Federal Reserve is going to be held responsible for controlling inflation

and deflation, it must be left free to set the terms on which it will acquire or relinquish assets.

Postwar adjustment. The theory that business fluctuations are the result of inappropriate variations in the quantity of bank reserves and that these variations in reserves result from Federal Reserve policies is supported by the course of events since 1917. To illustrate, let me review the changes in reserves, prices, and business during and since the close of World War II. In 1942 Federal Reserve authorities announced that the System would provide the banks with all the reserves they might need as a result of increasing their holdings of Government obligations. During the war years banks acquired a huge volume of Government obligations, and the amount of bank reserves and the quantity of bank deposits increased rapidly. Reserves continued to increase, though more slowly, for two years after V-J day. From the end of 1941 to the end of 1947 Federal Reserve bank assets nearly doubled, and member bank reserves, adjusted for changes in percentage requirements and other factors affecting their effectiveness as a base for deposit expansion, increased by about 60 percent. The money supply, measured by the Federal Reserve series of "deposits adjusted and currency," more than doubled. The money supply expanded more rapidly than effective reserves, because the extraordinarily large gold imports immediately preceding the war permitted the banking system to enter the war with substantial excess reserves. This great increase in the money supply between 1941 and 1947 led to some rise in prices during the war and to a rapid rise when wartime controls were removed. The wholesale price level rose about two-thirds and the consumers price index by about one-half from the first six months of 1942 to the first six months of 1948. This increase in prices reflects the impact of the excess of monetary expansion over the growth of production.

In the latter half of 1947 and the early months of 1948 various measures were taken for the purpose of preventing any further increase in the money supply. These measures impinged on bank reserves. By the end of 1947 the expansion of bank reserves was halted and turned into contraction. Between that date and the end of April 1949, the effective amount of bank reserves was reduced by 15 percent relative to the normal rate of growth. Bank deposits also declined substantially though not by so large a percentage. The price level turned down and business activity slackened in the fall of 1948, several months after the peak in reserves, repeating the typical sequence and lag which prevailed between the World Wars.

By the Spring of 1949 fears were arising that a serious postwar depression was at hand. At this point the Federal Reserve authorities reversed their pressure on reserves. Early in May they started a series of reductions in percentage reserve requirements, thus stopping the contraction in effective reserves and in deposits. In the summer and autumn business sentiment became more favorable, several of the leading indicators of revival appeared, and fear of a deep depression disappeared. "Deposits adjusted and currency" increased \$4 billion during the second half of 1949 and at the end of the year reached \$170 billion, which was the peak in the money supply reached at the end of 1947. During the first half of 1950, the Federal Reserve put pressure on bank reserves and stopped this expansion in the money supply. At the end of June, just at the outbreak of hostilities in Korea, "deposits adjusted and currency," after a slight decrease during the first quarter, were again \$170 billion. The Federal Reserve authorities had stopped the postwar inflation and at the same time avoided a postwar depression sufficiently deep to be a serious threat to our economy.

Controlling inflation. Before commenting on events since Korea, I want to review briefly some of the suggestions that are being made to control inflation.

Many economists who have been engaged in the study of business cycles have paid little attention to the role of changes in the quantity of money. They assume that business booms and depressions originate in forces outside the banking system, and that changes in the quantity of bank deposits and currency in use are the results of changes in the ups and downs of business rather than the cause of them. They explain a business depression like that of the early 1930's in terms of a postwar adjustment, the propensity to save, our mature economy, or the lack of investment opportunity. Even sun spots have been offered as an explanation of business cycles. Likewise, these economists explain the inflation of the 1940's in terms of the demand created by the war and the government deficit that accompanied it. Consequently, they believe that the war-time pressure on prices can be held to a minimum only by a decrease in nondefense and nonessential federal expenditures and by higher taxes.

While I agree with these programs, they are not the basic issues. Nonessential government expenditures should always be eliminated. But if we depend upon this to control inflation in our defense economy, we are doomed to disappointment. Likewise, I think we should make every effort to adopt a pay-as-you-go policy. But we must not allow this desirable objective to become the sole issue. In my judgment, inflation can be avoided during the years ahead only if the proper authorities exercise appropriate control over bank reserves. If banks are given ample reserves, they will acquire additional quantities of government obligations and other assets, and thus increase their

deposits. This is the road to inflation. On the other hand, if reserves are held to a reasonable rate of growth, bank deposits, the largest segment of our money supply, will be held stable, and inflation will be avoided. Under this condition, the Treasury will do its financing by taking purchasing power away from those that have it both by taxing and borrowing from nonbank investors. Very likely the Treasury will have to change the terms of its issues if it is to attract sufficiently large amounts of the savings of investors.

A brief review of events since June indicates that the Federal Reserve banks are being successful in preventing an excessive rate of expansion in the aggregate amount of bank reserves. Member bank reserve balances averaged \$16.2 billion during the month of June, \$16.3 billion during July and August, \$16.6 billion during September, \$16.7 billion during October, and \$16.8 billion during November. This is slightly more than a normal rate of growth, but a part of it is probably seasonal.

Meanwhile, the widespread belief that the prospect of a government deficit means inflation has led to a vast amount of anticipatory and speculative buying. This, together with hurried acquisition of supplies by the government to pursue a military campaign for which it was unprepared, has produced a substantial rise in wholesale prices, which has now been carried through to retail prices. The same upsurge of buying has led to requests for additional bank loans, to which the banks have responded by expanding as much as is feasible in the face of their reserve position. The money supply, as measured by "deposits adjusted and currency" has increased from \$170 billion at the end of June to approximately \$173 billion at the end of October. This change, like that in reserves, is slightly more than the estimated normal rate of growth, but

it also is probably partly seasonal.

Further expansion in the money supply is possible only with increased reserves. If member bank reserves continue to remain reasonably stable, we can expect stability in the volume of bank assets and bank deposits, and hence in the money supply. If this stability is maintained during 1951 the upsurge in buying by consumers and speculators initiated by developments in Korea will subside. As consumers and speculators meet the commitments they have already incurred, they will find their cash balances abnormally low relative to their spendings and will begin to reduce their expenditures to a normal volume in order to replenish their cash. If the Federal Reserve authorities continue to hold bank reserves around the \$16½ to \$17 billion level, they will have demonstrated their ability to prevent inflation, except for some temporary price fluctuations, even in the face of an increase in defense expenditures and in the government deficit.

With respect to the longer-run outlook, it has now been a long enough period of time since the peak in the money supply at the end of 1947 for the economy to become adjusted to the \$170 billion of "deposits adjusted and currency" in existence on that date and also at the middle of this year. As soon as the present speculative flurry dies down, it would be an appropriate policy to resume a rate of growth at or close to the estimated normal, which is about 5 percent per year. For maintenance of prosperity and a stable price level we need a reasonable growth in bank deposits and with appropriate banking and monetary policies this will be achieved.

Conclusion. In conclusion, I acknowledge I have made few specific comments on the economic outlook for 1951. Rather, I have tried to sketch a

simple outline of the essential characteristics of our economic system. This was done because the outlook for 1951, as well as for all future years, will be determined not only by the economic system itself, but in large part by how well society understands it. Few of us need to understand military science and strategy, international politics, or the hydrogen bomb and all its implications, but in our democracy it is essential that all of us have an understanding of the basic characteristics of our economy if it is to survive.

Let me summarize, then, the points I have emphasized. Our economic society based on competitive private business enterprise is not inherently unstable. On the contrary, competitive capitalism is an extremely flexible and adaptable type of economic organization. Its decentralization of decision-making is an aid in this adaptability. Adjustments to changing demands, to changing methods and techniques of production, and to changing sources of materials do not have to be funnelled through a single set of decision-makers. This is our nonsecret but most important weapon. But there is one essential condition if this method of decision-making is to work well, and that is stability in the value of the monetary unit or level of prices of the output of the economy. All business decisions are made in terms of money, and instability in the value of the monetary unit creates vast uncertainties and upsets business planning.

Maintenance of monetary stability is a governmental function and the powers of accomplishing it have been given by Congress to the authorities who determine Federal Reserve policy. Only if these powers are appropriately exercised, can we avoid serious price inflation during the awful emergency that faces us. If inflation is to be stopped, it must be stopped at the source; and

the source of inflation is our money supply. We must not increase bank deposits by financing the necessary expenditures through the sale of government obligations to banks. They must be financed through higher taxes and borrowings from nonbank investors. This is the key to mitigating the afflictions of war and to fortifying the inherent strength of our democratic economy.

Then when the war is over and the ruthless dictators that would enslave humanity are defeated, monetary controls can be used to prevent deflation, and we will never again have a depression like that of the 1930's. As time goes by, our experience with continuous prosperity will show the world that our system of individual liberty and competitive business enterprise is not inherently unstable. By eliminating this historical weakness, we will make possible the survival of the American Way of life.