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THE CURRENT ECONOMIC SITUATION

The years since the end of the war have been uneasy ones, economically as well as politically. While we have attained the objective of high levels of employment, there has nevertheless persisted widespread uncertainty as to our ability to sustain these levels. In part, our fears stem from our experience in the dismal thirties; in part, from the knowledge that recurrent boom and recession have always been characteristic of our economy; but especially are we afraid that the inflation of the past few years has set in motion forces that will eventually make a downturn both inevitable and severe.

In this general anxiety, we are beset by conflicting interpretations of the present and expectations of the future. On the one hand, every dip in price and every slackening in sales--whatever the commodity may be--is taken as proof that a general downturn is upon us. On the other hand, we have the thesis that despite the distortions which have developed in recent years the economy is fundamentally so strong that full employment, production, and income will go on more or less indefinitely, rolling over one difficulty today and another tomorrow--all the time approaching closer and closer to an equilibrium which is not defined. It is clear that the current economic situation--whenever "current" may be--is not a figure or a combination of figures, but an interpretation which looks both forwards and backwards.

Postwar Inflation in Retrospect

Looking backwards, we see that the war is largely responsible both for the high levels of employment and for the inflation that characterized the postwar years. During the war, about two-fifths of our gross national product was devoted to prosecution of the war. The expenditures for war goods created consumer and business incomes for which there was no matching supply of available goods.

A policy which financed all war expenditures through taxation would have soaked up this excess of purchasing power and would have prevented the large-scale increase in liquid assets. For a variety of reasons, such a rigorous policy was not feasible, and the war was financed through a combination of borrowing and increased taxes, with taxes accounting for less than half the total amount raised. From December 1939 to December 1945 the national debt, other than that held by Federal agencies and trust funds, increased by 210 billion dollars. Of this increase, nearly 115 billion was accounted for by nonbank investors; about 75 billion was held by commercial banks, and about 20 billion by the Federal Reserve Banks.

During the war, price and wage controls and rationing kept prices remarkably stable, even if allowance is made for activity in black markets. But this stability was possible only because consumers and industry in general exercised remarkable restraint in the use of their income by saving voluntarily, rather than attempting to secure larger individual portions of the limited civilian output. Thus, about one-fourth

of personal income after payment of taxes was saved in 1944 as compared to less than 5 per cent in 1929 and to about 7 per cent today. A very large share of these wartime savings took the form of liquid assets, i.e. currency, bank deposits, and government bonds. From the end of 1939 to the end of 1945, personal holdings of liquid assets more than tripled, increasing from about 50 to over 150 billion dollars.

When the war ended, the economy had available for spending not only high current incomes but the large accumulation of war savings as well as exceptional access to credit. The incentives to spend were strong in view of the great backlogs of demand for both consumer and producer goods. At the same time, we had heavy responsibilities abroad both for relief and reconstruction. It simply was not possible to increase production fast enough to meet demand. Moreover, increasing production itself increases current income correspondingly.

It was in such a war and postwar situation that inflation was bred. Inflation means that effective demand--i.e. demand backed by purchasing power--exceeds the current supply of goods and services at prevailing prices. Unless controlled, prices advance in such a situation and each advance breeds further advances without necessarily bringing supply and demand into balance at a reasonable price level. Rising prices have resulted in rising incomes and expanding credit which have maintained a gap between effective demand and supply. This now familiar spiral of increased prices followed by increased income has been repeated again and again since the end of the war. For example, since 1939 wholesale prices have increased about 120 per cent, consumer prices 75 per cent, and personal income 190 per cent. A very large proportion of each of these increases has come after 1945.

Notwithstanding all the inflationary forces at the end of the war, we removed prematurely such wartime controls as might have been used as transition safeguards. These included controls over prices and wages, consumer credit, material allocations, and the excess profits tax. Furthermore, for one reason or another we adopted policies which from a strictly economic point of view were more suitable for inducing recovery from low levels of activity than for curbing inflation. The extreme gravity of the housing shortage led to easy mortgage financing. Generous provision was made for veterans. The agricultural program resulted in price support for farm products at levels which prevented large crops from having as deflationary an effect as they might otherwise have had. Desires to grant taxpayers some relief after the long years of high taxation brought tax reduction at a time when incomes were already excessively high in relation to the available supply of goods. In short, when a policy desirable for other reasons came in conflict with price stability, stability frequently was sacrificed. It should not be surprising, therefore, that prices are very high.

Significance of Postwar International Situation

The problem of maintaining price stability would have been difficult in any event in the face of an unprecedentedly strong restocking and investment boom for new plant and equipment, inventories, construction, and consumers' durables and semi-durables with demand supported by large and widely held liquid assets and high and rising incomes. In addition,

however, a disturbed postwar international situation has been superimposed on an already inflationary domestic one. Postwar has unfortunately not meant peace. Defense expenditures were cut drastically after the termination of hostilities, but they nevertheless remained far above prewar levels. More recently, the intensification of international tension has resulted in a substantially enlarged defense program, with adoption of both a Selective Service program and plans for a 70 Group Air Force. For fiscal 1949, the expenditures for defense may run more than 1-1/2 billion dollars above those for the preceding year. The present program, if fully carried out, will mean a further substantial increase in fiscal 1950. The President was recently quoted to the effect that he was recommending a budget of about 14-1/2 billion dollars for defense in fiscal 1950. At the same time, the President indicated that military leaders had requested a budget of 23 billion dollars.

Furthermore, the war left a large part of the world desperately in need of outside aid. This was true both of our allies and of our former enemies. Our vast foreign aid programs for relief and reconstruction reflect not only humanitarian motives but also a desire for enhanced security. By the spring of 1947, our exports of merchandise had risen to a level close to that in wartime, which included lend-lease. Since then, exports have declined more or less steadily, but are still at very high levels. Meanwhile, imports have continued to increase. As a result of these divergent movements, the excess of exports of goods and services has declined from its peak in the first half of 1947, but is still very great, amounting to an annual rate of over 7 billion dollars in the second quarter of 1948.

The continued excess of exports of goods and services has been financed in a variety of ways, but the most important has been aid furnished by the United States Government. This aid has taken the form of both gifts and loans. It has included credits on sales of surplus property and ships, loans made by the Export-Import Bank, the British loan, contributions to UNRRA and post UNRRA, civilian supplies for occupied countries, interim aid to France, Italy and Austria, the Greek-Turkish aid program, and most recently the European Recovery Program. Loans have become relatively less important while gifts have become increasingly important. It is estimated that this country will spend or lend more than 6 billion dollars on such aid in the current fiscal year, which is close to the very high rate of the first half of 1947. A large proportion of this year's aid represents expenditures under the European Recovery Program.

Other major means of financing the export surplus have been liquidation of foreign holdings of gold and dollar assets (which were run down by 4-1/2 billion dollars in 1947 and by about 1 billion dollars in the first half of 1948), operations of the International Bank and the Monetary Fund, and gifts and loans from private sources in the United States.

Developments in 1948

The year 1948 has in general witnessed a continued development of postwar expansive forces. The first quarter was one of some business hesitation, with gross national product showing no change over the fourth quarter of 1947, and with prices of many farm products breaking sharply

in February. In the second quarter, however, adoption of the enlarged defense program, the European Recovery Program, and tax reduction furnished a strong upward push to the economy, and especially so since these actions were taken in a situation still characterized by excessive over-all demand. Expansive tendencies were further reinforced late in the second quarter by the responsiveness of large mass-production companies to wage demands after an earlier show of strong resistance to a third-round wage increase. After the signing of a two-year agreement between General Motors and the United Auto Workers on May 29, new wage contracts were soon negotiated elsewhere in the automobile industry and in such other key industries as electrical machinery, rubber, farm equipment, bituminous and anthracite coal, and steel. Wage increases have since spread, and are still spreading, throughout the economy generally. Although the increases this year have been more selective and diverse than in preceding years, the average increase approximates the rise in consumer prices during the last year.

After the first quarter, further increases occurred in retail sales and consumer and wholesale prices. Gross national product and disposable income (i.e., income of individuals after payment of personal taxes) reached new peaks in the second and third quarters as business, government, and individuals all enlarged their expenditures. Unemployment has continued at a low level, below 2 million persons. The index of industrial production which had declined in July, recovered in August, and by September was back to its June level.

Meanwhile, expansion in bank loans has continued to make a substantial contribution to total spending power, though not on quite as large a scale as last year. Loans of all banks are estimated to have increased 1.8 billion dollars between the second and third quarters, as compared to the 2 billion dollar expansion in the corresponding period last year. Though somewhat smaller in total, the second-to-third quarter growth of loans this year has followed a pattern not much different from that of last year. Increases have taken place in all three of the main loan categories—business, real estate, and consumer loans. Present estimates do indicate, however, that the somewhat smaller increase this year is chiefly to be accounted for by a decline in the rate of growth in the business loan category.

Data from the latest survey of planned expenditures for new plant and equipment indicate some increase in outlays by manufacturers for the second half of 1948 in comparison with planned expenditures reported in surveys taken earlier this year. Moderate gains over the first half of 1948 are also forecast by electric and gas utilities. All in all, on the basis of reported intentions, total plant and equipment expenditures should amount to about 18-1/2 billion dollars for all of 1948, as compared to about 16 billion in 1947.

Meanwhile, personal income continues to increase, both as a result of increasing employment and of the spreading of third-round wage increases throughout industry. Despite the sharp drop in prices of many crops, net income of farm proprietors has been maintained at a level above the already high level of last year. The price-support program combined with the large volume of marketings prevents substantial declines in farm incomes. Personal holdings of liquid assets are still very large and are widely distributed, despite some tendency to concentration in the hands of upper income groups. Re-establishment of Regulation W has not precluded the further expansion of

consumer credit.

These factors--high current income, large past savings, and ready access to credit--reinforced by the continued backlog of demand for some durables (e.g., automobiles) furnish a strong basis for continued high levels of personal consumption.

Taken together, all these indicate a considerable degree of current strength. Nevertheless, there are also evidences that in some important areas supply is equalling or exceeding demand at current prices. These products include not only some finished consumer goods but some raw materials as well. As these products tend to stabilize or fall in price, they serve to relax somewhat other upward pressures on costs and prices elsewhere in the economy. Probably the most important development of this sort has been the record breaking crops of this year, which have resulted in reduction of prices of wheat, corn, and cotton to support levels. The effects of these large crops have not yet been materially reflected in over-all retail food prices, however. Furthermore, meat prices have continued to rise until very recently, when they started to come down even more sharply than in broad conformity with their usual seasonal pattern.

Reports of possible balance or even excess of supply at current prices are also heard in connection with such products as cotton textiles, shoes, men's clothing, liquor, housefurnishings, coal, paper and radios. There have even been reports of more than seasonal weakness in prices of new-used cars.

It may also be noted that wholesale prices in general have shown smaller increases so far this year than in 1947. Furthermore, considerable divergence has developed in price movements of various commodities. Great strength has been shown by metals and moderate strength in such industries as building materials and fuels. On the other hand, prices of some foods, hides and leather, textiles, paper and pulp, and chemicals are close to or below their January levels.

Another possible symptom of general weakness may be read into the fact that new housing starts declined in August to 83,000 units, a level 11,000 below July and 3,300 below August last year. A further decline occurred in September. This behavior contrasts with that of 1947 when new starts increased steadily to a yearly high of 94,000 units in October. The declines this year at this time may be interpreted as an indication of some softening in the market, reflecting the facts that the most urgent demands for housing have been met, and that consumer resistance to the extremely high prices charged for houses is becoming effective. Nevertheless, construction costs have continued to advance steadily and the index of wholesale prices of building materials in early October was at its peak.

Any signs of general weakness must be watched closely, because after the great price increases of recent years, the economy is becoming increasingly vulnerable both to sharp price declines in particular areas and to the effects of such declines on credit and on business and consumer expectations generally.

On the other hand, it is well to remember that the postwar boom has

already over-ridden many deflationary forces and periods and that greater strength in some lines may well continue to offset weakness in specific lines. In the past two years, we have overcome the sharp break of stock prices in the fall of 1946, the weakness in nondurable goods and trade in the first half of 1947, some reduction in new private construction in the second quarter of 1947, the sharp break in prices of many farm products in February of this year, and the large Federal cash surplus in the first quarter of this year and the use of much of this surplus to retire bank held debt.

More important than all of these things in conditioning my thinking about current economic trends is the continued state of tension in international affairs. Our defense requirements have precluded any reduction in Federal expenditures. On the contrary, they are most likely to result in further sharp increases in Federal expenditures during the remainder of the fiscal year and well beyond that. The enlarged defense and foreign aid programs adopted this spring are being carried out at an accelerating rate. Their full economic effects will not be felt until next year. But who can say that the present programs will represent the peak of defense and foreign assistance efforts? In recent weeks, there have been more and more rumors in the press about the adoption of military lend-lease. Under the circumstances and with the continued threat of further deterioration in the international situation, it would be dangerous to assume that inflationary forces have run their course. While the recent indications of moderation of some inflationary pressures are hopeful signs, the direction of most broad measures of economic activity is still upward. It is still too early to be confident that our hopes for stability will not again be disappointed.

Monetary Measures to Curb Inflationary Tendencies

Under these circumstances, what can the Federal Reserve System do to curb inflationary tendencies? Traditional instruments of monetary control in a boom--increases in reserve requirements within existing laws and in rediscount rates and sales of securities in the open market--have only limited effectiveness because the banking system can obtain all the reserves it needs by selling Government bonds to the Federal Reserve. This situation is a result of our war-created debt. Holders of these various debt obligations--including commercial banks, insurance companies, other investment institutions, and individuals--feel free to sell their securities to obtain funds for other purposes. Thus, the total volume of current expenditures can be expanded. The Federal Reserve System has to serve as the residual buyer in the market for Government bonds in order to preserve confidence in Government credit and to provide an orderly market for the enormous refunding operations of the Treasury. Confidence in the stability of Government security prices is essential to prevent a possible large volume of selling of such securities. Aside from any considerations as to increased interest cost on the public debt, withdrawal of support might well have a disastrous impact on our whole financial system.

The Federal Reserve's support program keeps interest rates stable and at the same time gives the banking system access to all the reserves it needs with practically no deterrent. The banking system even obtains reserves which it does not itself seek when the Federal Reserve purchases bonds sold by nonbank investors. In recent months, unfortunately, nonbank

investors--notably insurance companies--have sold a substantial amount of restricted bonds to the Federal Reserve System.

It is true that the Federal Reserve System would presumably be able to curb credit and monetary inflation by withdrawing its support of the Government bond market. But, as I have already indicated, this would be drastic action indeed, all the major consequences of which cannot be foreseen. It therefore seems more desirable to make full use of less drastic measures and to explore new legislative methods of credit control. Some additional powers have recently been made available to the System through the restoration of consumer credit controls and the authority to increase reserve requirements. Use of these powers is possibly exerting some moderating influence. In addition, there have recently been further increases in short-term interest rates and perhaps further increases will be needed. The rediscount rate has been increased and in due course will, if necessary, be increased again.

Another remedy which can be tried is enactment of legislation which would prevent the ready conversion of Government securities into banking reserves. One such proposal which would restrain such conversion by commercial banks has been sponsored by the Federal Reserve Board. This would give the commercial banks an option to hold special reserves in cash or in the form of short-term Government securities. Since short-term Government securities afford reasonable earnings--especially as short-term rates increase--the likelihood is that a large part of bank holdings of Government securities would be immobilized. Means to prevent the creation of reserves through the sale of bonds by institutions and other holders outside the banking system should also be explored and adopted. Also, some pressure would be placed on the reserve position of commercial banks if the Treasury were to draw further on its War Loan Accounts at such banks and use the proceeds to retire debt held by the Federal Reserve.

There are further important measures which lie beyond the control of the commercial banks or of the Federal Reserve System. Most important of these is the maintenance of the Federal budgetary surplus. But here we run into the great conflict of this period between the need for economic stability and the demands of national security. Government expenditures cannot be reduced so long as the state of international relations is such as to require a large and increasing defense effort and large commitments for aid and reconstruction to foreign countries.

Our continuing inflationary pressures stem largely from our defense requirements. It is clear then that confidence in the existence of an enduring peace is the desperate need of our times from every point of view.