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INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

THE POSITION OF THE WORLD ECONOMY ON THE EVE OF THE OUTBREAK OF THE KOREAN WAR AND THE POST-KOREAN DEVELOPMENTS AND PROSPECTS

PART II. POST-KOREAN DEVELOPMENTS AND PROSPECTS

A. THE UNITED STATES

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balanced development of total national strength, both economic and military, for the long pull".[1/]

During fiscal year 1949-50 military expenditures amounted to $12,303 million. They rose to $20,462 million in 1950-51 and were expected to reach some $40,000 million in 1951-52. For 1952-53 the President requested $51.1 billion in his budget message of January 1952, but Congress has appropriated only $46 billion. In addition to these expenditures on the American armed forces, the American defense effort makes provision for military and economic aid to Allied countries and for the financing of programs related to defense, such as atomic energy, civil defense, and so on. Since Korea, the practice has been to group all these expenditures together under the heading of "expenditures for major national security programs". Most statements about defense expenditures made since Korea refer to this broader category of expenditures for national security. The following table shows the main components of these expenditures:

1/ The Mid-Year 1952 Economic Review by the Council of Economic Advisers, July 1952, p. 30.

	(Billion $)				
	1949-50	1950-51	1951-52	1952-53	
	(Actual)	(Actual)	Budget (Estimate)	Budget Message January 1952	Congressional Appropriations
Major National Security Programs	17.8	26.4	49.7	65.1	
Military Services	12.3	20.5	39.8	51.2	46
Of which:					
Military personnel		7.2	10.1	11.0	
Major procurement		4.3	13.0	20.0	
Acquisition & construction of real property		0.4	2.7	3.5	
Operation & maintenance		5.8	10.4	12.1	
Stockpiling	0.4	0.7	0.8	1.1	
Other	11.9	2.1	2.8	3.5	
International Security & Foreign Relations	4.8	4.7	7.2	10.8	
Of which:					
Military & economic aid	4.6	4.5	6.9	10.5 1/	6.0 1/
Conduct of foreign affairs	0.2	0.2	0.3	0.3	
Other 2/	0.7	1.2	2.7	3.1	

The preceding table shows that expenditures on national security amounted to some $18 billion in 1949-50 and $26.5 billion in 1950-51, representing 7 and 9

1/ of the $10.5 billion estimated in the Budget Message, new obligational authority was needed for only $7.9 billion. The President's request for funds to Congress was, therefore, made for this latter sum. It was this sum that was reduced by Congress to $6 billion.

2/ The figures shown under this heading were obtained by deducting military services and international security from the total of major national security programs as no detailed analysis of these other expenditures is given in the Budget. Information is available on the following items included in this category:

	1950-51 (Actual)	1951-52 (Estimate)	1952-53 (Budget Message)
Atomic energy	0.9	1.7	1.8
Civil defense	-	0.14	0.34
Economic stabilization agency	-	0.1	0.15

percent respectively of the gross national product. They were originally expected to rise to $51.5 billion in 1951-52 or 15 percent of the gross national product, but have not in fact exceeded $46.6 billion[1] due primarily to the fact that military aid to Europe has been considerably less than expected. The unspent appropriations from earlier years, which are estimated to total some $6 billion, will make possible the carrying out of the program for the American armed forces outlined by the President in his Budget Message of January 1952 in spite of the fact that Congress cut the appropriation requested from $51.2 billion to $46 billion.[2] With regard to aid to foreign countries, the lag in shipments of military equipment to Europe in 1951-52 means that there are sufficient unspent appropriations to bring the total of that aid in 1952-53 to well above the $6 billion voted by Congress, assuming that the expansion of military shipments to Europe makes this necessary. Thus, in spite of the cuts in appropriations made by Congress a program of expenditures for national security not much below the $65 billion requested by the President for 1952-53 is still possible, although experience to date suggests that actual spending will be below these estimates. The Council of Economic Advisers estimates that expenditures on national security will rise by $11 to $12 billion during 1952-53,[3] which would mean that they will reach a total of $58 to $59 billion. At such a level they will be absorbing 17 percent of a gross national product of $350 billion which may be reached in the coming fiscal year.[4]

Present indications are that the scale of defense spending that will be

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1/ This is stated in The Mid-Year 1952 Economic Review by the Council of Economic Advisers of July 1952 to be a preliminary estimate.

2/ See The Economist, July 5, 1952, p. 94:

"Military spending can now proceed to the expected tune of $52 billion in the next twelve months."

3/ The Mid-Year 1952 Economic Review by the Council of Economic Advisers, July 1952, p. 77.

4/ The gross national product totalled $328 billion in 1951 and reached an annual rate of $340 billion in the first quarter of 1952.

achieved in 1952-53 will be maintained in 1953-54.[1] Thereafter, barring new international tensions, the defense effort is likely to consist in preserving the strength built up during the earlier period. The Annual Economic Review by the Council of Economic Advisers of January 1952 assumes that "the total maintenance cost of forces now planned, plus the atomic energy program, would be in the general range of 40 to 50 billion dollars annually, until a firmer outlook for peace is established". The Council points out that since, meanwhile, the productive capacity of the American economy will have grown substantially, such a level of defense expenditures is not likely to absorb more than 12.5 percent of the national product if the country's resources are fully utilized.

It cannot, of course, be excluded that the demand for cuts in Government spending, which can only be satisfied if defense spending is cut, will force a curtailment of present programs in the coming years. In that case the burden on the American economy will be correspondingly reduced. The scope for such reductions appears, however, limited in the light of present international conditions and of American world responsibilities. It should not be forgotten that the size of American defense expenditures reflects much more the high standards of pay and maintenance and the high degree of mechanization obtaining in the American armed forces than an excessive military effort. If this is so, it seems unlikely that present plans will be drastically revised in the coming years. We may, therefore, assume that these plans indicate the probable magnitude of the American defense effort in the coming years.

In order to appraise the economic significance of American rearmament it

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1/ In his Economic Report of January 1952 the President states that the program which he is submitting will call "for a further increase in the rate of security outlays during calendar 1953. We cannot hope that security program expenditures will start declining toward a lower rate until 1954." (p. 8). Similarly, on page 13 it is stated that "the deficit will remain large, until the security program has passed its peak and tapers off, as we hope it can do in about 2 or 3 years".

is necessary to determine first, how it has affected the American and world economy to date and what are the problems it creates, and second, what its impact is likely to be in the future. In the following chapters we shall attempt to make this determination.

A--INTERNAL ECONOMIC DEVELOPMENTS

I--DEVELOPMENTS IN THE FIRST TWO YEARS OF THE POST-KOREAN PERIOD

During the last war the inflationary effects of military expenditures were felt long after the actual spending had taken place. During the post-Korean period events followed the opposite course: inflationary forces developed in the American economy well ahead of any increased spending on defense, while the increase in military spending coincided with a very remarkable degree of economic and financial stability. It is important for the understanding of post-Korean developments to examine the reasons for this difference between the war-time and post-Korean experience.

1--THE WAR-TIME EXPERIENCE

The economic and financial developments of the war-time period may be summarized as follows:

In 1940 the American economy was still operating below its full capacity: there were 8 million unemployed corresponding to some 15 percent of the total labor force; industrial production was only 10 percent above 1937 and 13 percent above 1929; agricultural production was 2 percent above 1937 and 13 percent above 1929; national income per head of the population was only 7 percent higher in real terms than a decade earlier. In view of the large gains in productivity made during that period such small increases in production and national income meant that the resources of the American economy were seriously underemployed. The year 1941 witnessed a large expansion in Government military expenditures and in foreign spending on munitions which induced the conversion of a substantial proportion of American industrial capacity to war production and at the same time resulted in large increases in civilian employment, incomes and spending. The available productive capacity was, however, so large that it could accommodate both the

increased needs of defense and the increased civilian demand.[1/] Thus, it was not until the late months of 1941 that serious inflationary pressures began to develop in the economy. By 1942, however, the discrepancy between the demand and supply of goods had grown to such proportions that a major inflation was inevitable unless drastic measures were taken to dam up the available purchasing power.[2/] This was so because by that time personal incomes had increased by 57 percent and corporate profits by 100 percent over 1940 while the military effort was absorbing the whole

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1/ Between 1940 and 1941 Government spending nearly doubled, from $14 billion to $25 billion, personal consumption expenditures increased by $10 billion or 15 percent and private investment by $4.5 billion or 30 percent. In spite of this increase in expenditures prices rose by an average of only 8 percent. A 16 percent increase in the real gross national product, due primarily to an increase of 30 percent in industrial production, took care of the bulk of the increase in spending, as follows:

Gross National Product
Billion $

	1940	1941 At Current Prices	1941 At 1940 Prices*	Percent Increase in Real Terms Between 1940 and 1941
Personal consumption	72.1	82.3	76.2	15%
Private investment	13.9	18.3	16.9	21%
Government spending	13.9	24.7	22.8	67%
Total	99.9	125.3	115.9	16%

* Assuming an 8 percent increase in prices (as shown by the index of retail prices for all commodities compiled by the U.S. Department of Commerce).

2/ Prices rose as follows between 1941 and the middle of 1942, when general price controls were put into force:

	Retail Prices All Commodities	Wholesale Prices All Commodities
	(1935-38 = 100)	
January 1941	101.9	100
April 1941	103.8	102.5
July 1941	107.8	110
October 1941	114.8	114
December 1941	116.7	116
January 1942	118.5	118.5
April 1942	123.1	122
July 1942	125.7	122
October 1942	127.8	123.5
December 1942	129.7	125

of the expansion in production which took place during the period and was leaving the civilian economy with a volume of goods and services not higher than in 1940.1/ Taxation, it was felt, had reached the limits of what could be taken away from the public without reducing the incentives and efforts required to sustain production at the high levels achieved during the period. Voluntary savings, stimulated by the war-time spirit of sacrifice and the disappearance of durable goods from the market, were high but were not sufficient to reduce the demand for goods to the level of available supplies. Thus, comprehensive controls and restrictions over production, consumption and spending became the only alternative to open inflation.

1/ Between 1940 and 1942 the real gross national product increased by some 30 percent as a result of a 60 percent increase in industrial production and a 16 percent increase in agricultural production. The following data show that the whole of this increase was absorbed by the military effort:

Gross National Product
Billion $

	1940	1942	1942 at 1940 Prices*	Percent Change in Real Terms Between 1940 and 1942
Personal consumption	72.1	91.2	73.0	+ 1%
Private investment	13.9	10.9	9.0	- 36%
Government spending	13.9	59.7	48	+240%
Total	99.9	161.8	130	+ 30%

* Assuming a 25 percent increase in prices.

The further expansion in the real national product which took place in 1943 and which resulted mainly from a 20 percent increase in industrial output was again devoted exclusively to the war effort and thus the whole of the 20 percent increase in personal incomes and profits had to be absorbed by price increases and savings:

Gross National Product
Billion $

	1942	1943	1943 at 1942 Prices	Percent Change in Real Terms Between 1942 and 1943
Personal consumption	91.2	102.2	95.5	+ 1.4%
Private investment	10.9	5.7	5.3	-50 %
Government spending	59.7	88.6	82.7	+40 %
Total	161.8	196.5	183.5	+13 %

There was no further increase in the national product after 1943 since all the available resources of manpower and equipment were already fully committed. Personal incomes, however, continued to rise although at a reduced rate and thus the gap between the volume of goods available for the civilian economy and the purchasing power in the hands of the public continued to grow.

As a result of these measures the pressure on prices was contained and it became possible to limit the rise in prices and costs over the four-year period mid-1942 to mid-1946 to only 18 percent, corresponding to an average rise of 4.5 percent per annum.1/ This, however, was achieved at the cost of a huge accumulation of liquid assets in the hands of the public which was reflected in the growth of the national debt and which represented a great potential threat to the value of the dollar.2/ The threat actually materialized once war-time restraints ceased to operate. During the two-year period June 1946 - June 1948, when peace-time production reached unprecedented levels and the huge Government deficits of the war years had been replaced by sizeable surpluses, prices rose as much as during the

1/ It should, however, be kept in mind that calculations based on price indexes ignore such important factors as quality deterioration and therefore tend to underestimate the degree of inflation which had taken place.

2/ During January 1942 - December 1945 the national debt increased by $215 billion. Of this total $45 billion were held by Government agencies and funds. The remaining were distributed as follows among the public:

	Jan. 1942	Dec. 1945 (Billion $)	Increase
Held by individuals	14	65	+ 51
Held by corporations	16	65	+ 49
Held by commercial banks	21	91	+ 70
Total	51	221	+170

There is obviously a close correlation between these war-time purchases of U.S. securities by the public and the volume of personal savings and undistributed profits of corporations effected in that period. The difference is largely accounted for by the accumulation of depreciation allowances and the depletion of stocks:

Personal savings	1942-1945		$120 billion
Undistributed profits of corporations	1942-1945		21 billion
		Total	$141 billion

four-and-a-half years of war, 1942 to mid-1946.[1/]

The fact that the sharpest rises occurred in the months following the abandonment of price controls is often quoted to support the view that it was the abandonment of price controls which was responsible for post-war inflation. This, however, is an oversimplification. Price control proved effective during the war because it was supported by high levels of taxation and saving, wage and manpower controls, rationing of essential commodities and by the fact that durable goods had become unobtainable. In the post-war period most of these supports disappeared.

First, taxation was reduced. Government receipts declined from $44,762 million in 1944-45 to $40 million in 1945-47 and $42,200 million in 1947-48. In the latter year they represented 20 percent of the national income as compared with 25 percent in 1944-45.

Second, the volume of savings declined sharply. Net personal savings fell from $35 billion in 1944 to $12 billion in 1946, $3.9 billion in 1947 and $10.9 billion in 1948, representing the following proportions of disposable personal income:

Percent of Total

1944	24.1	1948	5.8
1945	18.5	1949	4.6
1946	7.6	1950 (1st half)	6.5
1947	2.3		

1/ Retail prices, as measured by the U.S. Department of Commerce Index, rose as follows during the period:

(1935-39 = 100)

War-Time		Post-War	
June 1941	106.6	June 1946	147.7
December 1941	116.7	December 1946	172.7
June 1942	124.8	June 1947	178.7
December 1942	129.7	December 1947	188.4
June 1943	135.0	June 1948	193.5
December 1943	135.5	December 1948	192.5
June 1944	137.5		
December 1944	139.6		
June 1945	142.1		
December 1945	143.1		

Third, rationing was abolished and the demand for food increased sharply, while supplies were not larger than during the war. This, together with the increase in foreign demand for American food supplies, produced a rise in food prices of 46 percent between mid-1946 and mid-1948.

Fourth, the post-war increase in the public's expenditures for consumption and investment was greater than the reduction in Government spending, while overall production of goods and services was not higher than during the war years. As a result, the demand for goods exceeded the available supply and exercised a strong and cumulative pressure on prices.[1/]

Fifth, average hourly earnings in industry increased by some 10 percent

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1/ Between 1946 and 1948 total expenditures in the American economy increased as follows:

	1945	1948 (Billion $)	Difference
Personal consumption	123	177	+54
Private investment	11	43	+32
Government	83	37	-46
Total	217	257	+40

Since there was no increase in the total volume of goods and services between the two periods, this increase in expenditures implies a price increase of some 18 percent. The actual price increase was of the order of 30 percent. The difference is due to the familiar spiral operating in times of inflation to which the Council of Economic Advisers' Annual Economic Reviews of the period drew attention. Thus, the Review of January 1948 pointed out that "the general excess of demand does not fully explain the resumption of the price rise in the second half of the year. To an important degree the rise stemmed from actual and anticipated shortages of specific commodities which caused price rises at particular points and from there spiraled into higher costs and prices all through the economy". Similarly, the Review of July 1948 noted that "the inflationary effects (of excess demand) have been multiplied through the price-wage spiral ... Substantial wage increases, which often have been made in order to catch up with previous price increases, have been accompanied in turn or promptly followed by substantial rises in the prices of industrial goods."

during 1946 and in some key industries by as much as 15 percent.[1/] Since labor is the most important item in industrial costs, once wages were allowed to rise prices could not have been kept at their old levels.

Sixth, with the rapid reconversion of industry to peace-time production automobiles, electrical appliances and other durables were again available but not in quantities that could satisfy all the existing demand at the controlled prices. Under these conditions and since rationing was not possible in the case of those goods, black markets and other illegal methods of distribution were bound to result from the enforcement of price controls.

Our conclusion is that under the conditions obtaining in the post-war period prices could not have been held at their June 1946 levels merely by retaining the machinery of price control. In order to keep prices at those levels it would have been necessary not only to retain most of the other war-time policies, but also to take measures for ensuring that the liquidation of war-time accumulations of purchasing power would not outrun the available supplies. This would have required the adoption of a far more stringent monetary policy than was

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1/ As follows:

Average Hourly Earnings
(U.S. Dollars)

	1945	1946		
	Monthly Average	January	June	December
All manufacturing	1.023	1.004	1.093	1.148
Iron and steel	1.100	1.095	1.216	1.248
Machinery	1.140	1.139	1.223	1.277
Automobiles	1.256	1.230	1.347	1.395
Textiles	0.757	0.803	0.875	0.959
Food	0.881	0.921	0.972	1.058
Chemicals	0.989	1.015	1.084	1.133
Petroleum	1.210	1.249	1.347	1.362
Building construction	1.379	1.402	1.444	1.569
Coal: Anthracite	1.252	1.339	1.559	1.615
Coal: Bituminous	1.240	1.259	1.474	1.491
Electric light and power	1.141	1.177	1.275	1.337
Railways	0.956	0.953	1.139	1.150

considered desirable at that time and in particular a drastic change in the policy of supporting Government securities at their par value inaugurated during the war. In determining whether such a course represented a realistic alternative to the rise in prices which was allowed to take place the decisive factor is the length of time that would have been required to work off the war-time accumulations of demand and purchasing power. In our view, it would have taken at least three years and probably four years to complete the process,[1/] and we consider it highly doubtful that the American public would have been willing to put up with the rigidities and irritations inherent in a controlled economy for such a long period of time.

If this interpretation is correct, it follows that the post-war inflation was virtually unavoidable and that it was the direct result of the financing of the war. This means that the distinction often made between the war-time period of successful financial stabilization and the post-war period of unchecked inflation is a rather artificial distinction. In retrospect, the effect of war-time controls appears to have been to postpone rather than prevent the rise in prices rendered inevitable by the excessive purchasing power in the hands of the public. Thus, it is correct to describe the post-war inflation as a delayed inflation.

1/ We base this view on the following considerations: (a) Without controls it took two years to bring supply and demand into equilibrium and in the process the liquid assets accumulated during the war lost one-quarter of their value. It would, therefore, have taken nearly one more year to liquidate these assets at their 1946 value. (b) The rise in prices during 1946-48 was greater than the rise in the incomes of the majority of consumers. This means that if prices and incomes had been maintained at their 1946 levels current consumption would have been higher than it was during 1946-48 and consequently fewer goods would have been available to meet accumulated needs. (c) The maintenance of controls and restrictions over the economy, which would have been required in order to maintain the purchasing power of the dollar at its June 1946 level would undoubtedly have interfered with the reconversion of industry and the expansion of production for civilian needs. It is, therefore, probable that the increase, both quantitative and qualitative, in the output of civilian goods would have been slower under controls. These two factors, larger current consumption and less efficient production, might have added another year to the 3-year period that would have been required for the working off of war-time accumulations of purchasing power within the framework of a controlled economy.

In the first post-Korean year the American economy was again subjected to strong inflationary pressures but, unlike the earlier experience, the post-Korean inflation was of an anticipatory type. As shown in the first part of this Memorandum, the state of the American economy at the time of Korea was one of high economic activity supported by high levels of consumption and investment in the private sector of the economy. The number of unemployed was only 3 million, representing 5 percent of the total labor force and the capacity available for a further expansion in production was of the order of 10 percent. During that period Government receipts and expenditures were in approximate balance, which means that for the first time in many years Government finances were exercising no influence on the level of economic activity.

This was a situation vastly different from the one which obtained in 1941. In that year probably more than one-quarter of American industrial capacity was still unutilized[1/] in spite of the fact that the Government was running a deficit of $10 billion. This means that American resources were considerably in excess of the claims which the private sector of the economy was making upon them.

The second important difference between 1941-45 and 1950-51 is the attitude of the public towards money. Financially, depression and unemployment had been felt by the public as a shortage of cash and a surfeit of goods. The risk against which people wanted to protect themselves was falling prices, not rising prices. A high degree of liquidity was considered the best guarantee against losses. The idea of buying something because it might become more expensive or disappear from the market simply did not enter people's minds during the 1930's.

1/ This estimate is based on the fact that industrial production increased by 27 percent between January 1941 and January 1942 and by another 10 percent during the first six months of 1942. It is clear that the bulk of these increases must have been due to the utilization of available capacity rather than to additions of new capacity which take much longer to be reflected in higher production. Similarly, at the beginning of 1941 there were still 7 million unemployed representing 14 percent of the total labor force.

This psychology had been a serious obstacle to economic recovery during the depression but its existence when the war broke out and the fact that it lingered on for some time afterwards proved of great help in offsetting the inflationary effect of war financing. Thus, there was no general rush to buy goods in anticipation of shortages. Stocks were drawn upon or were allowed to be depleted with equanimity by both consumers and producers.[1/] War-time prices were considered too high and there was a general expectation that they would fall after the war. Without such an attitude on the part of the public neither controls nor appeals to patriotism would have been able to produce the rates of saving achieved during the war.

This attitude did not survive in the post-war period. The rise in prices and consequent loss in the value of the dollar made people aware of the disadvantages of holding liquid assets in times of inflation. With the high levels of economic activity maintained throughout the post-war period the fear of depression and unemployment receded and the desire for financial security, which had made people cautious about spending, weakened. This new confidence in the country's economic prospects and the irresistible appeal of post-war goods combined to revolutionize the behavior of American consumers. In 1941 personal savings corresponded to 10.7 percent of incomes. In the first half of 1950 the proportion was only 6.5 percent. The same change in attitudes occurred among businessmen. The reluctance to invest which had characterized the 1930's was replaced by a new faith in expansion and modernization as the keys to business success. Expenditures for new plant and equipment which had averaged $5 billion per annum during 1935-39 (or the equivalent of $10 billion in post-war dollars) were maintained at the following annual rates in the post-war period:

1/ The ratio of inventories to sales which averaged 1.4 to 1 before the war declined to 0.99 to 1 in 1945.

1947	$16.2 billion
1948	19.2 "
1949	18.1 "
1950 - 1st quarter	14.8 "
1950 - 2nd quarter	18.1 "
1950 - 3rd quarter	17.9 "

Given this attitude, the reactions of the public to the threat of a new inflation were bound to be violent and extreme. The mere announcement of an expanded military program was sufficient to conjure up memories of rising prices and shortages of civilian goods. War preparations and the possibility of war were felt to involve automatically inflation. In this atmosphere the only thought of consumers was how to protect their purchasing power and their high standards of consumption, while the only thought of producers was how to build up large stocks and safeguard their plans for business expansion. In other words, the American public of 1950, unlike that of 1941, was acutely inflation-conscious.

The third difference between the two periods is that the means available for financing anticipatory buying were much ampler in 1950 than in 1941. At the beginning of 1941 the total of U.S. Government securities held by the public amounted to $41 billion which corresponded to 45 percent of the national income. In 1950 these holdings had risen to $193 billion and corresponded to 88 percent of the national income.

These three differences between 1941-45 and 1950-51 largely explain the differences in the course of events during the two periods and especially why the inflationary rise in prices came so late in 1941-45 and so early in 1950-51.

2--THE PERIOD OF INFLATION JULY 1950 - MARCH 1951

Between June 1950 and March 1951 the index of wholesale prices rose by 17% and that of consumer prices by 8%. At that time, however, wholesale prices, as their subsequent 4% decline shows, were still influenced by speculative forces and were excessively high in relation to the real demand-supply situation.

Consumer prices, on the other hand, had not yet fully reflected the rise in wages and costs which had taken place during the preceding nine months. On the basis of these data it seems reasonable to conclude that between June 1950 and March 1951 the dollar had permanently lost some 10 percent of its value. During that period Government receipts expanded much more than Government spending and produced a surplus in Government finances. During that same period industrial production increased by 12%, adding over $10 billion worth of goods to the available supply. Thus, the inflationary forces which developed in the United States after Korea originated in the private sector of the economy and were produced, not by a withdrawal of resources from civilian uses, but by the increased claims of consumers and business as well as by an upward adjustment of prices effected by producers in anticipation of inflationary developments.

During July - September 1950 personal consumption expenditures rose by 7%, from an annual rate of $188.7 billion to $202.5 billion. Increased purchases of durable goods and higher food prices accounted for most of the increase.[1/] During that period there was very little change in the prices of goods other than food. Food prices, however, rose by 5 percent and absorbed the whole of the increase in consumer spending on food. During that period this increased demand for durable goods and the rise in food prices were the main inflationary forces in the economy. Wage rates and private investment had not yet risen significantly

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	2nd Quarter 1950	3rd Quarter 1950	Increase
	(Annual rates seasonally adjusted) (Billion Dollars)		
Total personal consumption	188.7	202.5	13.8
Automobiles	11.4	14.3	2.9
Other durables	15.2	20.0	4.8
Food	59.7	62.6	2.9
Other	102.4	105.6	3.2

in response to the prevailing inflationary conditions.[1]

During October - December 1950 personal consumption expenditures declined to an annual rate of $198.4 billion. At that level they were 5 percent over the rate of the pre-Korean months in terms of current dollars but were only slightly higher than before Korea in terms of constant dollars.[2] During that period food prices were 7 percent higher than before Korea, prices of clothing 5 percent higher and the overall consumer price index 4 percent higher. Business spending, however, continued to expand at an accelerated pace and wage rates began catching

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	Average Hourly Wages in Manufacturing (Dollars)	Inventories (Million Dollars) Manufacturing	Wholesale	Retail
June 1950	1.453	29,123	8,131	15,574
July 1950	1.462	29,104	8,025	15,175
August 1950	1.464	29,253	8,236	16,130
September 1950	1.479	30,123	8,424	16,559

	New Plant and Equipment (Annual Rates Not Adjusted Seasonally) (Million Dollars)	New Construction (Annual Rates Adjusted Seasonally) (Million Dollars)
2nd Quarter 1950	16,732	27,200
3rd Quarter 1950	18,048	28,800

2/

	2nd Quarter 1950	4th Quarter 1950	Increase
	(Annual Rates Seasonally Adjusted) (Billion Dollars)		
Total personal consumption	188.7	198.4	9.7
Automobiles	11.4	12.9	1.5
Other durables	15.2	16.5	1.3
Food	59.7	62.7	3.0
Other	102.4	106.3	3.9

up with the rise in prices.[1/] It may be said that these two factors were the main sources of inflationary pressures in the economy during that period.

During January - March 1951 there was a resumption of scare buying on the part of consumers and a sharp upward movement of prices. Consumption rose by 11 percent over the rate of the pre-Korean months in terms of current dollars, with increased purchases of durables and higher prices, especially higher food prices, accounting for most of the increase.[2/] Business expansion, inventory accumulation and the upward adjustment of wage rates continued to exert strong inflationary

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	Hourly Wages in Manufacturing (Dollars)	Inventories (Million Dollars) Manufacturing	Wholesale	Retail
June 1950	1.453	29,123	8,131	15,574
October 1950	1.501	30,947	8,775	17,390
November 1950	1.514	32,245	9,005	17,704
December 1950	1.543	33,253	9,388	17,793

	New Plant and Equipment (Annual Rates Not Seasonally Adjusted) (Million Dollars)	New Construction (Annual Rates Seasonally Adjusted) (Million Dollars)
2nd Quarter 1950	16,732	27,200
4th Quarter 1950	22,068	29,664

2/

	2nd Quarter 1950	1st Quarter 1951	Increase
	(Annual Rates Seasonally Adjusted) (Billion Dollars)		
Total personal consumption	188.7	210.5	21.8
Automobiles	11.4	12.6	1.2
Other durables	15.2	18.8	3.6
Food	59.7	68.5	8.8
Other	102.4	110.6	8.2

During that period food prices were 12 percent higher than before Korea, accounting for practically the whole of the $7.3 billion increase in food expenditures, clothing prices were 9 percent higher and the overall index of consumer prices had risen by 8 percent.

pressures in the economy.[1/]

For the nine-month period July 1950 - March 1951 as a whole it may be estimated that the gross national product increased by some $22 billion as compared with the level of the three pre-Korean months. The rise in prices which took place during that period accounted for some $12 billion of this increase, but the remaining $10 billion represented a real increase in the volume of goods and services produced and implied an increase in the real national product of nearly 5 percent. It may also be estimated that about two-thirds of this additional volume of goods and services were absorbed by the civilian economy and only one-third by defense requirements:

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	Average Hourly Wages in Manufacturing (Dollars)	Inventories (Million Dollars)		
		Manufacturing	Wholesale	Retai
June 1950	1.453	29,123	8,131	15,57
December 1950	1.543	33,253	9,388	17,79
January 1951	1.555	34,120	9,475	18,45
February 1951	1.561	34,657	9,715	19,04
March 1951	1.571	35,557	9,940	19,74

	New Plant and Equipment (Annual Rates Not Seasonally Adjusted) (Million Dollars)	New Construction (Annual Rates Seasonally Adjuste (Million Dollars)
2nd Quarter 1950	16,732	27,792
4th Quarter 1950	22,068	29,664
1st Quarter 1951	19,452	30,860

Increase in Gross National Product
During July 1950 - March 1951 Over Levels of 2nd Quarter 1950

	In Current Dollars (Billion Dollars)	In Pre-Korean Dollars (2nd Quarter 1950) (Billion Dollars)
Government purchases of goods and services	5.50 1/	3
Personal consumption	11.00	4
Private investment	5.50	3
Total	22	10

Compared with the levels obtaining during the three pre-Korean months, these additions represented an increase of 2.5 percent in personal consumption and of 11 percent in private investment.

Thus, it may be concluded that during the first nine months after Korea the rearmament program, far from entailing a curtailment in private consumption an

1/ Government purchases of goods and services as computed in national income statistics are not identical with Government expenditures as shown in the Federal budget. The latter include transfer payments which are made to certai sections of the population not in return for goods and services currently supplied to the Government, but in fulfilment of legal obligations undertaken by the Government. On the other hand, Government purchases of goods and services as computed in national income statistics, refer not only to the purchases of the Federal Government but also to those of State and local authorities. The differences between these magnitudes are illustrated below:

	Calendar Year 1950 (Billion Dollars)			
1—Total Government Expenditures				62.8
Federal			41.6	
State and local			23.5	
Less: Federal grants-in-aid to State and local authorities			2.3	
2—Government Purchases of Goods and Services				42.5
Federal			22.8	
State and local			19.7	
3—Other Government Expenditures				20.2
Federal			16.5	
State and local			3.7	
Of which:				
(a) Transfer payments		14.4		
Federal	10.9			
State and local	3.4			
(b) Net interest		4.7		
Federal	4.4			
State and local	0.3			

The fact that during the nine-month period July 1950 - March 1951 the increase in Government purchases of goods and services estimated above is larger than the increase in Federal Government spending which took place during that period is due to the decline which occurred in that period in transfer payments and especially in payments to veterans.

investment, i.e. an economic sacrifice for the civilian population, was instrumental in bringing about an expansion in both consumption and investment.

As already stated, in that period the Government was collecting more from the public than it was paying out to it. During the fiscal year 1950-51 Federal Government receipts increased by some $11 billion as compared with the previous year, while Government expenditures rose by only $4.5 billion, turning a $3 billion deficit in 1949-50 into a $3.5 billion surplus in 1950-51. Calculated on a cash basis, the deflationary effect of Government finances was still more pronounced, since the change was from a $2.2 billion deficit in 1949-50 to a $7.5 billion surplus in 1950-51.[1/]

1/ Federal Government Finances

	1949-50	1950-51
Net budget receipts	37,045	48,143
Net budget expenditures	40,167	44,633
Net budget surplus or deficit	- 3,122	+ 3,510
Cash receipts	40,948	53,394
Cash payments	43,155	45,850
Cash surplus or deficit	- 2,207	+ 7,589

The main difference between budget receipts and cash receipts is that the latter include the cash receipts of trust accounts (mainly social insurance funds), as follows:

	1949-50	1950-51
Net budget receipts	37,045	48,143
Cash receipts:		
Cash budget receipts	36,925	47,887
Cash receipts of trust accounts	4,046	5,552

The main difference between budget expenditures and cash expenditures is that the latter exclude non-cash budget expenditures (mainly inter-Government payments) and include the cash expenditures of trust accounts, as follows:

	1949-50	1950-51
Net budget expenditures	40,167	44,633
Cash expenditures:		
Cash budget expenditures	36,977	41,795
Cash expenditures of trust accounts	6,868	3,807

The exceptionally large expenditures of trust accounts in 1949-50 were due to larger payments for unemployment and veterans' bonuses.

Thus, the inflationary conditions which developed during that period resulted exclusively from an expansion in private spending. As already stated, the reason for this expansion was the anticipation of shortages and of price increases, but it is clear that the expansion would not have taken place if the financial resources available to the private sector of the economy had not been large enough to make possible the increase in spending. The main sources of funds for increased purchases were the following:

(a) A decline in the current volume of personal saving.

Available estimates show that personal net saving in the first nine months was as follows:

	Billion Dollars (Seasonally Adjusted Annual Rates)	Percent of Disposable Personal Income
1st half 1950	10.7	5.4
3rd quarter 1950	4.6	2.2
4th quarter 1950	16.8	7.8
1st quarter 1951	7.5	3.4

These estimates are admitted to be subject to a wide margin of error, since they are residual estimates obtained by subtracting personal consumption expenditures from disposable personal income which are much larger totals and are themselves no more than approximations. Moreover, personal saving, in the above definition, includes investment in houses and in non-corporate business and is not therefore, a satisfactory measure of changes in the private demand for goods and services. Estimates of liquid savings computed by the Federal Reserve give a better idea of the part which changes in personal saving have played in the financial developments of the period under consideration, since they refer to savings which are not translated in goods and services. These estimates show that during the period under consideration the volume of some of the most important forms of personal liquid saving declined to only a fraction of its pre-Korean level:

Changes in Amounts Outstanding
(Million Dollars)

	Time Deposits	Saving and Loan Shares	Total
During 1st half 1950	+1,223	+938	+2,161
During 2nd half 1950	- 318	+549	+ 231
During 1st quarter 1951	- 23	+309	+ 286

(b) A drawing down by the public of the liquid assets held at the time of Korea.

In June 1950 the total of U.S. Government securities held by individuals amounted to $67.5 billion. In March 1951 the corresponding figure was $66.2 billion and the bulk of the decline probably represented a conversion of liquid assets into goods.

(c) An expansion in consumer credit.

Between June 1950 and March 1951 consumer credit outstanding expanded from $17,651 million to $19,379 million, i.e. by $1,728 million. This expansion made possible the financing of a substantial part of the increased purchases of durable consumer goods which were made during this period.

These three sources of funds combined probably accounted for some $5 billion of additional consumer spending during that period.

(d) An expansion in bank loans.

Bank loans for commercial and industrial purposes increased from $16.9 billion in June 1950 to $23.8 billion in March 1951, i.e. by $6.9 billion, helping to finance the increase in inventories and the expansion in productive activity which took place during that period. This 40 percent increase in bank loans to business was possible due to the ability of the commercial banks to convert without loss a substantial proportion of their holdings of U.S. Government securities into cash. During the period under consideration these holdings declined from $65.8 billion to $58.8 billion, i.e. by $7 billion. Other bank loans, i.e. loans on securities, real estate loans, etc. increased by $2.7 billion, bringing the

total increase in bank credit to $9.6 billion.

To say that these additions of spending power were responsible for the inflationary conditions obtaining in that period does not mean that an excess of demand over supply and a shortage of goods actually developed in that period, which in turn were responsible for the upward movement of prices in that period. In most cases the sequence of events has been quite the opposite: Producers and traders, expecting inflation and shortages as a result of the rearmament program, put up their prices well before any pressure had time to develop on supplies. The fact, however, that ample financial resources were available to the public was decisive in creating the inflationary conditions of the first nine post-Korean months, since without the public's ability to pay the higher prices demanded by producers and traders, the rise in prices which took place after Korea could not have been sustained. What happened was that the increased sales and higher prices induced by the expectation of future shortages and made possible by the public's willingness to save less, draw on its reserves and borrow, resulted in increased production and employment, higher profits for business and larger earnings for labor, i.e. in higher incomes and hence in an increased demand for goods. In this way the original expectation of higher prices was realized, these higher prices brought about higher wages and profits and the economy emerged with a new, higher, structure of money costs. This type of inflation, resulting not from an actual excess of demand over supply but from psychological reactions on the part of the public, is a type of inflation which can feed on itself and which, therefore, may continue indefinitely unless expectations are reversed.

The conclusion that inflationary developments during the period July 1950-March 1951 were due exclusively to increased civilian spending and that the impact of the defense program had not yet been felt by the economy should be qualified

in one respect. At the beginning of a program involving the placing of huge orders for military equipment, budget expenditures on defense underestimate the extent to which resources are being devoted to the production of military items since they do not include work in progress or orders completed but not yet paid for.[1/] Thus, the $6 billion increase in defense spending during the period July 1950 - March 19 undoubtedly underestimates the increase in production of military items during tha period. On the other hand, defense obligations undertaken at the beginning of a program of vast military procurement overestimate the impact of the military program on the economy since not all the obligations undertaken lead to increased production of military equipment during that period. A contract given to a firm for, say, 10,000 aircraft may envisage deliveries over two or three years but the obligations undertaken during the period when this contract was signed will include the total value of the contract.[2/] Thus, the fact that defense obligations during July 1950 - March 1951 increased by $20 billion does not mean that the economy was occupied to that extent with military production. In order to measure the extent to which the military program absorbed resources formerly devoted to civilian needs one should be able to determine how much of current production during this

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1/ See Survey of Current Business, May 1951, p. 7:

"During this interval the output in question enters gross national product as an element of the change in business inventories rather than of Government pur chases since it represents accumulations of stocks still held on private account."

The same point is made in the President's Budget Message:

"The Department of Defense alone will have been granted for the fiscal years 1951 and 1952 an estimated 112 billion dollars of obligational authority for its military functions, and additional amounts will have been made available for foreign military-aid programs. Bidding for manpower and materials, which pushes prices upwards, begins as soon as procurement contracts to be paid from these authorizations are signed, even though expenditures may not take place for a year or more."

2/ As an illustration one may quote a report published in Business Week, June 2, 1951 that General Motors has obtained defense orders of over $3 billion, but that its production of military supplies was only $95 million in the first quarter of 1951 and was expected to be running at the rate of $1 billion per annum by the end of the year.

period was for military purposes. Unfortunately, no such information is available. As a rough approximation one may take a figure higher than the increase in defense payments but much lower than the increase in defense obligations, say $8 billion. Even after such an adjustment, however, the conclusion still holds that the resources available to the civilian economy during the period under consideration were larger than before Korea and that consequently the inflationary conditions which developed during that period originated exclusively in the private sector of the economy. As already shown, during that period the national product increased by some $22 billion, i.e. by much more than the higher figure for defense expenditures suggested here. What this adjustment implies is that the increase in private investment during that period was smaller than the estimates based on budget expenditures for defense seem to indicate.

Increase in Gross National Product
During July 1950 - March 1951 Over Levels of 2nd Quarter 1950

	Estimates Based on Budget Expenditures	Adjusted Estimates
Resources devoted to Government needs	5.50	8.00
Personal consumption	11.00	11.00
Private investment	5.50	3.00
Total	22.00	22.00

When the decision to rearm was made following Korea, the expansion in spending implied in the additional funds requested by the Administration was not of a magnitude that threatened to produce any serious disequilibrium between demand and supply in the economy.1/ Accordingly, the Administration took the view that "a complete set of economic controls" was not necessary in order to ensure financial stability during the period of rearmament and that general fiscal and credit measures would prove sufficient to restrain the inflationary pressures that would

1/ The first Presidential request made in July 1950 was for a supplementary authorization of $10.5 billion and a month later this sum was raised to over $15 billion.

develop during that period. Thus, the President, in his Economic Report to Congress dated July 26, 1950, requested legislative action along the following lines:

(a) An increase in tax revenue by about $5 billion a year.[1/]

(b) The restoration of the Government's authority, which terminated in the middle of 1949, to regulate and control consumer credit, real estate credit and commodity speculation.

(c) Authority to establish priorities and allocation of materials needed for defense and for essential civilian use, to prevent inventory hoarding and to requisition supplies.

(d) Authority to grant guarantees and loans for the increase in production and the expansion of productive facilities needed for defense.

Congress responded promptly by voting tax increases estimated to yield $4.7 billion and by passing the Defense Production Act, which not only granted to the President the powers he had requested, but in addition authorized him to

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1/ This was to be achieved mainly by increasing the normal tax rate on corporate incomes from 21 to 25 percent, by increasing individual income tax rates to the "tentative" levels adopted in 1945 which were reduced in 1945 and 1948 and by the closing of loopholes and other tax reforms. (See President's Economic Report, July 1950, p. 12-14).

institute comprehensive controls over prices and wages.[1/] The President, as already

1/ The main provisions of the Defense Production Act of September 8, 1950 are as follows:

Title I Priorities and Allocations - Establishes authority of the President to set up priorities and allocations for defense production and prohibit the accumulation of excessive stocks of materials designated scarce by the President.

Title II Authority to Requisition

Title III Expansion of Productive Capacity and Supply - Authorizes Government agencies to provide guarantees in whole or in part against loss of principal or interest on any loan, discount or advance which may be made by any public or private financing institution for the purpose of financing any contractor, sub-contractor or other purposes in connection with any contract or other operation deemed to be necessary to expedite production and deliveries of goods or services under Government contracts for the procurement or making of goods or the performance of services for national defense. Authorizes President to make provision for loans to private business enterprises for the expansion of capacity and the development of technological processes. Authorize President to make provision for purchases or commitments to purchase metals, minerals and other raw materials for Government use or for resale. Authorizes President to create new agencies to carry out the above functions.

Title IV Price and Wage Stabilization - Authorizes President to issue regulations and orders establishing ceilings on prices of goods and services and stabilizing wages, salaries and other compensations subject to the following conditions:

(a) Whenever a ceiling has been imposed on a commodity or service wages and salaries shall also be stabilized in the industry or business producing the commodity or service.

(b) Prices of agricultural commodities cannot be stabilized below their parity.

(c) The authority to regulate prices and conditions of operation doe not extend to rentals, fees for professional services, public utilities, margin requirements on any commodity exchange.

Instructs President to establish a new independent agency to administer price and wage controls.

Title V Settlement of Labor Disputes - Instructs President to initiate effective procedures for the settlement of labor disputes affecting national defense.

Title VI Control of Consumer and Real Estate Credit - Restores war-time powers of Federal Reserve Board to exercise consumer credit controls. Authorizes President to prescribe through Federal Reserve Board or other agencies regulations on real estate construction credit.

Titles IV, V, VI were to terminate at the close of June 30, 1951.

stated, had originally considered that such controls were not justified by the scale of the rearmament program, but the new upsurge of prices following the Chinese intervention in the Korean war in December 1950 convinced the Administration that drastic action on prices and wages had become imperative if the value of the dollar were not to slip still further. As the Economic Stabilization Agency, set up under the Defense Production Act,[1] did not yet possess the staff and machinery required to administer mandatory price and wage controls, it resorted at first to a request for a voluntary freeze of all prices at the levels prevailing on December 1, 1950,[2] coupled with the warning that if businessmen increased their prices in violation of the "fair standards" laid down, they could expect to see them rolled back as soon as mandatory controls had been instituted. The voluntary freeze, however, failed to arrest the upward movement of prices and the imposition of mandatory controls could no longer be postponed. On January 26, 1951 the Director of Price Stabilization issued a General Ceiling Price Regulation which froze most prices[3] at the highest levels at which deliveries had been made between December 19 and January 25. This was an emergency action intended to arrest the rise in prices; it could not form the basis of a rational system of price regulation since it froze a price structure which contained serious distortions and inequities. The objective was to replace, as soon as possible, the general freeze by detailed price regulations of the fixed-margin type used during the war and eventually establish dollar-and-cents ceilings for most goods. Thus, in April 1951 the General Manufacturers' Regulation was issued which provided that manufacturers could add to their pre-

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1/ The Economic Stabilization Agency, headed by an Administrator, was created by Executive Order of the President dated September 9, 1950. The Order provides that the Agency shall have a Director of Price Stabilization and a Wage Stabilization Board.

2/ Control orders were issued for only two categories of goods, automobiles and hides.

3/ The main exemptions were agricultural commodities.

Korean prices only the increases in costs of labor and materials which had taken place meanwhile, excluding increases in overheads. For many products this meant a roll-back from the ceilings fixed under the General Price Freeze of January 1951. However, when in July 1951 the Defense Production Act was extended for another year, an amendment was introduced, known as the Capehart amendment, which permitted manufacturers to add all cost increases, including overheads, between the outbreak of the Korean war and July 26, 1951. Another amendment, known as the Herlong amendment permitted profit margins of a percentage of costs instead of a definite amount. Both amendments were vigorously denounced by the President, who described the first as "an economic booby trap" and the second as inviting "America's two million distributors to become commission salesmen for inflation".[1/] In practice, with many prices declining below their ceilings and the Capehart amendment permitting the fixing of ceilings at the market price, the effects of the amendment on prices have to date proved less damaging than was feared.[2/] The fact that under the Capehart

1/ Other amendments restricting the powers granted under the original Act were those referring to installment credit and mortgages. On the other hand, the new Act granted to the Administration authority to control rents.

2/ See The Economist, November 3, 1951, p. 1047: "Many goods are selling below their ceilings which can thus be reduced in Senator Capehart's name; in some depressed industries, such as cotton textiles, the price officials have had to promise not to take full and unfair advantage of the law when they set permanent ceilings." Also The Economist, December 8, 1951, p. 1403: "The bark of the Capehart amendment which so alarmed the Administration at first, is proving somewhat worse than its bite. Manufacturers whose products are selling below their ceiling prices may not bother to apply to have the ceilings raised. And in cases where production increased between the outbreak of the Korean war and July 26th, unit overhead costs, which are taken into consideration under the Capehart amendment, may actually have fallen. Under the Defense Production Act Mr. DiSalle has the right to fix ceilings at the market price and it is this which is making the Congressional and business lions roar most loudly today. Last Summer they did not foresee that prices might fall. Mr. DiSalle has already reduced the ceiling on crude glycerine used in defense production from 49 cents a pound to 37 cents, about what it is selling for today. Tallow is likely to follow, to the indignation of the industrial advisory board, which has resigned en bloc on the ground that tallow-makers are losing money and, if the ceiling is lowered, will be deprived of a chance to recoup their losses. Soap, cleaners, hides, tyres on new cars and raw wool are also on the list. None of these are political high explosives, but Senators from the cotton states are already taking alarm. Cotton is still selling several cents under its ceiling. Senator Maybank is demanding that commodities selling below their ceiling prices should be decontrolled. Mr. DiSalle's view, however, is that the defenses against inflation must be kept intact in case the economic tide turns next year."

amendment increases in costs incurred after July 26, 1951 cannot be taken into account is also a factor limiting the scope for price increases allowed under the amendment. Thus, the Office of Price Stabilization was able to proceed with the fixing of dollar-and-cents permanent ceilings without having to make undue concessions to producers. There can, however, be no doubt that in the event of renewed inflationary pressures present price controls may prove seriously inadequate. Recent legislation extending the Defense Production Act until April 30, 1953 has further weakened the controls by exempting fruit and vegetable prices, restricting the powers of the Wage Stabilization Board, providing that rent controls will be terminated on September 30, 1952 unless extended by local option and cutting down the appropriations needed for the operation of the stabilization agencies. This new legislation has been described by the President as a "gamble with inflation".

Post-Korean economic developments greatly strengthened the bargaining position of labor and resulted in a widespread pressure for wage increases at a time when it was least in the interest of employers, confronted with a high demand for goods and an upward trend of prices, to resist the pressure. It was clear that, unless wage increases could be held down to what was justified by increases in productivity or an increased share in profits, this pressure for higher wages was bound to produce a rise in costs and prices and hence result in a loss in the value of the dollar. Thus, wage stabilization was an indispensable condition for the carrying out of an effective policy of economic and financial stabilization. Accordingly, on January 26, 1951 the Economic Stabilization Administrator issued the General Wage Stabilization Regulation No. 1 which froze wages, salaries and other compensations at the levels prevailing on January 25 and provided that no wage rate at a higher level could be paid without prior approval of the Wage Stabilization Board. As in the case of the price freeze, the wage freeze was subsequently amended to permit the elimination of distortions and inequities which existed at the time of

the freeze as well as take account of special situations. Thus, on February 27, 1951 a new Regulation provided that workers who had not yet received wage increases of 10 percent over the level of January 15, 1950 could be permitted increases up to 10 percent. On March 1, 1951 another Regulation specified that cost-of-living clauses contained in contracts executed on or before January 25, 1951 were valid even if the 10 percent limitation were exceeded as a result. Similarly, farm wages have in effect been exempted from control since it has been decided that increases of up to 95 cents an hour can be granted without approval of the Board.

The concessions on prices made subsequent to the general price freeze, together with this rather liberal interpretation of wage stabilization policy on the part of the Board, have meant that the level at which prices were finally stabilized was higher than that obtaining during the period December 19, 1950 to January 25, 1951, which had been taken as the base period for the imposition of the price freeze. Thus, the net effect of the subsequent departures from the general freeze was to raise prices above the level of the freeze. Using the average of January 1951 prices as an index of the level at which prices were frozen by the general Price Ceiling Regulation we find that in the next two months wholesale prices rose by another 2 percent and retail prices by 1.6 percent, indicating that the upward trend of the earlier post-Korean months had not yet been arrested. The break came in April, and since then a considerable degree of price stability has been maintained in the American economy.

3--THE PERIOD OF STABILIZATION APRIL 1951 - JUNE 1952.

Taking January 1951 as a base, we find that prices since then have moved as follows:

Wholesale Prices

(January 1951 = 100)

	1951			1952			
	March	July	December	March	April	May	June
All Commodities	102.2	99.6	99	97.6	97.2	97.3	96.8
Farm Products:							
Total	104.9	100	100	96.3	96.7	96.2	95.5
Foods	102.4	102	102.9	99	98	98.5	98.7
Industrial Goods:							
Total	101.2	99	98.3	97.6	97.1	96.9	96.6
Textile products	102.8	97	90	87.8	87.1	86.6	86.4
Hides & leather	100.6	94.5	82.8	77	73.9	74.3	75.1
Metals & metal products	100.6	100	102	98.8	98.8	98.2	97.6
Building materials	101	99	99.4	n.a.	n.a.	n.a.	n.a.
Chemicals	101.3	96	95.3	94.6	94	93.6	93.6
Housefurnishing products	102.3	102.3	98.5	98	98.1	97.8	97.8
Fuel & lighting materials	101.6	101	102	101	100	99.6	99.6
Miscellaneous	100	97.3	100.7	106.4	106.5	105.6	105.3

Consumer Prices

(January 1951 = 100)

	1951			1952		
	March	July	December	March	April	May
All items	101.6	102	104.1	103.5	103.9	104.1
Food	101.9	102.6	104.6	102.5	103.6	104
Apparel	102.3	102.5	104.1	102.5	102.2	101.
Rent	101.1	102.2	104.5	105.4	105.5	106
Fuel, electricity, etc.	100.6	100.5	101.1	101.3	101.3	100.9
Housefurnishings	101.6	102.4	101.5	100	99	99
Miscellaneous	101.3	101.9	104	105.3	105.5	105.7

These tables show that wholesale prices have declined by some 2 percent from the level of January 1951 and by some 4 percent from the peak reached in March 1951. Consumer prices, on the other hand, rose by another 4 percent during the same period. These divergent changes in the two sets of prices are due primarily to the fact that the cost of materials, which is the principal component of the wholesale price index, and the cost of labor, which is the major component of the retail price index, have moved in opposite directions during the period under consideration. Between January 1951 and May 1952 spot commodity prices[1] declined by

1/ As reflected in Moody's daily index.

15 percent and industrial raw material prices[1] by 30 percent. During the same period wage rates increased by 6.5 percent.[2] The decline in raw material prices was due to the fact that in the earlier period of July 1950 - January 1951 speculation had pushed these prices beyond what the supply-demand situation justified.[3] The rise in wage rates is in part attributable to the fact that increases had to be granted to offset the earlier rise in the cost of living and the continuing rise in the cost of food, which was due to the fact that throughout this period farm commodities other than meat could not be controlled under the Defense Production Act since they were selling below parity. In large part, however, the rise in wage rates was the result of the stronger bargaining position of labor and of the reluctance to apply the wage stabilization policy too strictly. This is shown by the fact that wage rates have risen more as compared with the pre-Korean levels than either wholesale or retail prices:

(June 1950 = 100)

	April 1952	May 1952
Wage rates	113.8	114
Wholesale prices	112	112
Retail prices	110.7	111

In addition to the higher cost of food and labor, higher rents have been

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1/ As reflected in the daily index of the Bureau of Labor Statistics.

2/ As follows:

Average Hourly Wages

(January 1951 = 100)

	1951			1952		
	March	July	December	March	April	May
All manufactures	101	102.7	105.2	106.4	106.4	106.5
Durable manufactures	101.4	103.2	105.7	107.0	106.8	106.9
Non-durable manufactures	100.2	102.2	104.1	105	105	105.4
Building construction	101.3	102.8	105.8	107.4	106.6	106.1
Retail trade	99.6	102	100.6	103.6	103.9	105.8

3/ Between June 1950 and January 1951 spot commodity prices had risen by 26 percent and industrial raw material prices by 58 percent.

an important factor in the rise in consumer prices since January 1951. The upward adjustment of rents during that period was, however, a process which had been going on since the end of the war and which would have continued even if there had been no other inflationary pressures in the economy, since it was the result of the gradual decontrol of rents, of the increases allowed in controlled rents and of the rising proportion of new rental units in the total of rented dwellings, i.e. of factors which would have operated in any case in the American economy until rents had been brought in line with other costs and prices.[1/]

While a 4 percent rise in consumer prices over a period of 16 months cannot be considered as negligible, it represents a very substantial improvement over the earlier period June 1950 - March 1951, when in less than a year consumer prices rose by 8 percent.

To what extent, if any, can the improvement be attributed to the imposition of price and wage controls? This is a question which is being hotly debated at present and which is of great practical significance in determining the need for the maintenance of controls in the coming years.

The opponents of controls argue that prices would have been stabilized in

1/ The following table shows that while the index of consumer prices remained stable in 1949 and in the first half of 1950, the index of rents rose by 8 percent during that period. Similarly, while the former increased by only 3.8 percent between January 1951 and April 1952, the latter increased by 5.5 percent during that period:

	Index of Rents	Index of Consumer Prices (Including Rents)
	(1935-39 = 100)	
1946	110.1	139.5
1947	113.6	159.6
1948	121.2	171.9
1949	126.4	170.2
June 1950	130.9	170.2
January 1951	133.2	181.5
June 1951	135.7	185.2
January 1952	139.7	189.1
April 1952	140.8	188.7

1951 even in the absence of price and wage controls. They base this view on the following considerations:

1. Since the rise in prices was largely speculative, it was bound to subside when prices had risen beyond the point where they reflected the true demand-supply situation. The fact that many prices declined below the levels at which they had been frozen shows that economic factors and not Government decrees were behind the stabilization of prices in 1951. In fact, it has been argued, the expectation of price controls had been one of the major inflationary factors in the economy during the three months preceding the imposition of controls since it caused a rush of price and wage increases to beat the controls.[1/]

2. One of the greatest inflationary dangers of the post-Korean period was that the demand for materials needed in large quantities in both military and civilian production would be so greatly in excess of supply that their prices would skyrocket, thereby causing a serious inflation of costs and prices throughout the economy. The Defense Production Act of 1950 provided against this danger by granting extensive powers to the Administration for the control and allocation of scarce materials and the expansion of their production. The National Production Authority set up under the Act, began by operating a simple system of priorities

1/ See American Economic Review, May 1952, p. 301.

and limitations,1/ but by the middle of 1951 it had developed the Controlled Materials Plan for the three basic metals, steel, copper and aluminum, which provided for actual allocations to firms working on military contracts or making essential civilian goods of the quantities needed by them to fulfil their production schedules. The opponents of price controls argue that since this system of priorities and allocations was designed to prevent a scramble for scarce materials and keep their demand and supply in equilibrium, it obviously made the imposition of price controls on such materials unnecessary. All other materials proved more than plentiful, after speculation had subsided, to meet the demand for them and in their case price controls were wholly meaningless.

3. One of the most decisive factors in arresting the inflationary rise in prices of the first post-Korean phase has been the expansion in production which took place during the period. Between July 1950 and March 1951 the production of such commodities as vacuum cleaners, washing machines, clothing, which the public

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1/ A priority regulation issued by NPA entitled the Defense Department and the Atomic Energy Commission to give their contracts a Defense Order (DO) rating. This obliged producers to fill these orders first and enabled them to use the rating against producers of materials needed for the orders. This system was supplemented by regulations limiting the use in non-military production of certain scarce materials. For early 1951 the cuts ordered were as follows:

Percent of Consumption in First 6 Months of 1950 Allowable for Non-Military Production

	January	February	March
Tin	100	80	80
Copper:			
Brass & wire mill products	85	85	80
Foundry products	100	100	100
Aluminum	80	75	
Nickel	65	65	
Cobalt	33 1/3	Complete allocation	
Zinc	80	80	
Cadmium	Use limited to specific products		
Rubber	83	80	

had been frantically buying in fear of future shortages, increased by 10 to 15 per-cent,1/ meeting amply all the extra claims made against it.

When consumers saw that no shortages developed, they realized that their fears had been unjustified and simply stopped buying. Moreover, the large purchases they had made in the earlier period had both depleted their financial reserves and anticipated their future needs. Thus, a period of restricted purchases by consumers following the earlier buying spree was inevitable and was bound to bring the upward movement of prices to a halt. Again, the fact that this occurred shortly after the imposition of price controls was largely coincidental.

4. The general fiscal and monetary measures taken after Korea in order to control inflation could not bring about immediate results. The stabilization of prices in 1951 largely coincides with the time when these measures began to make themselves felt in the economy:

(a) The tax increases voted by Congress in September 1950, together with the imposition of an excess profits tax in January 1951[2/] could not show results

1/ Figures are available for the following commodities:

	June 1950	October 1950	December 1950	March 1951
Vacuum cleaners (number)	250,190	331,445	288,756	290,242
Washing machines (number)	325,200	439,900	377,000	376,458
Refrigerators (1936 = 100)	332	236	219	330
Hosiery (thousands of pairs)	12,520	14,874	12,817	14,736
Cotton cloth (millions linear yds. quarterly)	2,401		2,639	2,835
Rayon cloth (thousands linear yds. quarterly)	551,842		602,000	630,000
Woolen goods (thousands linear yds. quarterly)	111,647		122,520	102,320
Shoes (thousands of pairs)	39,070	44,083	35,894	46,176

2/ The measure provided for an increase in the rate of tax on profits in excess of $25,000 from 45 to 47 percent, but its main feature was the imposition of a tax of 77 percent on excess profits. In determining their excess profits corporations were allowed to use one of the two following standards:

(i) everything above 85 percent of average annual earnings in the most profitable three years from 1946 to 1949, inclusive;

(ii) earnings greater than 12 percent of the first $5 million of invested capital and retained earnings, 10 percent of the next $5 million and 8 percent of all capital above $10 million. The amount that could be taken by combined regular and excess profits taxes was limited to 62 percent of a corporation's income. The tax was made retroactive to July 1, 1950. A relief clause provided for hardship cases. The measure was expected to yield $3,200 million per annum but the actual yield has been higher.

until the beginning of 1951.[1] Similarly, the additional tax increases voted in October 1951[2] to offset the rising spending on defense undoubtedly contributed to the maintenance of price stability in 1952. Altogether tax collections in 1951-52 exceeded those of the pre-Korean period by some $25 billion, of which over $15 billion were due to higher tax rates. It may be estimated that the tax burden of the population as a whole increased by 30 percent during that period[3] and this has undoubtedly been one of the major factors in the economic stabilization achieved during the second phase of the post-Korean period.

(b) The restrictions on consumer and real estate credit authorized under the Defense Production Act became fully effective only by the end of 1950 or the first months of 1951.

The first Regulation W issued on September 18, 1950 by the Federal Reserve

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1/ Comparing net budget receipts in fiscal years 1949-50 and 1950-51 we find that the bulk of the increase occurred in the first half of 1951:

	Fiscal Years 1949-50	Fiscal Years 1950-51	Increase
		(Million Dollars)	
July-September	9,257	9,346	+ 89
October-December	8,416	9,118	+ 702
January-March	11,148	16,817	+ 5,669
April-June	8,212	12,861	+ 4,649
Total	37,033	48,142	11,109

2/ The new tax measure increased existing rates of individual income taxes by some 11 percent, raised the rate on profits in excess of $25,000 from 47 to 52 percent, reduced the standard for determining excess profits from 85 percent of the profits in the three years 1946 to 1949 to 83 percent, raised the limit of total taxes on profits from 62 to 70 percent for corporations earning $100 million or more, increased excise taxes on whiskey, beer, cigarettes, gasoline, etc., imposed a 10 percent tax on most consumer durable goods and increased the capital gains tax from 25 to 26 percent. These increases were estimated to yield an additional $5.7 billion in revenue.

3/ Net budget receipts increased from $37 billion in 1949-50 to $62 billion in 1951-52. During the same period the gross national income increased from $260 billion to $335 billion. Thus, budget receipts represented 14.2 percent of the national product before Korea and 18.5 percent in 1951-52, which corresponds to an increase of 30 percent in the tax burden of the population.

Board established terms for consumer installment credit which were barely more restrictive than the terms generally prevailing at that time. It was only after the Regulation was amended on October 13th and terms considerably tightened up that control over consumer credit began to exercise a restraining effect on consumer demand.[1/] Thus, while between the end of June and the end of October 1950 total consumer credit outstanding increased by $1.7 billion, between the end of October and the end of January it increased by only $540 million and between the end of January and the end of March it actually declined by $560 million. Expansion in consumer credit had, therefore, ceased to be an inflationary factor after October 1950.

Similarly, the first Regulation X issued on October 12th by the Federal Reserve Board and companion regulations issued by the Federal Housing Administratio covered only real estate credit extended on new one-to-two family houses. It was not until January 12, 1951 that these regulations were amended to cover new

1/ The extent of tightening up is shown in the following table:

	Minimum Down Payment		Maximum Maturity	
	Regulation September 18	Regulation October 13	Regulation September 18	Regulation October 13
Passenger cars	33 1/3%	33 1/3%	21 months	15 months
Major appliances	15 %	25 %	18 "	15 "
Furniture	10 %	15 %	18 "	15 "
Home improvements	10 %	10 %	30 "	30 "

A considerable liberalization of these terms was ordered by Congress in July 1951 when it extended the Defense Production Act for another year.

multi-family units as well[1] and it was not until February 15, 1951 that most non-residential construction was also brought under control. Moreover, the effectiveness of these regulations was limited at the outset by the large volume of building then under way and by the large volume of financing commitments outstanding.[2] It

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1/ The terms of borrowing for the purchase of new houses established under these regulations were as follows:

One or Two Family Units

If Value Per Unit Is:	Maximum Loan Value Is:
Over $2,500 but not more than $5,000	90% of value
Over $5,000 but not more than $9,000	$4,500 plus 65% of excess of value over $5,000
Over $9,000 but not more than $15,000	$7,100 plus 60% of excess of value over $9,000
Over $15,000 but not more than $20,000	$10,700 plus 20% of excess of value over $15,000
Over $20,000	$11,700 plus 10% of excess of value over $20,000 but not less than 50% of value

Multi-Family Units

If Value Per Unit Is:	Maximum Loan Value Is:
Not more than $7,000	83% of value
Over $7,000 but not more than $15,000	$5,810 plus 53% of excess of value over $7,000
Over $15,000 but not more than $23,500	$10,000 plus 20% of excess of value over $15,000
Over $23,500	50% of value

With respect to loans guaranteed by the Veterans Administration, loan ratios 5 to 10 percent higher were authorized by the Federal Housing Administration.

The regulations also prescribe maturity and amortization requirements. As in the case of installment credit, a considerable liberalization of the above terms was ordered by Congress in July 1951.

2/ It should also be noted that since the Defense Production Act authorizes controls over real estate credit only on new construction and not on existing houses, a large part of real estate credit has remained virtually uncontrolled. Thus, it has been estimated that in 1950 about three-fifths (some $9 billion) of all the credit extended on one to four-family properties was credit extended on existing houses. (See Federal Reserve Bulletin, May 1951, p. 492).

was not until after March 1951 that a marked decline in residential construction set in. This is shown in the following table which compares the number of non-farm dwellings started in 1951 and in the first quarter of 1952 with those started in 1950:

	1950	1951	1952
1st quarter	278,900	260,300	240,600
2nd quarter	426,800	329,700	
3rd quarter	406,900	276,000	
4th quarter	283,400	225,300	
Total	1,394,000	1,091,300	

It should be noted, however, that a month ago in reviewing the Defense Production Act Congress terminated the authority of the Federal Reserve Board to control consumer installment credit and real estate credit. It only provided that controls over real estate credit may be restored if the number of houses started seems likely, on the basis of three months' experience, to exceed 1,200,000 a year.

(c) It was not until the beginning of 1951 that effective measures were taken to restrict the growth of bank credit which had been a major factor in the inflationary developments of the first phase of the post-Korean period.

On August 18, 1951 the Federal Reserve Board approved an increase in the discount rate of the Federal Reserve Bank of New York from 1 1/2 to 1 3/4 percent and within a few days approved a similar increase at other Reserve Banks. This, however, was of little practical effect since the commercial banks did not then need the rediscount facilities of the Federal Reserve. On December 28, 1950 the Federal Reserve Board increased the amount of reserves required to be maintained with the Federal Reserve Banks by member banks by percentages estimated to raise the required reserves by some $2 billion and thereby reduce the capacity of the

banks to expand their lending activities.[1] Similarly, effective January 17, 1951 margin requirements for credit extended by brokers and banks to finance purchases or short sales of securities were increased from 50 to 75 percent of the value of the securities.

On March 12, 1951 the Federal Reserve Board addressed a request to all financing institutions in the United States to act in accordance with the provisions of a program for voluntary credit restraint worked out by the Board in consultation with representatives of financing institutions. The purpose of the program was to discourage bank credit not essential to the economy. The program envisaged the creation of a National Voluntary Credit Restraint Committee and entrusted it with the responsibility of establishing criteria for distinguishing between essential and non-essential credit and of setting up regional committees to deal with regional problems of credit restraint. Assessing the contribution of this program to monetary stabilization the Federal Reserve[2] states that "while it is impossible to determine precisely the volume of credit that has been denied, a very large number of loan requests, including several sizeable ones, have been delayed or refused by lenders acting voluntarily in accordance with the principles of the program".

So long, however, as the banks and other investors were able to convert without loss their vast holdings of Government securities into cash none of these

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Increase in Percent of Net Demand Deposits Required to be Held with Federal Reserve Banks	Effective Date
For central reserve city banks	
from 22 to 23	January 11, 1951
from 23 to 24	January 25, 1951
For reserve city banks	
from 18 to 19	January 11, 1951
from 19 to 20	January 25, 1951
For county banks	
from 12 to 13	January 16, 1951
from 13 to 14	February 1, 1951

2/ Federal Reserve Bulletin, July 1951, p. 745.

measures could prove really effective in checking the growth of credit during a period of expanding business activity and high demand for funds. This ability of the public to treat its holdings of Government securities as virtual demand notes was the result of war-time monetary policies continued in the post-war period. During the war it was decided to maintain a structure of very low interest rates, ranging from 3/8 of 1 percent on 90-day Treasury bills to 2 1/2 percent on long-term bonds, in order to keep down the cost of the huge national debt which was being accumulated in the financing of the war effort. For such low interest rates to be maintained it was necessary that the Federal Reserve stand ready to buy at par all Government securities offered to it. After the war short-term rates were allowed to rise[1/] but the pegging of the long-term rate at 2 1/2 percent was continued. Banks and other financing institutions which were large holders of Government securities and which were eager to invest in more profitable assets, took advantage of this policy in order to convert vast amounts of Government securities into cash by selling them to the Federal Reserve at par. This process has been termed "monetization of the national debt" and has been held in large part responsible for the inflation of the immediate post-war period. The Federal Reserve soon found that this obligation to support the market for Government securities at par made it powerless to perform its main function, which is to manage the country's money supply and maintain monetary stability. It therefore pressed for higher interest rates on the Treasury's refunding issues which would have created a more realistic structure of interest rates and discouraged the monetization of the debt. This course was vigorously resisted by the Treasury, whose main concern was to keep down the cost of the national debt.[2/] The issue lost its

1/ From 0.375 percent on three-month Treasury bills to 1.174 percent in June 1950.

2/ It was pointed out that a 1/2 percent rise in the average rate of interest on the public debt would cost the Government $1.5 billion per annum.

urgency after 1948 when inflation came to an end, but it revived in an acute form during the post-Korean period and led to a spirited and widely-publicized controversy between the Treasury and the Federal Reserve. It should be noted, however, that the controversy was not about whether a sharp increase in interest rates and a corresponding sharp decline in bond prices should be allowed. This was considered undesirable by both sides. The argument was about what could be expected from small rises in interest rates. The Federal Reserve view was that even fractional changes in interest rates would prove sufficient to check monetary expansion, while the opposite view was that such small changes would prove ineffective, would only create uncertainty in the bond market and would increase unnecessarily the cost of borrowing and the profits of commercial banks at a time when strenuous efforts were being made to prevent costs and profits from rising.

On August 18, 1950 the Treasury announced that it would refund $13.5 billion of Government bonds and certificates maturing September 15 and October 1 with a new issue of 13-month notes bearing 1 1/4 percent interest. This was an intimation that rates of interest would not be allowed to rise. The public did not accept the offer; some $2,376 million of the old issue were turned in for cash and most of the rest was sold to the Federal Reserve. These purchases were offset in large part through sales by the Federal Reserve of shorter term securities with higher yields, but the net effect of these and other operations was to increase the reserves of member banks by $800 million.[1/]

In a second refunding operation affecting $8 billion of Government securities, more attractive terms, i.e. five year 1 3/4 percent notes, had to be offered due to the fact that the Federal Reserve, against Treasury opposition, was allowing short-term interest rates to rise.

1/ Bank reserves have been called "high powered dollars" because they serve as a basis for manifold further credit expansion by the banks.

On March 4, 1951 a joint statement by the Treasury and the Federal Reserve announced that the Treasury would refund $19.6 billion of two bond issues maturing in 1972 but callable in 1967 carrying 2 1/2 percent interest and not eligible for bank investment. In exchange investors were offered an issue of longer maturity (1975-80) at 2 3/4 percent, also not eligible for bank holdings and in addition not directly marketable. A holder who wanted to turn these bonds into cash would first have to convert them par for par into a new issue of five-year 1 1/2 percent notes saleable on the market, probably only at a small discount.

The purpose of this move was to encourage investors to hold their long-term obligations rather than convert them into other higher-yielding assets such as mortgages and corporate securities. (Of the total of $19.6 billion outstanding, $13.6 billion were exchanged for the new issue.) More important than this specific step, however, was the unannounced but soon apparent agreement between the Treasury and the Federal Reserve that the latter would no longer peg the price of Government bonds at a precise figure. Since then the Federal Reserve has abstained most of the time from supporting the bond market and has discontinued its purchases of short-term securities. The effect of this change of policy on interest rates has been as follows:

	Percent Per Annum	
	3-Month Treasury Bills	Taxable Bonds 15 Years and Over
June 1950	1.174	2.33
January 1951	1.387	2.39
March 1951	1.422	2.47
June 1951	1.499	2.65
January 1952	1.688	2.74
March 1952	1.658	2.70

The Treasury accepted this rise in interest rates by offering securities with higher yields. Thus, in May 1951 it announced the offering of a new savings note with yields ranging from 1.44 percent for 6 months up to 1.88 percent for the full three-year investment. (These yields were about 1/2 to 1 percent higher

than those on the old savings notes).[1/]

The fact that such relatively moderate increases in interest rates allowed the Federal Reserve to withdraw its support from the Government securities market has been hailed as evidence of how effective even fractional increases in interest rates can be to arrest the expansion in credit and in the money supply. In fact, the experience of 1951 is far from conclusive on this matter since economic conditions at the time when the new policy was adopted were such as to make the interest rate changes unusually effective. It is by no means certain that under different conditions small changes in interest rates would have produced similar results.

1/ Recent borrowing operations by the Treasury are described as follows in The Mid-Year 1952 Economic Review by the Council of Economic Advisers of July 1952, p. 64-65:

"... The Treasury engaged in substantial new borrowing activities during the second quarter. The volume of 3-month Treasury bills was increased, and, in May, 2 3/4 percent nonmarketable bonds of the type first issued in March 1951 were offered (with minor exceptions) to nonbank investors, who were given the right to turn in certain marketable bonds in payment for up to three-fourths of their subscriptions. In June, the Treasury offered, for cash subscription only, a 2 3/8 percent marketable 6-year bond. The amount, initially announced as approximately 3 1/2 billion dollars, was the largest cash offering of Government securities since the end of World War II financing. It was heavily oversubscribed. Accordingly, the total offering was expanded to 4 1/4 billion dollars in order to meet in full the subscriptions of nonbank investors, and to allow commercial banks, which had been permitted to make limited subscriptions, the minimum amount promised them.

"Effective in May, the Treasury also announced changes in the terms of U.S. savings bonds to make the bonds more attractive to investors. The changes, which involved the offering of three new series of savings bonds and the discontinuance of two preexisting series, as well as a modification of the terms of Series E bonds, had the general effect of raising the average rate of interest on bonds held to maturity, and of increasing the rate of return in the first years after purchase. In addition, the annual purchase limits were doubled for the different series."

It should be pointed out, however, that the 2 3/4 percent non-marketable bonds had not been well received and that part at least of the success of the 2 3/8 marketable bonds was due to the fact that non-bank investors, who were given preference over banks, borrowed from the banks in order to buy the bonds and then resell them at a profit. Thus, in spite of the Treasury's efforts to tap the funds of nonbank investors it would appear that a large part of the purchases of bonds were financed by the banks. (See The Economist, July 12, 1952, p. 93 and also The Mid-Year 1952 Economic Review by the Council of Economic Advisers, July 1952, p. 39.)

During the first half of 1951 there was a budget surplus of $4.1 billion, part of which was used for debt retirement. During the next twelve months there was a sharp increase in personal savings and a decline in the rate of credit expansion whose combined effect was to increase the supply of funds seeking investment in Government securities. Finally, the fact that the Treasury has so far been unable to sell long-term bonds for refunding or new borrowing and has had to confine its activities to the short-term market means that the long-term rate of interest has not yet been tested.[1/] It also means that the proportion of the total Government debt held in the form of short-term issues is larger now than it was a year ago, and this is obviously an undesirable development from the point of view

1/ It also seems to lend support to the argument advanced by those who favor the pegging of interest rates, that creating uncertainty about the future of interest rates may be a means of discouraging the sale of long-term securities by the public, but it is also a means of discouraging the purchase of such securities by the public.

of future monetary stability.[1]

1/ See American Economic Review, May 1952, W. Thomas, "Inflation Control in the United States, p. 278:

"In view of the large commitments made by institutional investors in the private credit area and their desire to sell Government bonds, it was hardly possible for the Treasury to sell long-term bonds in any substantial amount. On the other hand, there was an expansion in holdings of short-term funds by corporations and others and some shift by institutional investors from bonds to short-term securities. Hence, Treasury refunding and more recently new-money financing were confined to the short-term area."

See also The Annual Economic Review by the Council of Economic Advisers, January 1951, p. 142. Separate Note by Mr. Clark:

"There is general agreement that every effort should be made to place the Government debt in long-term bonds in non-bank hands. The Treasury now finds no market for long-terms and its heavy financing has to be in the form of short-term securities eligible for bank portfolios."

The following changes have taken place in the structure of the Government debt since Korea:

	June 1950	June 1951	May 1952
Marketable public issues			
Short-term	52.4	58.9	65.6
Treasury bonds	102.8	78.8	76.8
Non-marketable public issues			
U.S. saving bonds	57.5	57.6	57.6
Treasury tax & saving notes	8.5	7.8	7.5
Investment bonds (issued in exchange for Treasury bonds)	-	14.5	12.5
Total	221.2	217.6	220.0

With regard to the ownership of Government securities, the following changes have taken place since Korea:

	June 1950	June 1951	May 1952
Private holdings			
Commercial banks	65.6	58.4	61.1
Other financing institutions	59.9	59.5	59.4
Individuals*	67.5	64.0	63.6
Total	193.0	181.9	184.1
Public holdings			
Federal Reserve	18.3	23.0	22.3
State & local Governments	8.2	9.4	9.9
Total	26.5	32.4	32.2

* There is a difference of some $2 billion between the figures shown in earlier Reviews by the Council of Economic Advisers and the one issued last month. The figure for June 1950 has been taken from the earlier issues as the series contained in the new issue do not go back to June 1950.

It is highly improbable that an earlier adoption of the monetary policy represented by the accord between the Treasury and the Federal Reserve would have had any substantial effect on the forces working for a price rise during the period July 1950 - March 1951. It has been argued that under the conditions prevailing during that period the rise in prices could have been completely averted only by increases in interest rates which would have caused a 20 to 30 point decline in the prices of Government securities as compared with the 4 percent maximum decline which the rise in interest rates produced in the subsequent period. This means that the long-term interest rate might have had to rise to 4 or 4 1/2 percent.[1/]

As far, however, as the conditions of 1951-52 are concerned, the new monetary policy did help to check monetary expansion in the following three ways:

(i) While maintaining an orderly market for Government bonds it introduced sufficient uncertainty to make investors realize that they could no longer expect to convert securities into cash without some market risk.

(ii) It forced the large institutional investors, such as insurance companies, who were reluctant to accept the capital loss involved, to stop turning their holdings of Government securities into mortgages and other higher-yielding assets.[2/] It is argued that the decline in housing construction which set in in the second quarter of 1951 and which contributed so greatly to reduce demand for

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1/ See Report of the Subcommittee on General Credit Control and Debt Management (Patman Subcommittee) of the Congressional Joint Committee on the Economic Report, June 26, 1952, p. 22-23 and 35.

2/ The Patman Subcommittee has made the following calculations of the effect of increases in interest rates on the price of a 20-year 2 1/2 percent bond:

Assumed Yield	Market Price
2 1/2	100
3	92.52
3 1/2	85.70
4	79.48
4 1/2	73.81
5	68.62

consumers' durables owes at least as much to this reluctance of financial institutions to sell their Government securities as to the controls imposed on real estate credit by the Federal Reserve.

(iii) It forced the banks, for the first time since the war, to utilize extensively the rediscount facilities of the Federal Reserve in order to adjust their reserve positions instead of selling U.S. Government securities to the Federal Reserve as they had been doing under the regime of pegged interest rates. Thus, during the first five months of 1952 the daily average of outstanding Federal Reserve discounts and advances to member banks was $362 million, 1 1/3 times the average amount in the same period of 1951 and almost four times that in the same period of 1950.[1/] The necessity for banks to borrow from the Federal Reserve has acted as a restrictive force on credit and monetary expansion in view of the well-known reluctance of banks to rely on borrowed funds for any extended period of time, a reluctance which induces them to adjust their lending and investing activities downwards in order to repay their debt.

On the other hand, there is no evidence that the fractionally higher interest rates themselves had any effect on the demand and supply of funds. It is true that the expansion of bank credit slowed down considerably after March 1951,[2/] but this was the result of the general stabilization of the economy rather than of the higher cost of credit. Similarly, it is true that bank holdings of U.S. Government securities, which, as already stated, declined by $7 billion during

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1/ Federal Reserve Bulletin, July 1952, p. 733.

Also The Economist, July 12, 1952, p. 93:

"The commercial banks have been forced to borrow large sums from the Federal Reserve Banks in order to meet their reserve requirements. This method of providing reserves temporarily is in sharp contrast to the injection of more permanent funds through purchases of Government securities in the pegged markets of more than a year ago."

2/ Between March 1951 and March 1952 bank loans increased by $3.4 billion as compared with $9.6 billion in the earlier period.

the earlier period, increased by $2.5 billion during March 1951 - March 1952. This, however, is only partly attributable to the higher yields of U.S. Government securities. It is due primarily to the already mentioned fact that the unpegging of interest rates made it generally more profitable for the banks to borrow from the Federal Reserve in order to make temporary adjustments in reserve positions than sell bills in the market at a low price and buy them back later at a high price, and also to the fact that the expansion in deposits and the earlier sales of U.S. securities had reduced bank holdings of such securities below what liquidity considerations indicated as desirable.[1/]

An interesting fact about monetary developments during the post-Korean period is the absence of any correlation between price changes and changes in money supply, indicating that money supply is not as significant a magnitude as is commonly held and is certainly not a major determinant of economic and financial conditions in a given period. During the period of sharp price inflation July 1950 - March 1951 the privately held money supply (defined as adjusted deposits plus currency outside the banks) increased by $2.5 billion or only 1.5 percent, while during

1/ The ratio of bank investments in U.S. Government securities to their total investments, which stood at 54 percent in June 1950, declined to 47 percent in March 1951 and to 46 percent in March 1952.

Similarly, the ratio of bank holdings of U.S. Government securities to total private dem and deposits, which stood at 77 percent in June 1950, declined to 66 percent in March 1951 and to 64 percent in March 1952:

Million Dollars

	Bank Holdings of U.S. Government Securities	Total Bank Investments	Total Private Demand Deposits	Ratio of U.S. Government Securities To Total Investments	Ratio of U.S. Government Securities To Total Private Demand Deposits
1940	17,800	43,900	34,945	40%	50%
June 1950	65,800	121,800	85,040	54%	77%
March 1951	58,800	125,700	89,000	47%	66%
March 1952	61,100	132,500	94,800	46%	64%

the following period of economic stabilization the money supply expanded by $10.4 billion or 6 percent.[1] The reason, of course, for this total absence of correlation is that the monetary circulation is determined not only by the quantity of money but also by its velocity, i.e. its turnover, which increases in a period of rising prices and decreases in a period of falling prices.[2]

The factors enumerated above have undoubtedly made a major contribution to the stabilization achieved in 1951-52. The conclusion, however, that the same degree of stabilization would have been possible without the imposition of price and wage controls ignores the following considerations:

1. While it is true that most of the rise in prices which occurred during the first phase of the post-Korean period was of a speculative and anticipatory

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1/ Changes in money supply during the post-Korean period have been as follows:

	Million Dollars			
	June 1950	March 1951	March 1952	May 1952
Demand deposits adjusted	85,040	89,000	94,800	95,300
Time deposits	59,739	59,100	62,500	63,000
Currency outside banks	25,185	24,400	25,700	26,000
Total privately-held money supply	169,964	172,500	182,900	184,400

Comparison Between Changes in Money Supply and Changes in Prices

	Percent Increase		
	Money Supply	Consumer Prices	Wholesale Prices
July 1950 - March 1951	1.5	8	17
March 1951 - March 1952	6.0	2.4	- 4
July 1950 - May 1952	8.4	11	12

2/ See Report of Subcommittee on General Credit Control and Debt Management (Patman Subcommittee) op. cit. 19-22.

character, it is also true that this is a type of inflation which can feed on itself and which can, therefore, continue for a long time until arrested by a reversal of expectations. The argument that high prices check the dem and for goods and cannot, therefore, be maintained if they are not justified by the demand-supply situation ignores that higher prices bring in their train higher profits, higher wages and higher farm incomes and hence a higher demand for goods. Between the third quarter of 1950 and the second quarter of 1951 consumer prices rose by 4 percent but personal incomes after taxes rose by 7 percent. Between the first half of 1950 and the first half of 1951 consumer prices rose by 8 percent but personal incomes after taxes rose by 11 percent. The fact is that whenever a large proportion of producers and sellers decide to raise their prices they automatically create a larger dem and for their products which is sufficient to support the new price structure. It is only when such action is resorted to by a small group of producers or when the rise in the prices of some commodities is far greater than that of most other commodities that the higher prices are economically untenable and must come down. In the situation prevailing at the beginning of 1951 there was no inherent reason why prices could not have continued to rise for several more months.

Similarly, while it is true that by the spring of 1951 consumers were overstocked with goods and had, in particular, amply met their needs for durable goods, it is also true that in a period of rising prices (and prices were still rising fast when controls were imposed), the public will seek to convert as much as possible of its cash and liquid assets into goods and other hedges against inflation, thereby adding to the inflationary pressures existing in the economy. The fact that after March 1951 consumers have been willing to save such an unusually high proportion of their incomes and to invest these savings in highly liquid assets indicates that the fear of price rises subsided during that period. There can be no doubt that the imposition of price and wage controls, for which the public <u>and</u>

Congress had been clamoring for months, gave assurance that prices would no longer be permitted to rise and thereby contributed to bring about a reversal of expectations. From then on the process of stabilization, like the earlier process of inflation, acquired a momentum of its own: the fact that people stopped buying helped to stabilize prices and the fact that prices were being stabilized removed the incentive to buy. Even if price controls were only a straw, it can fairly be said that they were the straw that broke the camel's back.

2. It would, however, be incorrect to describe the contribution which price and wage controls have made to date to the stabilization of the American economy as primarily psychological. While there are wide areas of the economy where considerable price "softness" developed after March 1951, there are also important sectors where inflationary forces continue to exert their pressure and to threaten the stability of the general price level. One such sector is labor costs which are steadily moving upwards as a result of the strong bargaining position of labor under conditions of full employment. Another inflationary force is the strong demand for materials needed in both military and civilian production. Physical controls and limitations on the use of scarce materials no doubt reduce the pressure of demand on their prices, but in the absence of price controls the enforcement of physical controls would have been a formidable, if not impossible, undertaking. The fact alone that the price level is still rising shows that the controls are needed and are performing a useful function.1/ It should also be noted that the

1/ The Mid-Year 1952 Economic Review by the Council of Economic Advisers dated July 16, 1952 describes the recent price situation as follows:

"... A Bureau of Labor Statistics' study indicated that in March, for example, prices of commodities representing 85 percent of the coverage of the consumers' price index, including some prices not subject to control, were still at their post-Korean peaks or within 5 percent of those peaks. In such tight market areas, the Office of Price Stabilization continued generally to hold the line, granting increases only when justified under its standards requiring a limited amount of cost absorption. An increasing number of demands for higher ceilings were denied under the chief of these standards, the industry earnings standard: where, as in the case of wholesale and retail grocers, this standard required moderate increases, they were granted. In soft market areas, OPS developed a ceiling-suspension policy, which by midyear had been used in about 20 cases, including fats and oils, hides and leathers, wool, raw cotton, all textiles, and whiskey and wine. ..."

stability exhibited by the general price level since March 1951 is in part deceptive since it is made up of price declines in the depressed industries which will be reversed as soon as the demand for the products of these industries revives (and this it is certain to do in the coming months) and of substantial rises in costs and prices in other sectors which are not likely to be reversed. If, for instance, wholesale prices of clothing and leather had not declined by more than 15 percent since March 1951 (the greatest decline registered by any group of commodities included in the wholesale price index) consumer prices of apparel would not have been maintained at their March 1951 levels and consequently the overall index of consumer prices would now have been higher than it is, probably by 1 to 2 percent.

3. Without the exceptionally high volume of personal saving and the slowing down of inventory accumulation which have characterized the second post-Korean year conditions in that year would have been much more inflationary than in 1950.

In the first place, Government finances which in 1950-51 had exerted a strong anti-inflationary influence on the economy ceased to do so in 1951-52. In 1950-51, as already stated, Federal cash receipts exceeded cash expenditures by $7.5 billion. In 1951-52 there was no surplus: cash receipts are estimated to have been $68 billion and payments $67.9 billion. In terms of purchases of goods and services, Government spending increased from $30 billion in 1950-51 to $50 billion in 1951-52, i.e. by $20 billion.

In the second place, there was no decrease in the volume of investment: a decline of $2.10 billion in residential construction was offset by an expansion of $1.75 billion in expenditures on plant and equipment.[1/]

1/

	(Billion Dollars)		
	July 1950-June 1951	July 1951-June 1952	Change
Industrial plant and equipment	28.75	30.50	+ 1.75
Residential construction	12.6	10.50	- 2.10

In the third place, the export surplus, whose impact on the economy is obviously inflationary, had been only $1,417 million in July 1950 - June 1951, but increased to $5,047 billion in July 1951 - June 1952.

In the fourth place, personal incomes after taxes increased from $216 billion in 1950-51 to $230 billion in 1951-52, i.e. by 6.5 percent. Two things are significant about this increase: (i) It represented an increase in the purchasing power of the population and not merely an increase in money incomes. During that period consumer prices rose on the average by some 4 percent, which means that personal incomes after taxes expressed in 1950-51 dollars totalled $221 billion, i.e. increased by $5 billion or nearly 2.3 percent. (ii) The bulk of the increase consisted of increases wages and salaries. The other categories of incomes registered only slight gains:

	(Billion Dollars)		
	July 1950-June 1951	July 1951-June 1952	Change
Salaries & wages	160.7	176.1	+15.4
Agricultural income	19.6	20.7	+ 1.1
Proprietors and rental income	28.3	31.0	+ 2.7
Dividends	9.5	9.2	- 0.3
Personal interest	10.8	11.6	+ 0.8
Transfer payments	12.0	12.5	+ 0.5
Total	240.9	261.1	20.2
Minus taxes	24.6	31.1	6.5
Disposable income	216.3	230.0	13.7

The fact that incomes after taxes were higher in 1951-52 than in 1950-51 and that most of the increase occurred in the lower income groups meant that consumption in 1951-52 would normally have been higher than in 1950-51.

Added together, the increase in Government spending, the larger export surplus and the higher wage and salary earnings represented large new claims on available resources which only to a limited extent could have been met out of increased output, since by March 1951 the productive machinery was operating near capacity levels and shortages of materials precluded any further large expansion in total output. Moreover, even where increases were possible, they would have been achieved

at the cost of bidding up prices still further. Finally, a higher volume of production would have also meant a higher level of personal incomes and hence a larger demand for goods.

As already stated, the reason why, in spite of these new claims on available resources, the economy was stabilized in 1951-52 is that there was a sharp increase in personal saving and a slowing down of inventory accumulation.

During 1951-52 personal saving increased as follows as compared with the earlier period:

	Billion Dollars	Percent of Disposable Income
January-June 1950 (Annual rate)	10.7	5.4
July 1950-June 1951	11.9	5.5
July 1951-June 1952	18.9	8.2
Change between 1950-51 and 1951-52	+ 7.0	

As stated in an earlier section, these data on personal saving, besides being mere approximations, are not a satisfactory measure of changes in private demand for goods and services since they include investments in houses and in non-corporate business. Such investments were extremely high in 1950-51 but declined considerably in 1951-52. Thus, the increase in liquid savings between 1950-51 and 1951-52 was much greater than the expansion in total personal savings suggests. Time deposits, for instance, which declined by $0.5 billion in the second half of 1950 and increased by only $0.7 billion in the first half of 1951 expanded by $1.5 billion in the second half of that year and by $1.8 billion in the first half of

1952.[1]

As a result of this increase in personal saving, overall consumption in 1951-52, measured in constant dollars, was slightly smaller than in the previous year.[2] Thus, no additional claims on available resources resulted from the increase in incomes. In fact, this overall stability of consumption concealed sizable reductions in purchases of durable goods, i.e. of goods competing directly with military requirements, and an increase in expenditures on services, i.e. in expenditures which

1/ More comprehensive estimates of liquid savings, which, however, do not cover the whole period under consideration, are contained in The Annual Economic Review by the Council of Economic Advisers of January 1952, p. 74, as follows:

	1950		1951	
	2nd Quarter	3rd Quarter	2nd Quarter	3rd Quarter
	(Billion Dollars)			
Total personal saving (not adjusted for seasonal variations)	+3.5	+2.0	+6.8	+7.0
Liquid saving:	-0.5	-0.3	+2.0	+4.7
Currency, deposits & savings and loan shares	+0.7	+2.3	+1.1	+4.5
Private insurance reserves	+0.9	+1.0	+0.9	+1.0
Securities:				
U.S. Government	+0.5	-0.4	-	-0.1
State & local Government	-0.1	-0.2	+0.4	-
Corporate and other	+0.4	+0.5	+1.1	+0.6
Debt liquidation				
Mortgage	-1.7	-1.9	-1.7	-1.4
Consumer	-1.3	-1.7	+0.2	-0.1

For the year 1951 the Council estimates that liquid savings expanded by $8 billion.

2/ Personal consumption expenditures:

	Current Prices	1950-51 Prices
	(Billion Dollars)	
July 1950-June 1951	204	204
July 1951-June 1952	211	203

make fewer claims on scarce resources.[1/]

We have seen that the accumulation of business inventories had been one of the major inflationary forces in 1950-51. In the second half of 1951 there was a considerable slowing down of inventory accumulation, while in the first half of 1952 there was an actual reduction in inventories. The result was that the claims of the business sector on available resources were $3 billion lower in 1951-52 than they had been in 1950-51:

Net Change in Non-Farm Business Inventories
(Annual Rates Seasonally Adjusted)

	Billion Dollars
1st half 1950	2.8
2nd half 1950	4.4
1st half 1951	12.1
2nd half 1951	6.7
1st half 1952	- 1.3

1/ This is shown in the following breakdown of personal consumption expenditures. It should be noted that the increase in expenditures on food is due exclusively to higher prices and not to increased consumption:

Seasonally Adjusted Quarterly Totals at Annual Rates
(Billion Dollars)

	1950			1951				1952
	II	III	IV	I	II	III	IV	I
Total consumption	187.7	202.5	198.4	208.2	202.4	204.0	206.7	209.6
Durable goods								
Automobiles	11.4	14.3	12.9	12.5	10.8	9.7	9.4	9.5
Furniture & household equipment	11.5	16.0	12.4	14.8	11.0	11.4	11.4	11.2
Other	3.8	4.0	4.1	4.3	4.0	4.1	4.2	4.3
Non-Durable goods								
Clothing and shoes	18.5	19.6	19.2	20.4	19.5	19.7	20.2	20.3
Food	59.7	62.6	62.7	67.0	67.1	67.9	69.1	70.8
Gasoline and oil	5.1	5.1	5.2	5.4	5.5	5.5	5.6	5.7
Semi-durable house-furnishings	1.9	2.4	2.0	2.4	2.0	2.1	2.0	2.0
Tobacco	4.4	4.4	4.5	4.7	4.6	4.7	4.8	4.9
Other non-durables	10.8	11.3	11.2	11.6	11.3	11.6	11.9	12.0
Services								
Household operation	9.2	9.3	9.8	10.1	10.2	10.1	10.2	10.4
Housing	19.7	20.1	20.5	20.9	21.3	21.7	22.2	22.5
Personal service	3.8	3.9	3.9	3.9	4.0	4.0	4.1	4.2
Recreation	4.0	3.9	3.9	3.9	3.9	4.1	3.9	3.9
Transportation	5.1	5.2	5.3	5.4	5.7	5.7	5.8	5.9
Other services	19.9	20.3	20.7	21.0	21.3	21.6	21.9	22.2

As a result of this larger personal saving and smaller inventory accumulation, rising defense expenditures were more than offset by declining civilian expenditures. Thus, areas of slackness developed in several sectors of industry, especially textiles, while the declining civilian expenditures on durable goods and in particular automobiles made possible a considerable diversion of materials and capacity to military production without the emergence of any of the shortages which had been widely feared when the rearmament program was decided upon.[1/]

Several factors contributed to bring about this change in the attitude of the public and of business towards spending and the accumulation of inventories. Overbuying and overstocking in the earlier period were no doubt important. The fact that no shortages developed convinced the public that its earlier fears had

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1/ Overall industrial production in 1951-52 was at the same level as in 1950-51 with considerable increases in certain sectors and considerable declines in others:

Overall Industrial Production

1st half 1950	= 100
2nd half 1950	111.6
1st half 1951	117
2nd half 1951	114.7
1st half 1952	114

Production of Selected Commodities

	March 1951	March 1952
	(June 1950 = 100)	
Increases		
Non-ferrous metals and products	101	105
Machinery	127	136
Petroleum and coal products	120	125
Chemicals	111	112
No Change		
Iron and steel	114	114
Manufactured foods	101.7	101.2
Decreases		
Lumber and products	109	101.5
Textiles	108	87
Cars and trucks (Number)	87	59

been exaggerated. Restrictions on credit also helped considerably. But it is very unlikely that in a period of rising prices and rising defense expenditures people would have saved more than at any time since the war[1] unless they were convinced that prices would be held in check. Similarly, it is very unlikely that in a period of rising prices and costs businessmen would have slowed down the building up of their inventories to the extent that they did unless they felt that the rise in prices would be checked. Nor was the size of inventories so abnormally high that it would have been impossible to sustain the build up irrespective of expectations.[2]

1/ Rates of saving have been as follows in recent years:

	Saving as Percent of Disposable Income
Prewar	
1936	5.4
1937	5.4
1938	1.5
1939	3.8
1940	4.9
Post-war	
1946	7.6
1947	2.3
1948	5.6
1949	3.4
1st half 1950	5.4
Post-Korean	
2nd half 1950	5.1
1st half 1951	5.9
2nd half 1951	9.1
1st half 1952	7.3

2/ The ratio of inventories to monthly sales has been as follows in recent years:

	Manufacturing	Wholesale Trade	Retail Trade
1939	2.12	1.35	1.53
1940	2.07	1.30	1.49
1948	1.73	0.99	1.40
1949	1.85	1.07	1.41
1st half 1950	1.64	1.06	1.31
2nd half 1950	1.50	1.01	1.35
1st half 1951	1.61	1.10	1.55
2nd half 1951	1.91	1.16	1.53
1st half 1952	1.85	1.13	1.41

Our conclusion is that price and wage controls have been a factor in the rise in personal saving and the slowing down of inventory accumulation which made possible the stabilization of the economy during the second post-Korean year. There can be no doubt that without the increase in taxation, the tightening up of credit and the other anti-inflationary measures adopted since Korea price and wage controls alone would not have been able to stem the inflationary tide since they were neither strict enough nor comprehensive enough to maintain price stability in the face of rising income pressure.[1/] Experience, moreover, shows that even when price controls are successful in holding the line in the face of such pressure, as they were during the last war, success is likely to consist in postponing rather than preventing the surge of inflation. It is, however, equally true that the

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1/ See American Economic Review, May 1952, G. Griffith Johnson, "Reflections on a Year of Price Controls":

"... While the public and the Congress have seemed by and large to expect too much from direct controls in securing over-all stability, they are unwilling to support the measures by which direct controls can attempt to fulfill their expectations. Thus, authority is limited by law and circumstance, adequate appropriations are not available, regulations are harder to administer and enforce, staff is more difficult to recruit, and group pressures can more easily force the adoption of weaker standards. A major symptom is the prevalence of escalation devices, which now in one form or another cover wage earners, manufacturers, distributors, and farmers, thus greatly reducing the proportion of the population which feels that it directly suffers from inflation." (p. 292).

"In World War II direct stabilization controls were the main foundation of what has been called the 'disequilibrium system'. Under that system we supported, with remarkably little effect on prices, a growth in money incomes far in excess of the available supply of goods and services. ... In the past eighteen months we have witnessed a surprising popular nostalgia for the immediate results of this system—without, however, a comparable recollection of the full scope of the controls framework which was involved. General price and wage stabilization measures were only the beginning. They were backed up by such major elements as: the rationing of many consumer goods, particularly food; the use of subsidies on a large scale, particularly to hold consumer food costs; a no-strike pledge on the part of labor; a widespread system of production and distribution controls other than consumer rationing; an effective influence or control over imports and their prices; a willingness of people to accumulate large liquid assets; and a very elaborate organizational setup extending down to the local level. These were all required tools for implementing a hold-the-line policy, in particular with respect to living costs and wages. Even with them in operation, the system creaked in important places despite our involvement in war." (p. 294-295).

anti-inflationary measures alone, which are by nature slow moving, could not have arrested the rapid rise in prices and wages which developed after Korea nor could they have dealt effectively with the partial disequilibrium situations and with the strong pressure for wage increases which have characterized the post-Korean economy. Finally, it should not be overlooked that the monetary measures adopted in 1951 owed much of their effectiveness to the sharp increase in liquid savings which, as already shown, could not have taken place if the imposition of price and wage controls had not created the conviction that prices would henceforth be kept in check.

The following appraisal may be considered as a sober estimate of the contribution which price and wage controls made in 1951-52 to economic stabilization:

> "... Price ceilings doubtless reduced speculative expectations about industrial raw materials prices. And by setting up a complicated machinery for price ceiling increase or avoidance, some particular prices rose less than they would have otherwise. Possibly their most notable effect was to make politically feasible that degree of restraint on wage advances which has occurred and the consequent limiting of the rise of incomes. ..."1/

Our overall conclusion about the period 1951-52 is that the stabilization achieved was of a precarious kind and was based primarily on less than normal buying by the public and on a cautious inventory policy on the part of business. Moreover, to the extent that the intention of consumers was to postpone rather than forego their purchases, the stabilization achieved may prove short-lived and may be followed by a new wave of buying and by new inflationary pressures. Similarly, the decrease in inventories which occurred in the first half of this year may soon be replaced by extensive restocking. Thus, there is no justification for interpreting the stabilization of 1951-52 as evidence that the danger of inflation no longer exists and need not be guarded against. On the contrary, as will be shown in the next chapter, the outlook for the immediate future is unmistakably inflationary.

1/ See American Economic Review, May 1952, p. 304-305.

4—CONCLUSIONS: THE IMPACT OF REARMAMENT ON THE AMERICAN ECONOMY.

When an expanded rearmament program was decided upon following the outbreak of the Korean war, it was widely held that the carrying out of such a program would inevitably impinge on the living standards of the population and would call for restraint and even sacrifices on the part of the public. Reporting to Congress in January 1951, the President said:

> "American families must make sacrifices. They can expect very sharp curtailments in the supply of durable equipment which brings convenience and entertainment to the home. They will have to make their household goods last longer, their automobiles and appliances, their linen and clothes. They must save a larger portion of their incomes. Many of them must postpone buying a new house."1/

To date, however, the American economy has been able to meet all the new burdens placed upon it and, in addition, maintain civilian consumption at better than pre-Korean levels. This happened first, because the military build-up has been slower than was originally contemplated, and second, because the output of goods increased faster than was originally thought possible.

Between the first half of 1950 and the first half of 1952 the American gross national product, measured in constant dollars, expanded by 14 percent. This expansion was sufficient to take care of the whole of the increase in defense requirements and in productive investment which occurred during that period,

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1/ See also The Annual Economic Review by the Council of Economic Advisers, January 1951, p. 77:

> "Even with the large increase in total output which has been estimated as attainable, the expanding defense program will have a major impact upon consumption and living standards. If the total output and national security programs discussed in the preceding section are realized, some reduction in total per capita consumption may take place, and very sharp cuts in the production of individual items of consumption will be required, at a time when total employment and working hours had increased substantially.
>
> "Defense needs for basic materials and skilled manpower can be expected to force particularly sharp cutbacks in some areas. Production of passenger cars and other metal-using durable goods may well have to be cut by percentages ranging from one-third to well over one-half below the record levels of the second half of 1950."

leaving consumers actually better off than before Korea:

Gross National Product at 1951 Prices[1/]
(Billion Dollars)

	1st Half 1950 (Annual Rate)	1951	1st Half 1952 (Annual Rate)	Increase Between 1950 & 1952
1-Personal consumption	204.4	208.0	211.2	+ 6.8
2-Private domestic investment				
Producers' equipment	22.5	24.9	25.4	+ 2.9
New construction	23.0	23.3	23.1	+ 0.1
Change in inventories	3.6	10.3	- 0.8	- 4.4
3-Government expenditures on goods and services	45.2	62.6	75.8	+30.6
4-Net foreign investment	- 4.6	0.2	1.3	+ 5.9
	294.3	329.3	336.0	+41.7

These are global money estimates. What they mean in real terms can be gauged from the following account of what has been accomplished during that period in the fields of national security and of expansion in productive capacity.

The defense build-up, although slower than originally expected, has resulted in a vast increase in American military strength: Since 1950 the size of the American armed forces has more than doubled from about 1.5 million men to nearly 3.5 million. At the beginning of 1951 production of aircraft, tanks, artillery and so on was five times what it was during the first three months of the Korean war. Five and a half million men out of a total of some 47,000,000 wage and salary workers were engaged directly or indirectly on defense production.

The expansion in basic productive capacity, which is the second major goal of the rearmament program, has been still more impressive: Plans formulated after Korea called for large increases in the following sectors of the economy:

Finished steel - Increase in capacity from the 82 million per annum existing in the first half of 1951 to 86 or 87 million in 1952 and 90 to 92 million in 1953. Such an increase in finished steel capacity required an increase

1/ Estimates made in The Mid-Year 1952 Economic Review by the Council of Economic Advisers, July 1952, p. 141.

in ingot-producing capacity from 103 million tons in early 1951 to 120 million in 1953.

Aluminum - In 1950 production was 719,000 tons or 84 percent of capacity. Post-Korean plans called for an output of 1,494,000 tons by the end of 1953, which implied an expansion in capacity of 73 percent.

Electric power - In 1950 capacity was 70 million kilowatts. Post-Korean plans called for an increase to 97 million by 1953 or by 40 percent.

Petroleum industry - At the time of Korea the petroleum industry which had expanded by 40 percent since 1940, was operating below full capacity.[1/] A further 15 percent increase in capacity by 1953 was planned after Korea which was expected to take care of doubled military demand, rising civilian consumption and the need for maintaining some spare capacity.

Increases in capacity were also envisaged in machinery, transportation, chemicals, and so on.

A substantial part of the financing required for this expansion is provided by the Government through such means as accelerated tax amortization, loans and guarantees, advance payments by the military services, and so on. By June 1952 projects representing an investment of $21 billion had been approved for tax

1/ The following table shows that production of the main petroleum products during the three months before Korea was below the level of 1948 and considerably lower than six months later, i.e. in December 1950 - January 1951. Prewar figures are also given:

		1940	1948	2nd Quarter 1950 Monthly Average	Dec. 1950	Jan. 1950
Crude petroleum	000 bbls.	113	168	156	177	183
Fuel oil: distillate	" "	15	32	30	42	44
residual	" "	26	39	32	40	42
Kerosene	" "	6	10	9	11	13
Lubricating oil	" "	3	4	4	5	5
Motor fuel	" "	51	77	84	91	94

amortization aid under the system of "necessity certificates".[1] However, private financing is also very large.

In early 1952 the expansion in productive capacity achieved since Korea is estimated to have been as follows:[2]

	Percent Increase Since 1950
Steel	12
Petroleum refining	8
Chemicals	22
Electrical machinery	24
Other machinery	30
Transport equipment	52
Automobiles	20
All manufacturing	16

Other notable increases are an addition of 7 million kilowatts to electric power capacity[3] (an addition of 10 percent in existing capacity) and a 67 percent

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1/ As follows:

Necessity Certificates Approved Through June 20, 1952

	Proposed Investment (Millions of Dollars)	Tax Amortization (Millions of Dollars)
All industries	21,295	12,411
Iron and steel	3,726	2,266
Coke and by-products	182	138
Railroads	3,485	1,710
Great Lakes transportation	144	107
Petroleum refining	1,203	777
Welded and heavy riveted pipe	195	134
Aircraft, ordinance, and accessories	1,133	742
Electric light and power	2,938	1,310
Aluminum (primary refining)	673	503
Machinery	1,023	616
Chemicals (excluding synthetic fibers)	2,276	1,212
Pulp, paper and allied products	746	387
Synthetic fibers	140	72
All other	3,431	2,437

2/ Estimate quoted in The Mid-Year 1952 Economic Review by the Council of Economic Advisers, July 1952, p. 58.

3/ The Economist, January 19, 1952, p. 143, has commented that "there has never been, either here or anywhere else on earth, such an increase in twelve months in electric power capacity".

expansion in the aircraft industry.

These achievements have been described as the "mammoth, glacier-like progress of American production".[1/] They would not have been possible without the sharp increases in productivity registered during that period. Between the first half of 1950 and the first half of 1951 employment in manufacturing increased by 12 percent and weekly hours by 2.5 percent, but output increased by 17.2 percent, implying an average increase in productivity of nearly 5 percent. The increase was still greater in the durable goods industries, averaging some 6 percent.[2/]

The widespread tendency to attribute these gains to the stimulus of rearmament assumes that if rearmament had not intervened there would have been no growth in the American economy. There seems to be little justification for this interpretation of American economic conditions. As shown in the first part of this Memorandum, at the time of Korea there was every prospect that the high levels of economic activity obtaining in the first half of 1950 would have been maintained for a considerable time through the combined effect of high levels of consumption, large new construction and sustained business investment. There was also every

1/ The Economist, January 19, 1952, p. 143, under the title "Miracles Taken For Granted".

2/

	Total Manufacturing	Durable Goods	Non-Durable Goods
	1-Number of Workers Employed		
1st half 1950	14,220,000	7,568	6,653
1st half 1951	15,925,000	8,927	6,997
1st half 1952	15,733,000	8,954	6,779
	2-Weekly Hours		
1st half 1950	39.9	40.5	39.1
1st half 1951	40.9	41.8	39.8
1st half 1952	40.4	41.4	39.2
	3-Production (1935-39 = 100)		
1st half 1950	198	220	181
1st half 1951	232	274	199
1st half 1952	226	275	186

indication that increased Government spending on such seriously neglected needs as highways, schools, conservation and reclamations works, and so on, would have taken care of any slack in the economy that might have developed as a result of a falling off in private spending. It is true that the expansion in productive capacity which would have taken place under these influences would have been less rapid than it has been under the stimulus of rearmament, but this would have been all to the good, since it would have spared the American economy the inflationary strains to which pushing ahead at forced draft has subjected it. What the post-Korean experience has demonstrated is that Americans can meet any challenge to their energy and resourcefulness as producers, it has not demonstrated, as has been widely contended, that the United States "cannot have butter without guns".

Because of the high productivity of its economy the United States has been able to meet the additional claims on its resources made by rearmament without sacrificing either its living standards or its economic growth. For the American economy the strains and difficulties of rearmament are exclusively financial in character. They arise primarily from the fact that the production effort necessary to fulfil the requirements of defense generates large increases in money incomes and in profits without leading to a corresponding increase in the volume of goods and services available to the civilian economy. Thus, unless this increase in incomes and profits is prevented from expressing itself as an increased demand for goods, inflation becomes inevitable. From the financial point of view, the fact that high levels of consumption and investment obtained before the increase in defense expenditures is no assurance that the necessity for abstaining from spending the increased incomes and profits will be readily accepted. When incomes increase people will normally want to spend a large part of that increase on goods and services. At practically all levels of income there are always needs which, because they cannot be satisfied, do not seem to exist but which become very real and clamorous as soon as income increases. A person, for instance, earning $3,000

a year will not normally consider owning a car as part of his needs, but the moment he moves to, say, $4,000 a year, ownership of a car may begin to be felt as an urgent necessity. It is difficult to convince such a person that since the increase in his income was directly or indirectly caused by the military effort and since the military effort makes it impossible to produce more cars, it is his duty to abstain from entering the market for cars. Similarly, when profits increase and the outlook is for continued high economic activity, businessmen will normally want to expand their productive capacity and make heavy investments in plant and equipment. The first conclusion one reaches when considering this problem of increased purchasing power versus unchanged volume of goods is that the public cannot be expected, for more than a short period, to abstain voluntarily from spending a large part of its additional income. The financial problem of rearmament consists in how to force people to do so.

The difficulty does not lie in devising the policies and measures required to deal with the problem, but in ensuring their adoption and effective application. The measures themselves are well-known and no serious differences of opinion exist about the necessity of adopting some or all of them in a period of financial strain. They are: increased taxation, credit restriction, control over the use of scarce materials of strategic importance to the economy, control over prices and wages. The difficulty of adopting and applying effectively these measures arises from two facts:

1. The very nature of these policies as measures which take away or restrict makes them unpopular with the public. People resent the taxes which reduce their incomes or the controls which prevent them from buying what they want, but they seldom stop to think that the alternative is higher prices which would reduce the value of their incomes and their ability to buy goods just as effectively. As the Council of Economic Advisers has pointed out, "the imposition of harsh restraints goes against the grain and requires all of us to do things we would

very much rather not do. The reasons for a mighty productive effort are more or less self-explanatory, but to succeed with controls requires a constant effort toward the enlargement of public understanding."[1]

2. The increase in incomes and profits resulting from rearmament is not uniform among the population. Certain groups benefit more than others while some groups do not benefit at all. Similarly, certain types of spending must be curtailed more drastically than others while for some types a curtailment might be actually harmful to the economy since it might render idle resources which cannot be effectively utilized elsewhere. The measures that are adopted to curtail overall demand must ensure that the financial burden of rearmament is fairly distributed among the population and that the pressure on resources is relieved where it is greatest.

The first requirement raises formidable difficulties since the groups which benefit most from the increased spending on rearmament are also to a large extent the groups best able to resist the measures which aim at preventing their incomes from rising. This is true of businessmen, farmers and organized labor, and it means that the burden of rearmament tends to fall disproportionately on the other sections of the population. Which are these other sections? They are most of the salaried workers, the non-unionized wage earners, the old age pensioners, the disabled and all those who live on fixed incomes. How large a group do these sections constitute? According to the Council of Economic Advisers "between early 1950 and early 1951, when personal income rose by about 13 percent half the population did not obtain any increase in income. In fact, 18 percent had decreases in income."[2] This comparison undoubtedly exaggerates the longer-term effects of inflation because it refers to a period when many categories of wages and salaries,

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1/ The Annual Economic Review by the Council of Economic Advisers, January 1951, p. 97-98.

2/ The Mid-Year 1951 Economic Review by the Council of Economic Advisers, July 1951, p. 96.

which have since then caught up with prices, had not yet done so. There can be little doubt, however, that a considerable section of the population is penalized by inflation and this has very serious implications for the country as a whole: (a) Since fixed-income recipients are heavily concentrated in the lower income groups, a deterioration in the position of these groups relative to that of other groups violates one of the fundamental principles of a modern community and an essential prerequisite for social cohesion and tranquility, namely that disparities of economic status should be reduced and burdens imposed in accordance with each group's capacity to pay. (b) Economic power does not always measure the usefulness of a group's contribution to the general welfare. Certain groups, such as teachers and nurses, which have little bargaining power, perform some of the most important functions in a civilized society. A decline in the real incomes of these groups in a period of general prosperity inevitably leads to a depletion of their ranks to the detriment of all. Moreover, no community can allow a large group of its weaker members to bear a disproportionate share of a common burden without dangerously weakening its social fabric.

Paradoxically, however, from the financial point of view, the larger the number of people who can protect themselves against inflation by raising their incomes, the more serious will be the effects of inflation on a country's financial structure. This is so because of the well-known spiral: if prices rise because demand is in excess of supply, an increase in incomes to offset the increase in prices will merely result in new price increases which will produce a new round of income increases and this ad infinitum. What usually stops this process is the fact that not all incomes can be adjusted upwards and that consequently when prices rise demand is brought into equilibrium with supply. Thus, the larger the number of people who cannot adjust their incomes upwards the more limited will be the effects of a rise in prices on the value of money, and inversely, the larger the

number of people who can obtain income increases the more serious will be the effects of rising prices on the value of money. In post-war America there are few groups so weak that they cannot in the long-run obtain relief from rising prices. This is a sign of social and political health, but it also means that the threat to the value of the dollar implied in the inflationary conditions created by rearmament is much greater than it would have been in times when there was less economic democracy. Thus, what is needed to ensure financial stability in a period of large military expenditures is to persuade the economically stronger groups to exercise restraint and refrain from taking undue advantage of the opportunity of bettering their position afforded to them by the high demand for goods and services resulting from rearmament.

The second condition of successful stabilization, namely that certain types of spending be curtailed more drastically than others, means that, in addition to such general measures as taxation and quantitative credit restrictions, a program of financial stabilization calls for selective measures and for the application of qualitative criteria. A curtailment in the demand for passenger cars, for instance, cannot be achieved through income tax increases alone without forcing a curtailment in the demand for other goods as well, which, however, may be in ample supply. Even an excise tax on cars may not produce the desired result if people choose to pay the tax on cars and to cut down other expenditures. Similarly, an increase in bank reserve requirements will result in a general tightening up of credit while what may be needed is a curtailment of credit for civilian production and an expansion of credit for defense production. In such cases, direct restrictions on the production of passenger cars, restrictions on consumer and real estate credit and similar selective measures will be needed to supplement the general fiscal and monetary policies adopted to deal with the financial problems of rearmament. These, however, are measures which require a vast, competent and impartial administrative

machinery in order to be carried out effectively and which, because they interfere with the freedom of action of individuals, are resented by the public as bureaucratic and tyrannical.

Finally, since each stabilization measure has its disadvantages as well as its advantages (taxes reduce incentives, price controls create rigidities in production, wage controls produce strikes, and so on), an effective stabilization program must combine the different measures in such a way as to minimize the disadvantages and maximize the advantages of each one of them. There can, however, never be complete agreement on what constitutes the optimum combination: each measure has its fervent advocates who insist that it should be the principal weapon in the fight against inflation and who belittle the contribution which can be made by other measures. Thus, a stabilization program is bound to be controversial and to be subject to frequent shifts of emphasis.

It is with difficulties of this type, which are political, social and psychological rather than strictly economic in character, that the American economy has been faced in the post-Korean period of expanded defense expenditures. We have seen that on the whole the difficulties have been successfully met and that the policies adopted have prevented any serious weakening of the American financial structure. The extent to which these policies have fallen short of ensuring complete financial stability is measured by the loss in purchasing power suffered by the dollar during that period. This loss, amounting to 10 percent, represents the main unfavorable impact of rearmament on the American economy during the first two post-Korean years.

It is, however, important to realize that the inflation experienced during that period has been due as much to the state of full employment created by rearmament as to the fact that the resulting increase in incomes was not matched by a

corresponding increase in civilian supplies. There can be little doubt that the rise in wage costs which took place during that period would have occurred even if the additional goods produced had been civilian in character. It would have occurred because a state of full employment strengthens the bargaining position of labor while weakening the resistance of employers to the granting of wage increases in excess of what is justified by gains in productivity, i.e. increases which force a raising of prices.

The inflationary implications of full employment are generally recognized but no satisfactory way of dealing with them has yet been found. Those who hold that the preservation of the value of money must be the overriding consideration of economic policy view unemployment as part of the essential mechanism of the private enterprise system and argue that economic policy must be so devised as to ensure that unemployment does not fall below what is needed to discourage the pressure for wage increases. They also argue that the gains to the economy which result from a higher level of output are more than offset by the disruption caused by monetary instability. Those who hold that the primary consideration of economic policy must be to ensure the full employment of the country's resources of manpower and industrial capacity argue that rising prices are far preferable to the economic wastefulness and human misery of unemployment and are a small price to pay for the benefits of full employment. It is clear that neither view offers an acceptable solution. There can be no doubt that in a dynamic economy, where tastes and techniques constantly change, unemployment cannot be entirely eliminated without loss to the stability and flexibility of the economy. But if unemployment is to serve as a means of discouraging the pressure for wage increases, it must be much greater than this minimum and in fact must approximate the levels of the prewar decade. Unemployment on such a scale, besides being an economically wasteful method of ensuring monetary stability, has also become politically impossible since the

war and is not likely to be tolerated in the future under any circumstances. On the other hand, inflation is such an unmitigated evil that no gains in physical output can compensate a society for the injustice, uncertainty, instability and disruption which a steadily depreciating currency brings in its train.

If the twin objectives of full employment and monetary stability, which at present appear so completely contradictory, are to be ultimately reconciled, it will be necessary to devise new methods and a new approach to the problem of wage determination. In the past, sectional wage bargaining has been compatible with monetary stability only because there was a considerable amount of unemployment to moderate the claims for wage increases and because there was a sufficient lack of effective demand and a sufficient degree of competition among firms to prevent employers from satisfying these claims by raising prices. Without these safeguards, sectional wage bargaining has serious inflationary implications. It was Sir William Beveridge himself, one of the chief advocates of full employment, who pointed out that "there is no inherent mechanism in our present system, which can with certainty prevent competitive sectional bargaining for wages from setting up a vicious spiral of rising prices under full employment".[1] He argued that "in the new conditions of full employment wages ought to be determined by reason, in the light of all the facts and with some regard to general equities and not simply by the bargaining power of particular groups of men ... each of which sees only its own sectional interest and tries to exploit its particular strategic advantages and none of which attempts to judge the position of the whole economy".[2] The solution he advocated was based on three principles: (a) inclusion of an arbitration clause in collective bargaining which would pledge in advance employers and unions to accept the decision of an agreed arbitrator and to give no support to

1/ W. Beveridge, Full Employment in a Free Society, p. 199.

2/ Op. Cit., p. 200.

lock-outs or strikes in defiance of arbitration. (b) Responsibility of the State to maintain price stability since "it is unreasonable to expect from trade unions a reasonable wage policy unless there is a reasonable price policy just as much as it is impossible to have a price policy without a wage policy". (c) Acceptance by business management of the need for making available to others than themselves full information as to the financial condition of industry. "The correlative to acceptance by trade unions of an arbitration clause in all collective bargains would be acceptance by employers in all important industries of standardized accounting practice and their readiness to put all facts as to profits, costs and margins unreservedly at the disposal of the arbitrator and an expert staff for criticism."1/

During the last two years, under the pressure of rearmament, American thinking and practice have moved along strikingly similar lines but no wholly effective policy has yet emerged. Until it does, a state of full employment, whether produced by rearmament or by civilian spending, private or public, will continue to exert strong inflationary pressures. In the case of the United States such pressures will be mitigated, but they will not be completely eliminated, by the rapid increases in productivity which the American economy has demonstrated itself so highly capable of achieving.

1/ W. Beveridge, Full Employment in a Free Society, p. 200-201

II--PROSPECTS IN THE COMING YEARS

The high degree of instability widely ascribed to the American economy has been conspicuously absent throughout the post-war period. The end of the 1947-48 boom produced nothing worse than a mild recession soon followed by a strong revival of economic activity. The inflation of 1950-51 was brought under control within a reasonably short time in spite of expanding defense spending. This post-war experience seems to warrant the expectation that the American economy will continue to follow a steady course in the years to come. The world, however, is still haunted by the fear of violent fluctuations in the American economy and especially of a serious American depression some time in 1954 when American military expenditures will level off or decline. How much justification is there for these fears?

1--THE SHORT-TERM OUTLOOK

In the preceding section we stated that the outlook for 1952-53 was unmistakably inflationary. This conclusion was based on the following considerations:

(a) For the first time since Korea there will be a large budget deficit. Defense expenditures, which totalled $46.6 billion in 1951-52 and reached an annual rate of $50.5 billion in the second quarter of 1952, are expected to increase by another $11 to $12 billion in the fiscal year 1952-53. This would raise total Federal cash payments in 1952-53 to $79-80 billion compared with $68 billion in 1951-52. Receipts are not expected to show any substantial increase since the President's proposals for tax increases have not been acted upon by Congress. Thus, a cash deficit of some $10 billion seems to be in prospect for 1952-53[1/]

1/ Although the bulk of the deficit (some $8 billion) is expected to occur during July - December 1952, the fact that during that period corporations will invest tax reserves for 1953 of over $3 billion in special Government securities means that in effect the inflationary impact of the deficit will not be greater during the first half of fiscal 1952-53 than it will be during the second half.

unless Congress raises taxes when it reconvenes, which appears unlikely at present, and even in that case increased collections will not begin to materialize until the middle of 1953.

(b) State and local Governments are planning larger outlays for public works which they intend to finance through borrowing.

(c) Business investment in plant and equipment is expected to continue at the high levels of the first half of 1952 throughout fiscal 1952-53.[1/]

(d) Residential construction is expected to be as high as in 1951-52, and in view of the relaxation of controls on real estate credit recently enacted by Congress, it may even rise above the 1,091,000 housing starts realized in 1951-52.

(e) Inventories may once more decide the issue between stability and inflation. A prevalent opinion is that the drop which occurred during the first

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1/ See The Mid-Year 1952 Economic Review by the Council of Economic Advisers, July 1952, p. 79:

"The 1952 survey of the intentions of businessmen with respect to investment in plant and equipment during the rest of this year, which was made by the Commerce Department and the Securities and Exchange Commission, indicates that plant and equipment investment will continue above the levels of the first half of 1952 during the second half of this year. And there are other indications that it will remain strong in the first half of 1953. Such outlays by defense and defense-related industries, mostly producers of durable goods, are expected to continue to show considerable increase in 1952 over 1951, with only a slight increase in industries turning out nondurable goods. Accomplishment of these plans has been facilitated by the easing of metal supplies and the relaxing of some credit controls.

"Additional evidence that plant and equipment outlays will probably remain high for some time is to be found in the scheduled rate of completion and estimates of "value-put-in-place" for activity covered by certificates for accelerated amortization; the continued increase, at least until the steel strike, in National Production Authority construction authorizations, which will add to construction in the second half of 1952, and push into 1953; and the still sizable volume of applications for certificates of necessity pending before the Defense Production Administration."

half of 1952 will continue in the second half of the year,[1] but it seems much more likely that there will be a renewed accumulation. Three considerations point to the probability of renewed inventory accumulation: (i) In May 1952 the ratios of inventories to sales were not much above pre-Korean levels;[2] (ii) sales are likely to increase in the coming months; (iii) prices of many commodities will be rising. It is true that the experience of 1950-51 has made businessmen cautious about overstocking, and it is also true that any shortages that may develop will be temporary, but the fact remains that if consumer spending revives, as it seems almost certain to do in the coming months, businessmen will have to undertake a considerable amount of restocking.

(f) The behavior of consumers will be a decisive factor in the 1952-53 picture. Personal incomes after taxes will continue to rise under the impact of rising defense expenditures. Thus, even if the rate of saving of 1951-52 is maintained, consumption expenditures will increase substantially. We have seen, however, that the rate of saving attained in 1951-52 was abnormally high by either pre-war or post-war standards, and it has, in fact, been declining in recent months. Thus, a substantial expansion in consumption expenditures appears probable in the coming months. In the first half of 1952 personal incomes after

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1/ See Business Developments (The Chase National Bank - Economic Research Department), July 15, 1952, p. 17:

"With consumer buying remaining cautious and prices generally soft and with the memory of last year's overstocking still fresh, it seems rather doubtful that business will soon commence building up stocks on any large scale. Rather, the outlook over the rest of the year is for some further inventory liquidation, especially in consumer durable lines, and a continuation of the conservative hand-to-mouth buying policy which has characterized business purchasing for the past year."

2/ Ratios of inventories to monthly sales:

	1st half 1950	May 1952
Retail trade	1.31	1.38
Wholesale trade	1.06	1.13
Manufacturing	1.64	1.85

taxes totalled $231.5 billion (annual rate). Assuming, on the conservative side, that they will average $235 billion in 1952-53 and assuming further that the rate of saving will be equal to that obtaining during the first half of 1952, i.e. 7.3 percent, personal consumption expenditures in 1952-53 will increase by $4 billion or 2 percent, as compared with the levels of the first half of 1952. This is a minimum which is very likely to be exceeded for the following reasons: (i) The termination of consumer credit control will undoubtedly stimulate buying. Already, consumer credit outstanding, which had remained virtually unchanged between March 1951 and March 1952, increased by $900 million or 4.5 percent between April and June 1952. (ii) The fact that consumers have abstained from buying in 1951-52 is likely to produce a reaction in 1952-53. (iii) The fact that the public has increased its liquid savings will be an inducement to spend. The Council of Economic Advisers assesses as follows the effects of past increases of liquid savings on future spending:1/

> "... Additions to such liquid assets as currency, deposits in mutual savings banks, demand and time deposits in commercial banks, shares in savings and loan associations, and Government securities expanded about 8 billion dollars during 1951, to reach the total of 232 billion dollars. This is the financial backlog which buttresses current personal disposable income, now running at the annual rate of nearly 230 billion dollars. The existence of this large body of assets gives its owners a sense of security that encourages them to spend their current income freely, while many of the liquid assets would themselves be fuel for an inflationary blaze if one were to start. That such a blaze would need to be ignited by new forces, and not by this potential buying power itself, may be demonstrated by the attitude today of consumers who prefer to build up their liquid savings. But this is a barrier to spending which becomes progressively weaker as liquid assets and other savings move upward."

Thus, while under favorable conditions consumer expenditures may not increase by more than $4 billion in 1952-53, it seems probable that they will in

1/ The Mid-Year 1952 Economic Review by the Council of Economic Advisers, July 1952, p. 82.

effect increase more and might conceivably expand by as much as $11 billion, or 5 percent.[1/]

The additional claims which the increases in public and private expenditures enumerated above will make on American resources in 1952-53 are not likely to be less than $15 billion and might reach $30 billion.[2/] Will the American economy be able to meet these claims without experiencing a new surge of inflation? According to the Council of Economic Advisers, with only moderate increases in the labor force working no longer hours than during 1951 and with the expansion of plant capacity which will have been completed by the end of 1953, the national output could expand by some $25 billion between now and the end of 1953 and thus take care of all the claims, public and private, that will be made on it at that time. The question, however, arises: What will happen during fiscal year 1952-53 if total expenditures increase by, say, $20 to $25 billion and output does not expand correspondingly?

It would, of course, be a mistake to underestimate the productive capacity of the American economy. We know from experience that its performance has invariably exceeded the most optimistic expectations. Moreover, there is at present a substantial margin of unused capacity as well as underemployment in many consumer

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1/ Assuming that personal incomes after taxes increase from $231.5 billion to $240 billion instead of the $235 billion previously assumed, and that the rate of saving is 6 percent instead of 7.3 percent, the increase in personal expenditures will be $11 billion.

2/ These estimates are based on the following calculations:

	Minimum	Maximum
	(Billion Dollars)	
Increase in defense expenditures	10	15
Increase in expenditures by State and local Governments	1	3
Increase in inventories	2	4
Increase in personal consumption expenditures	4	11
	17	33

The only likely offset to these increases is a smaller export surplus. As already stated, the export surplus exceeded $5 billion in 1951-52. In view of the present dollar difficulties of foreign countries, the export surplus may decline by as much as $2 billion in 1952-53.

goods industries. These industries would quickly respond to any increase in demand by increasing production. Similarly, supplies of scarce materials have expanded considerably and will continue to do so in the coming year. A substantial expansion in output is, therefore, possible during the current fiscal year. There will, however, be two serious limiting factors: (i) food supplies cannot increase in response to increased demand; (ii) there may be a large increase in consumer demand for durable goods which compete with defense requirements as far as materials and even capacity are concerned. Since defense expenditures will also be rising during that period and since there will be no offsetting decline in business investment, it is unlikely that available materials and capacity will prove sufficient to take care of all the demands that will be made on them. Moreover, the greater the effort to expand output the greater will be the pressure on resources and hence on prices and wages. An expansion of output sufficient to take care of all additional demand may be possible only at the cost of renewed inflation. The inflation would not be such that it could not be checked by a policy of increased taxation, tighter credit restrictions and stricter controls over prices, wages and the use of scarce materials. Such a policy, however, requires Congressional action, which is not likely to be forthcoming <u>before</u> the inflation actually develops.

In the light of the preceding considerations, it would seem that stability can be maintained in fiscal year 1952-53 only if the public reacts to shortages and rising prices by abstaining from buying. This cannot be altogether excluded: There will be the memories of 1950-51 which will have a sobering effect on the attitude of consumers and businessmen, and there will be the certainty that supplies will expand and that the defense program will taper off in the near future. It is, however, impossible to know in advance what the psychological reactions of the public to a renewal of inflationary pressures will be, and since the maintenance of stability in the coming year depends so much on these reactions, it is also impossible to

gauge accurately the extent of the present inflationary threat. All that can be said is that if the public refuses to be drawn into the inflationary spiral, stability will be maintained in spite of the increased spending and the larger incomes, and in that case, the budget deficit will not seriously matter. If, on the other hand, the public reacts to higher prices and shortages by stepping up its purchases, if farmers, businessmen and organized labor try to take advantage of their stronger positions by raising their prices and wages and if Congress delays action on the strengthening of the anti-inflationary program, a renewal of inflation will be inevitable. Even in that case, however, a sharp inflation of the 1950-51 type appears unlikely unless a deterioration in the international situation revives the fears of imminent war.

In assessing the prospects for 1952-53 we have ignored the effects which the recent steel strike may have on the economy in the coming months. Certain effects, such as the curtailment of consumer goods production and the fear of rising prices and wages, will be clearly inflationary. Other effects, such as the delay in the execution of the defense program, the loss in incomes resulting from cuts in output, will be deflationary. The net result will again depend on psychological reactions.

2—THE LONGER-TERM OUTLOOK

Even if inflationary conditions develop in 1952-53, they will have abated by the end of 1953 since by that time the economy will have "grown up" to its defense burden. By then productive power will have been expanded to an extent enabling the American economy to support both a large defense program and high levels of business and consumer spending.[1/] After 1953, however, defense expenditures will begin to decline, plant expansion will have been completed, and the problem will arise of how to keep the vastly expanded American productive machine operating at a reasonably

1/ See The Mid-Year 1952 Economic Review by the Council of Economic Advisers, July 1952, p. 112.

high level of activity. In many quarters serious misgivings are entertained about the prospects of avoiding an American depression after 1953.

It is argued that since both defense expenditures and expenditures on plant and equipment will decline after 1953, the vast productive capacity and enlarged labor force that will be inherited from the period of high defense spending and of expanding industrial mobilization base can continue to be fully utilized only if there is a corresponding increase in personal consumption expenditures and in Government spending for non-military purposes. On both counts, it is argued, the outlook is unpromising:

Unlike the immediate post-war period, it is said, there will be little backlog of consumer demand to be satisfied when defense expenditures decline, since the post-Korean American economy will have been a "guns and butter" economy. Similarly, unlike the post-war period, there will be no depletion of inventories to be made good. Finally, when present programs of expansion in plant capacity are completed, there will be a contraction in overall business investment even though some projects of expansion in non-essential industries, which have been held up during the rearmament period, may prevent too sharp a contraction in investment. According to an estimate, expenditures on equipment for industry and agriculture will decline from the current rate of $30 billion per annum to $21 billion per annum by the end of 1953.[1/]

Increases in non-defense Government expenditures, it is said, even if they do take place, are unlikely to neutralize the effects of the decline in defense expenditures. This is so for two reasons: (i) Taxation is high and the pressure to reduce it will become irresistable. As a matter of fact, no positive action on the part of the Government will be needed to effect such a reduction in taxes, since

1/ U.S. News and World Report, June 6, 1952, p. 16.

most of the tax legislation passed after Korea expires by 1954.[1] This means that even if some deficit financing is tolerated, there will be little room for an expansion in non-defense Government spending.[2] (ii) A reduction in taxation will no doubt result in larger incomes left to individuals and corporations, but since it is assumed that consumers will be well supplied with goods and that the era of business expansion will be over, there is no reason to expect that the increases in incomes resulting from reduced taxation will be spent rather than saved. Under the post-rearmament conditions, however, such savings will be distinctly deflationary.

The combined effect of these developments, it is argued, will be to leave a substantial proportion of the available labor force and capacity unutilized. On the assumption that the gross national product will have grown to $365 billion by the end of 1953, (it had reached an annual rate of $340 billion during the second quarter of 1952), reductions of $15 to $20 billion in Government spending and of $10 billion in business investment will represent a decline in total spending of 6 to 10 percent. This will be the initial effect of the completion of the rearmament program. Experience, however, shows that a decline in total spending of this magnitude is bound to set in motion a cumulative process of economic contraction: the increase in unemployment and the decline in profits which this initial curtailment in total spending will bring about will further reduce the demand for goods, this will lead to a further curtailment in production and hence to a further rise in

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1/ The excess profits tax will expire on June 30, 1953, the October 1951 increases in individual income tax will expire on December 31, 1953 and those in corporation income tax and in excise taxes will expire on April 1, 1954.

2/ The assumption made by those who expect a depression in 1954 is that defense expenditures will decline by $15 to $20 billion from a peak of $60 billion in 1953. This would mean that total Government spending will decline from $80 to $60 or $65 billion. The automatic cuts in taxation mentioned above will reduce Government receipts, which under present legislation bring in $68 billion, by at least $10 billion, i.e. to $58 billion. Thus, the budget deficit, even if there is no increase whatsoever in non-defense Government spending, will be $2 to $7 billion. The margin for increases in Government spending will, therefore, be small.

unemployment and a further decline in profits. Once the downward spiral sets in it will be intensified by pessimistic expectations until a full-scale depression develops in the economy.

It would be idle to deny that some or all of these things could happen after 1953. The question, however, is: Are they likely to happen?

The following considerations suggest that present fears are greatly exaggerated:

(a) A sharp decline in defense spending after 1953 does not appear feasible. As already stated, the new world responsibilities of the United States will call for a permanently high level of defense expenditures. At the time of Korea, when the United States was virtually unarmed, military spending totalled $13 billion a year or nearly $15 billion at current prices. It seems unlikely that defense expenditures will be reduced below $40 to $45 billion per annum in the foreseeable future. Moreover, the reduction, when it starts, will be gradual rather than precipitate, since it will come about as a result of completion of specific programs rather than as a result of general cuts in military strength. The Council of Economic Advisers suggests that the decline in defense expenditures will be of the order of $5 billion a year during the first two years after the present program has been completed, i.e. after 1953. It also points out that the effect of such a decline on a $350 to $375 billion economy will be very small, especially when compared with the $115 billion decline in military expenditures which the economy took in its stride in 1946.1/

(b) The assumption that consumer demand will not rise significantly above present levels because the public will be well supplied with goods ignores several important considerations:

(i) Since the war population has been growing at the rate of 1.8 percent per annum, more than twice the pre-war rate. This factor alone means that two to

1/ Measured at 1951 prices. In current dollars the decline was $69 billion.

three years hence consumer demand will be 4 to 5 percent higher than it is today and will continue to grow.

(ii) Increases in productivity make possible the steady rise in incomes which Americans have come to consider as their right in the post-war period. In fact, as already stated, the real problem since the war has been not that incomes did not rise fast enough to absorb the growing output of American industry, but rather that they rose faster than was compatible with the maintenance of price stability. An increase in productivity of only 2 percent per annum, which is less than what the American economy is capable of, would increase the public's ability to consume by 4 percent in two years. These two factors combined, growing population and rising real incomes, mean that consumer demand in 1954 will be 8 percent higher than it is today and will be steadily growing.

(iii) The concept of saturation of demand is meaningful only in connection with particular commodities and for short periods. It makes no sense when applied to the field of consumption as a whole over a period of years. The argument that American consumers will emerge from the rearmament period well stocked with goods and will not, therefore, have any incentive to expand their consumption, assumes that rising incomes will have no effect on consumption patterns and needs and that there will be no new products to tempt consumers. Experience to date does not support these assumptions. It is true that because such a large proportion of American consumption consists of "postponable purchases"1/ (this is another way of saying that Americans enjoy a high standard of living), even a temporary abstention from

1/ See The Banker, "The Risk of American Slump", May 1952, p. 253-259:

"Something like 40 percent of current expenditures by American consumers seems to be of the sort that can be postponed in anticipation of a price fall, and this is a proportion that has never been achieved in any country before."

buying can produce a downturn in business activity.[1] But it is also true that there is no consumer resistance that cannot be overcome by more attractive terms of sale, product improvement, the offering of new products and vigorous merchandizing. The Council of Economic Advisers has pointed out that during 1951-52 when durable goods sales declined sharply, "home freezers, driers, air conditioners and other new products were relatively immune to the drop".[2]

In the light of these considerations the assumption that consumption expenditures in 1954 will not be significantly greater than they are today because the public will not "need" more goods, appears unjustified. On the other hand, to argue that consumption will not rise because incomes will have been reduced as a result of the reduction in defense expenditures is to argue in a circle, since what has to be demonstrated is that the reduction in defense expenditures will, in fact, result in a decline in incomes, i.e. in a depression. (A temporary slackening of economic activity does not produce any serious decline in incomes, as was demonstrated in 1949). This is not demonstrated by saying that there will be no deferred needs to be satisfied.

(c) The expectation that business investment will decline sharply after 1953 is justified only if the assumption of a stagnant or even declining consumption is accepted. Rising living standards and the new needs and new products which they bring into existence induce a large amount of new investment in plant and equipment. It has been pointed out that a considerable part of the investments made by industry in the post-war period have been of this "induced" type instead

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1/ This is one of the new arguments in support of the thesis that the American economy is inherently unstable and liable to violent fluctuations. See The Banker, op. cit.:

"Consumption in America is so heavily weighted by durable goods that it is unlikely to rise speedily in line with rising money incomes; the trend of the curve seems likely to be rather slowly upwards, with an alarming tendency to zigzag on price expectations change."

2/ The Mid-Year 1952 Economic Review by the Council of Economic Advisers, July 1952, p. 115.

of the "autonomous" type emanating from technical innovations and this has been interpreted as signifying that in the post-war American economy investment tends "to be functionally related to the level of national income instead of being independent of and leading the latter".[1] The danger that is seen in this development is that a decline in incomes and consumption is likely to be accompanied by a sharp drop in investment outlays which will intensify the contraction of the economy. Under conditions of rising consumption, however, "induced" investments guarantee a rising volume of business spending on plant and equipment. It will, however, be asked: Will such investments, plus the less essential projects which will have been delayed during the rearmament period, make up for the drop in outlays that will result from the completion of the industrial mobilization program? The answer is that there seems to be no reason why overall investment could not be maintained. The Council of Economic Advisers assesses the prospects for new investments as follows:

> "... the expansion of some industries shows every sign of increasing. Despite the rapid expansion of electric power capacity which has been taking place, analyses of power needs and investment plans indicate that outlays for that purpose will probably rise to even higher levels for several years to come. Similarly, present plans call for further increases in investment in the development of oil and gas facilities. The chemical industry also has been growing with great speed, and most evidence points to a maintained or possibly higher rate of investment for several years ahead. The motor truck and bus transportation industry also gives promise of requiring higher investment outlays in the future.
>
> "The history of industrial development indicates that other new industries are even now in their early stages, and will be expanding to support investment. Most forecasts of the volume of investment tend to be too low, because the intangible character of these dynamic elements of investment seems too uncertain and insecure a foundation for raising expectations. Nevertheless, to disregard them is almost certain to result in underestimating future investment."[2]

1/ See Economic Journal, March 1952, D. Hamberg, "The Recession of 1948-49 in the U.S.A.", p. 14.

2/ The Mid-Year 1952 Economic Review by the Council of Economic Advisers, July 1952, p. 116.

(d) Given rising incomes and a growing population, residential construction can not only be maintained at the recent level of 1 million new housing units per annum but also further expanded. An advancing standard of living, liberal credit terms and new methods of production, that would reduce costs and improve quality, could easily combine in the coming years to produce a building boom of unprecedented magnitude.

(e) There exists at present a staggering backlog of public non-defense needs that will have to be met as soon as defense expenditures begin to decline. Since 1940 expenditures on such urgent communal needs as highways, schools, hospitals, public recreational facilities, local water supplies, conservation and development works, public housing, etc. have been severely restricted and have failed to keep pace with the growth of the economy and of the population. In 1949-50 Federal expenditures for such purposes were not higher than before the war in absolute terms, while in relation to total budget expenditures and to the national product they were considerably smaller than before the war:

	1938-39	1948-49	1949-50
	(Million Dollars)		
Housing and community development	154	282	261
Agriculture and agricultural resources (other than financial aid)	913	547	940
Natural resources other than atomic energy	228	890	1,004
Transportation and communications (other than postal service)	458	1,092	1,160
Public health	37	171	242
Education	36	70	114
	1,826	3,052	3,721
Percent of total budget expenditures	20	7.5	9
Percent of national product	2.0	1.1	1.4

Similarly, State Government expenditures failed to keep pace with expanding needs: in money terms they increased from $5.5 billion in 1941-42 to $11.8 billion in 1948-49[1] which, taking into account the rise in prices, means that there had

1/ These are the only pre-war and post-war years for which comparable figures are available.

been no real increase. The backlog of public construction requirements alone is conservatively estimated at $30 billion, which, spread over ten years, would represent an annual expenditure of $3 billion.[1/]

1/ See Fortune, March 1952, "Business Roundup":

"One quick measurement of the backlog is the fact that non-defense construction during the eight years from 1941 through 1948 ran $30 billion less than it would have at either the prewar or 1949-50 levels. That $30 billion is the minimum backlog today, though variously computed estimates of 'needs' for specific types of construction easily total more than double that. To clean up these backlogs even in ten years would thus take a $3 to $6-billion increase in annual volume. The question, of course, is how much of this can be financed, but the 'market' is certainly there. Here is a quick rundown by specific types of construction:

"Highways: Over half our roads were built in the 1920's or early 1930's and they are beginning to cost more to maintain than to rebuild. The Association of State Highway Officials has estimated that three-fourths of our basic (or federal aid) highways and three-fifths of the local roads require $30 billion worth of improvements. Highway traffic has jumped 75 percent in five years, more than doubling the present volume—and is still growing fast (7 percent last year). This would suggest a minimum annual cost of $3 billion just to keep up with growth, in comparison with the $2.5-billion average of the 1930's. So theoretically, it would seem, we could spend $6 billion a year for ten years on our highways—in comparison with an estimated $2.2 billion this year—just to catch up. But $4.5 billion a year is perhaps all that financing can be obtained for by 1955.

"Schools: A school-building program could easily absorb $20 billion for ten years. This is an estimate by the Office of Education (Federal Security Agency) and covers just grade and high schools, not colleges or technical schools: Eight billion dollars for the backlog of a quarter of a million classrooms needed now, a comparable sum to handle the noisy millions of war and postwar babies as they move through the school system, and $5 billion to $6 billion for minimum replacement needs. Outlays in 1951 were $1.3 billion and they cannot help increasing because the big bulge in the school population will come in the next three to four years.

"Hospitals: It would cost over $1 billion a year for the next ten years to meet the Public Health Service's estimate of minimum hospital needs, as compared with outlays of half that amount last year. Expenditures will continue their recent rising trend once materials are available, though not necessarily to the PHS levels.

"Housing: The Public Housing Act of 1950 itself sets a probable minimum of $1.3 billion a year of federally aided housing. This compares with $600 million spent in 1951. In addition, urban redevelopment under the act could grow to impressive dimensions.

"Other construction: Sewerage projects will likely continue fairly stable. But there is a large potential demand for control of stream pollution, which arises from the growing national problem of water supply. Reclamation, river and harbor works, etc. are the pork-barrel favorites of Congress, and tend to grow steadily, but the nation is beginning to run out of rivers for the giant dams, unless the U.S. goes in for such major new developments as the Missouri Valley Authority. Meanwhile, however, other demands will be growing—for parks, airports, beaches, etc.

"Defense construction: The atomic program will be the main factor by 1955. Present plans call for $7.5 billion in new plant over five years. Outlays could go up if the vast industrial potential in atomic power is tapped. Military construction and building of arms plants should be way down by 1955 but higher than in the 1946-49 period."

Some of these projects are so urgently needed that they are rapidly becoming self-liquidating propositions.[1/] Nor is there any sound economic reason for such projects to be financed entirely out of current tax receipts. It is as sound for the Government to borrow in order to finance projects that will improve the general environment in which people live and work as it is for industry to borrow in order to expand and modernize its productive facilities. Moreover, in a period of slack economic activity, which is by definition a period when people prefer to save rather than spend, neither public nor private borrowing will be inflationary.

In the light of the preceding considerations, the gloom engendered by the post-Korean expansion in American productive capacity seems wholly unwarranted.[2/]

1/ See The Economist, June 28, 1952, p. 888-891, on recent experience with New Jersey Turnpike:

"The extraordinarily good business done on the New Jersey Turnpike since it opened five months ago largely explains the success of the huge issue of $326 million of 3¼ percent tax-free bonds for financing a similar toll-road in Ohio. Traffic on the 118-mile long highway from the Delaware river to New York City has already reached a volume, of 36,000 vehicles a day, that had not been expected until 1960, and the road will probably pay for itself in 15 instead of the promised 30 years. ..."

"... Both private motorists and businessmen sending their goods by lorry find the toll charges, of from 1 to 3.3 cents a mile, worth the time, petrol and energy that are saved on these direct, fast roads, where there are no delays for crossings or local traffic. The point about the turnpikes is that they are self-supporting, at least until a depression comes. ..."

"The $1,000 Ohio Turnpike bonds were oversubscribed and selling at a $25 premium on the first day, proving that it is easy to raise the money for such highways. Altogether about 2,000 miles of them are already completed or planned, but the country has over 3 million miles of ordinary roads, financed by state taxes, mainly on petrol, and federal grants, and for these it is much more difficult to find money. Congress has just extended the federal highway programme for another two years, authorising an expenditure of $1.4 billion in 1953 and 1954, but $4 billion a year is needed to make the roads fit for today's traffic. The size and speed of modern cars make most existing highways unsafe as well as crowded and the weight and number of lorries and trailers using them wear the roads out faster than they can be repaired."

2/ Foreign Report of The Economist, June 26, 1952, illustrates as follows the fears prevailing in certain quarters:

"Characteristic of the malaise which tempers the pride of American business at these attainments are the remarks made last year by David F. Austin, a vice-president of US Steel. 'What of the future?' asked Mr. Austin of his Philadelphia audience. 'What will we do with all this productive capacity when we have completed our rearmament effort? What will we do with it when this so-called 'limited emergency of unlimited duration' is over? Will our markets then be glutted with the unsaleable products of this added capacity?'"

Given the appropriate public and private policies there will be ample opportunity for utilizing the additional capacity to ensure the steady rise in living standards demanded by the population.

More important, however, than the preceding calculations of probable post-rearmament needs and expenditures is the fact that for nearly 15 years Americans will have enjoyed the prosperity and security of high levels of economic activity and will not readily accept a return to unemployment and stagnation. There is sufficient understanding of economic issues in the United States to guarantee that the picture of machines made idle and men thrown out of work by an excessive preoccupation with balanced budgets and Government retrenchment will remain a Communist dream. Moreover, once the conviction that prosperity will be maintained is firmly established in people's minds, the degree of Government intervention that will be needed to support economic activity will be much less than is commonly assumed. As the Council of Economic Advisers has pointed out, confidence alone is sufficient to generate prosperity:

> "... If the people expect prosperity, they act in ways which promote prosperity; individually, they plan and spend consistently with rising production and rising markets. If they expect depression, they act in ways which promote depression; they tighten their belts, and the effects may cumulate in a downward spiral of production and consumption. Men make conditions."1/

Mild recessions, it is true, cannot be avoided in an economy as flexible and dynamic as the American economy. But so long as they are not allowed to degenerate into depressions, they hold no threat to either American or world economic stability. A recession is probable by 1954, but there is every reason to expect that it will be as successfully overcome as the recession of 1949.

1/ The Mid-Year 1952 Economic Review by the Council of Economic Advisers, July 1952, p. 120.

B--EXTERNAL ECONOMIC DEVELOPMENTS

In the first part of this Memorandum it was argued that the closer balance achieved in the American external accounts during the six months preceding the Korean war was the result of a decline in American exports rather than of an expansion in American imports. The decline in exports was primarily brought about by the fact that foreign countries, by increasing their own production and stimulating exchanges among themselves, had succeeded in becoming less dependent on American resources for the functioning of their economies. In other words, during the pre-Korean months when American aid was being reduced, foreign countries were adjusting themselves to a low volume of trade with the United States. This, it was pointed out, was a welcome development in the sense that it heralded the return to more normal economic and political relations between the United States and the rest of the world, but it was not the process through which a unified world economic system, based on universal convertibility of currencies and non-discrimination in trade, could be created.

The outbreak of the Korean war raised the hope that the world dollar shortage would be eased during the period of American rearmament as a result of the higher American demand for imported materials, the higher prices that these materials would fetch and the fact that American industry, busy with military orders would be less interested in exporting its products to foreign markets. It was even hoped that as a result of the expanded American productive capacity this greater dependence on foreign supplies would become a permanent feature of the American economy, while the absence of American goods from foreign markets would enable European goods to establish themselves firmly in these markets and meet successfully the stronger American competition of the post-rearmament period. Thus it was hoped that the gains that would be made during the period of American rearmament in relieving the dollar shortage would be maintained after the rearmament program

had been completed. Developments during the first post-Korean year seemed to bear out these expectations and even led the more sanguine to visualize the emergence of an American balance of payments deficit and an American shortage of foreign currencies. The rejoicing, however, proved short-lived. The stabilization of the American economy in the first half of 1951 brought to an end the hoarding and speculation which had driven the prices of industrial materials to unprecedented heights. Prices declined and American purchases were curtailed. The American demand for domestically produced goods, whose supply had increased by over 10 percent during that period, dropped considerably, thereby reviving the interest of American producers in foreign markets. Meanwhile the foreign demand for American goods was rising steadily as a result of inflation and of a relaxation of import restrictions on American goods induced by the higher dollar earnings of the first post-Korean year. Thus, after a brief interlude, the dollar shortage reappeared as the major world economic problem. Not only this, but the gains made during the pre-Korean months in reducing the world's dependence on American supplies were lost, necessitating a continuation of American aid programs beyond the date originally contemplated.

The post-Korean developments in the American external position may be summarized as follows:

1. Imports

During the first half of 1950 American imports totalled $3,967 million and had an unmistakable upward tendency. It seems reasonable to assume that imports during July - September 1950, which amounted to $2,533 million, had not been significantly affected by post-Korean developments since they must have consisted mostly of purchases made before the outbreak of the Korean war. If this is so, it may be said that the imports of the nine-month period January - September 1950 represented the American demand for foreign goods under pre-Korean conditions. Comparing

This period with the following nine months October 1950 - June 1951 we find that imports increased during the latter period by $2,561 million, as follows:[1/]

Nine Pre-Korean Months	(Million Dollars)	Nine Post-Korean Months	
1st quarter 1950	1,960	4th quarter 1950	2,815
2nd quarter 1950	2,007	1st quarter 1951	3,214
3rd quarter 1950	2,533	2nd quarter 1951	3,132
	6,500		9,161
Annual rate	8,666		12,214

This 40 percent increase in the value of imports was largely accounted for by higher prices: of the total $2,561 million increase, nearly $2,000 were due to the rise in prices and only $625 million to the rise in the quantity of imports:

Index of Quantities (1936-38 = 100)		Index of Unit Values (1936-38 = 100)	
January-September 1950	142.3	January-September 1950	233.3
October 1950-June 1951	156	October 1950-June 1951	292.6
Increase	9.6%	Increase	25.4%

These are overall calculations. An analysis of the changes in the various categories of imports shows that there was an inverse correlation between increases in quantities and increases in prices: the categories of imports whose prices rose most showed the smallest increase in volume, while those whose prices rose least showed the largest increases in volume:

1/ By calendar years imports have been as follows:

	(Million Dollars)
1949	7,066
1950	9,315
1951	11,668
1st half 1952 (annual rate)	11,730

Increase Between
January-September 1950 and October 1950-June 1951

	Unit Values[1]	Quantities[1]
Crude materials	51 %	4.2%
Crude foodstuffs	14.5%	8.3%
Semi-manufactures	25 %	10.8%
Finished manufactures	11.1%	22.2%

1/ The changes in the indexes have been as follows:

	January-September 1950	October 1950-June 1951
	1--Unit Values (1936-38 = 100)	
Crude materials	198	299
Crude foodstuffs	442.7	506.6
Semi-manufactures	184	232
Finished manufactures	248.7	276
	2--Quantities (1936-38 = 100)	
Crude materials	149	155.3
Crude foodstuffs	113.3	122.7
Semi-manufactures	207.3	229.7
Finished manufactures	117	143

The relative importance of these groups is shown in the following table:

	1950 (Million $)	Percent of Total	1951 (Million $)	Percent of Total
Crude materials	2,465	28.2	3,364	31.1
Foodstuffs	2,648	30.3	3,084	28.5
Semi-manufactures	2,126	24.3	2,455	22.7
Finished manufactures	1,504	17.2	1,909	17.7
Total	8,743	100	10,813	100

The main commodities included in each group are the following:

	1950 (Million $)	1951 (Million $)
Crude materials		
Rubber	458	808
Wool	428	714
Crude petroleum	369	375
Non-ferrous ores	243	300
Hides & skins	119	133
Oilseeds	106	104
Diamonds	81	95
Semi-manufactures		
Non-ferrous metals	721	656
Wool pulp	240	352
Gas oil & fuel oil	205	208
Sawmill products	265	229
Iron & steel semi-manufactures	93	217

	1950 (Million $)	1951 (Million $)
Foodstuffs		
Coffee	1,092	1,361
Cane sugar	381	387
Fruits, nuts, etc.	215	222
Cocoa	167	197
Meat products	113	187
Fish	157	158
Alcoholic beverages	113	121
Finished Manufactures		
Paper	473	544
Machinery	124	186
Steel mill manufactures	37	125
Burlaps	91	112
Wool manufactures	76	93
Cotton manufactures	65	69
Clocks & watches	57	67
Vehicles	34	57

In the following nine months we find that the value of imports declined by $874 million, a decline of 10 percent:

(Million Dollars)

Nine Pre-Korean Months		First Nine Post-Korean Months		Second Nine Post-Korean Months	
1st quarter 1950	1,960	4th quarter 1950	2,815	3rd quarter 1951	2,677
2nd quarter 1950	2,007	1st quarter 1951	3,214	4th quarter 1951	2,645
3rd quarter 1950	2,533	2nd quarter 1951	3,132	1st quarter 1952	2,96[illegible]
	6,500		9,161		8,28[illegible]
Annual rates	8,666		12,214		11,03[illegible]

The whole of the decline was due to a lower volume of imports, since during that period the unit value of imports increased by another 3.7 percent. As a result of these changes imports during the nine-month period July 1951 - March 1952 were not higher than before Korea in terms of quantities but cost 30 percent more in money terms:

(1936-38 = 100)

Index of Quantities		Index of Unit Values	
January-September 1950	142.3	January-September 1950	233.3
October 1950-June 1951	156	October 1950-June 1951	292.6
July 1951-March 1952	139.3	July 1951-March 1952	303.3
Change		**Change**	
January-September 1950	100	January-September 1950	100
October 1950-January 1951	109.6	October 1950-June 1951	125.4
July 1951-March 1952	97.9	July 1951-March 1952	130

An analysis of the changes which took place during the period July 1951 - March 1952 shows that declines in quantities occurred in all categories of imports, but there was a smaller degree of correlation between these declines and the rise in prices than in the earlier period:

Changes Between
October 1950-June 1951 and July 1951-March 1952

	Unit Values[1/]	Quantities[1/]
Crude materials	- 1 %	-11.2%
Crude foodstuffs	+ 0.6%	- 3.8%
Semi-manufactures	+ 8 %	-20 %
Finished manufactures	+11.4%	- 8 %

Comparing this second phase of the post-Korean period with the pre-Korean situation we find that in the two categories of imports where price increases were largest, i.e. crude materials and semi-manufactures, there was an actual decline in volume in relation to the pre-Korean period:

July 1951-March 1952
(January 1950-September 1951 = 100)

	Unit Values	Quantities
Crude materials	150	92.5
Crude foodstuffs	115	100
Manufactured foodstuffs	110.5	110.6
Semi-manufactures	136	88
Finished manufactures	123	112.8
All imports	130	97.9

During this period the American national income increased by 22 percent in money terms and by nearly 10 percent in real terms. The fact that the volume of imports actually declined in that period means that instead of a decline there has

1/ The changes in the indexes have been as follows:

	October 1950-June 1951	July 1951-March 1952
1--Unit Values (1936-1938 = 100)		
Crude materials	299	297
Crude foodstuffs	506.6	509.7
Semi-manufactures	232	250.6
Finished manufactures	276	307.6
2--Quantities (1936-38 = 100)		
Crude materials	155.6	138.3
Crude foodstuffs	122.6	118
Semi-manufactures	229.6	183.6
Finished manufactures	143	131.7

been an increase in American self-sufficiency. It is only because the prices of imports rose considerably more than American prices that the ratio of imports to the national income increased somewhat during that period. It might be argued that the period July 1951-March 1952 is not representative of the American dependence on imports after Korea since it is a period of abnormally low purchases following the excesses of stockpiling and inventory accumulation of the earlier period. This is partly true, although it is truer of individual commodities than of the total volume of imports, but even if we take the whole 18 post-Korean months as one period, the conclusion still holds that there has been no increase in the American dependence on foreign goods during the rearmament period:

	January-September 1950	October 1950-June 1951	July 1951-March 1952	October 1950-March 1952
		(Annual Rates)		
American gross national product				
(a) At current prices	276	318	336	327
(b) At January-September 1950 prices	276	290	300	295
American national income				
(a) At current prices	232	268	284	276
(b) At January-September 1950 prices	232	243	253	248
American imports				
(a) Value at current prices	8.7	12.2	11.0	11.6
(b) Value at January-September 1950 prices	8.7	10.0	8.5	9.3
Ratio of imports to gross national product				
Imports (a) to gross national product (a)	3.1	3.7	3.3	3.5
Imports (b) to gross national product (b)	3.1	3.4	2.8	3.1
Ratio of imports to national income				
Imports (a) to national income (a)	3.8	4.5	3.8	4.2
Imports (b) to national income (b)	3.8	4.1	3.4	3.75

This failure of American imports to expand during a period of extremely high economic activity in the United States cannot be attributed to any restrictive measures taken against imports. The protectionist tendencies which developed durin that period have serious implications for the future of world trade, but they have not yet affected significantly the volume of American imports. It is impossible not to conclude, on the basis of the available evidence, that the main reason for t failure of American imports to expand has been the excessive increase in the prices of foreign goods. As already stated, American retail prices rose by 10 to 12 percent during that period as compared with the 30 percent rise in the average unit value of imports. American export prices during that period rose by 15 percent. The result of this disproportionately great rise in import prices has been to discourage consumption, encourage greater economy in the use of materials, substitutio with local materials and expansion in the domestic production of such materials. The cases of rubber and wool illustrate this effect of high prices on American demand: in both cases American consumption was curtailed and in the case of rubber local production of the synthetic material was stimulated.[1/]

1/ Prices of these materials rose as follows during the period under consideratio

	Rubber		
	Natural	Synthetic	Scoured Wool
	(U.S.A. prices $ per 100 lbs.)		
January-June 1950	23.5	18.5	162
July 1950	39.1	18.5	178
December 1950	71.4	24.5	260
March 1951	72.2	24.5	360
June 1951	66.0	24.5	282
January 1952	52.0	26.0	172
March 1952	50.5	23.7	138

U.S.A. Imports

	Rubber	Wool
	(Million lbs.)	
1949	1,480	277
1950	1,795	477
1951	1,642	368

A regional breakdown of imports corroborates the view that the main factor in the decline of imports between the first and second phases of the post-Korean period was the excessive rise in prices. The breakdown shows that the largest declines occurred in imports from Latin America, Asia and Oceania, i.e. of the regions where prices of primary products rose to unprecedented heights during the period of sharp inflation July 1950 - March 1951. It is interesting to note that Canada, also an exporter of primary products to the United States, continued to expand its exports at a time when practically all other areas experienced declines:

(Million Dollars)

	January-September 1950	October 1950-June 1951	July 1951-March 1952
Canada	1,386	1,689	1,721
Other Western Hemisphere	2,285	2,798	2,513
OEEC countries	806	1,484	1,337
Asia	1,082	1,691	1,348
Africa	361	502	432
Oceania	148	327	244
Total	6,068	8,491	7,595

	Change Between October 1950-June 1951 and July 1951-March 1952	Change Between January-September 195 and July 1951-March 1952
Canada	+ 2%	+24%
Other Western Hemisphere	-12%	+10%
OEEC countries	-10%	+66%
Asia	-20%	+24.5%
Africa	-14%	+20%
Oceania	-25%	+65%
Total	-11%	+26%

2. Exports

As already stated, American exports declined sharply in 1950 as compared with 1949. They rose again in 1951 and continued rising during the first half of 1952:

(Million Dollars)

Total 1949	12,337
Total 1950	10,658
Total 1951	15,486
1st half 1952 (annual rate)	16,670

By Quarters[1/]

(Million Dollars)

4th quarter 1949	2,664	4th quarter 1950	3,106	4th quarter 1951	4,130
1st quarter 1950	2,439	1st quarter 1951	3,404	1st quarter 1952	4,155
2nd quarter 1950	2,615	2nd quarter 1951	4,103	2nd quarter 1952	4,180
3rd quarter 1950	2,498	3rd quarter 1951	3,849	Total	12,465
Total	10,216	Total	14,462	Annual rate	16,620

These very large increases in American exports were due only in part to higher prices. The unit value of exports rose by 14.4 percent in 1951 and by another 0.7 percent in 1952, accounting for nearly $2,000 million of the $4,828 million increase in exports in 1951 and of the $6,012 million increase in the first half of 1952 (annual rate). The remaining increases were due to increases in the quantities exported. In 1951 the volume of exports was 27 percent higher than in 1950 and it rose further to 39 percent over 1950 in the first half of 1952:

Index of Quantities

	1936-38 = 100	1950 = 100
1950	193	100
1951	247	127
1st half 1952	269.5	139

Index of Values

	1936-38 = 100	1950 = 100
1950	180	100
1951	206	114.4
1st half 1952	207.5	115.3

The largest increases in volume occurred in exports of foodstuffs and finished manufactures, and again, as in the case of imports, these were the groups in which increases in prices were smallest:

1/ The decline in American exports which followed the devaluations of September 1949 and the tightening up of import restrictions in foreign countries began to take effect in the last quarter of 1949. The expansion in exports following the relaxation of import restrictions abroad began in the 4th quarter of 1950. The quarters have, therefore, been grouped here to reflect these changes in the trend of American exports.

	Index of Quantities 1/ (1950 = 100)		Index of Values 1/	
	1951	1st Quarter 1952	1951	1st Quarter 1952
Crude materials	111	122	118	116
Crude foodstuffs	165	190	109	119
Manufactured foodstuffs	111	112	125	111
Semi-manufactures	121	127	123	122
Finished manufactures	132	137	109	112

A regional breakdown of exports shows that the increase in exports was

1/ The relative importance of these groups in total exports is shown in the following table:

	1950 (Million $)	Percent of Total	1951 (Million $)	Percent of Total
Crude materials	1,886	18.6	2,471	16.6
Foodstuffs	1,362	13.4	2,242	15.1
Semi-manufactures	1,121	11.1	1,663	11.2
Finished manufactures	5,773	56.9	8,492	51.1
	10,142	100	14,868	100

The main commodities in each group are as follows:

	1950 (Million Dollars)	1951 (Million Dollars)
Crude materials		
Cotton	1,024	1,146
Coal	269	586
Tobacco	251	326
Crude petroleum	103	82

	1950 (Million Dollars)	1951 (Million Dollars)
Foodstuffs		
Wheat	489	997
Corn	152	190
Fruit & vegetables	171	201
Meats & fats	107	195
Dairy products	103	153

	1950 (Million Dollars)	1951 (Million Dollars)
Semi-manufactures and manufactures		
Machinery	1,985	2,522
Automobiles & parts	703	1,157
Chemicals	708	997
Textiles	516	815
Iron & steel products	472	612
Petroleum	397	701
Military equipment	471	1,281

fairly well distributed among foreign countries:[1/]

	1950	1951	1952 1st Quarter Annual Rate	Increase Between 1950 & 1951	Increase Between 1950 & 1952
Canada	1,996	2,588	2,492	30%	25%
Other Western Hemisphere	2,764	3,772	3,944	36%	43%
OEEC countries	2,792	3,820	4,180	36%	50%
Asia	1,440	2,180	2,584	51%	79%
Oceania	132	244	292	82%	118%
Africa	344	580	700	70%	100%
Total	9,468	13,184	14,192	39%	48%

The main reasons for the large increase in American exports in 1951 and 1952 are the following:

The new inflations which developed in primary producing countries as a result of the rise in the prices of their exports increased the demand for imported goods. The relaxation of import restrictions by most countries following the improvement in their dollar earnings similarly led to a large increase in their imports from the United States.

Inflation and rearmament in Europe have meant that many European countries were unable to take advantage of the increased demand for manufactures, leaving the field free to American exporters.

The greater rise in foreign prices as compared with American prices

1/ Regional data of shipments of military equipment are not published for security reasons and are, therefore, excluded from the above table.

increased the competitive position of American products in foreign markets.[1/]

Special circumstances, such as the closing down of Iranian oil refineries, Europe's failure to expand its coal production, India's need for wheat increased once more the world's dependence on American supplies.

Finally, since 1949 the United States has been sending increasingly large quantities of military equipment to foreign countries and these are included in American exports. These shipments totalled $349 million in 1949, $471 million in 1950, $1,281 million in 1951 and were probably around $1,400 million per annum during the first half of 1952.[2/] If these shipments are excluded, as they should be in an appraisal of economic developments during that period, American exports are reduced as follows:

1/ The following comparisons are made in The Mid-Year 1952 Economic Review, by the Council of Economic Advisers, July 1952, p. 164.

December 1951
(June 1950 = 100)

	Wholesale Prices	Cost of Living
United States	113	111
United Kingdom	129	114
France	147	134
Germany	128	113
Italy	116	113
Belgium	131	114
Switzerland	116	108
Canada	113	115
Australia	132	133
New Zealand	122	118
Union South Africa	125	111
India	109	106
Brazil	131	111
Mexico	132	122

2/ This is an indirect estimate based on the fact that total American military aid to foreign countries which was $215 million in 1949, $583 million in 1950 and $1,491 million in 1951 was at the rate of some $1,600 million during the first quarter of 1952.

(Million Dollars)

	Total Exports	Military Shipments	Net Exports
1949	12,337	349	11,988
1950	10,658	471	10,187
1951	15,486	1,281	14,205
1st half 1952 annual rate	16,670	1,600	15,070

3. The Trade Balance

As a result of the developments described above, the American export surplus increased as follows during that period:[1/]

	Including Military Shipments	Excluding Military Shipments
	(Million Dollars)	
1949	5,271	4,922
1950	1,343	872
1951	3,818	2,537
1st half 1952	2,470	1,670
1st half 1952 (annual rate)	4,940	3,340

Thus, the gains made before Korea in reducing the world's dependence on American supplies were not maintained in the post-Korean period. It should be noted that this deterioration occurred in spite of the fact that American import prices rose twice as much as American export prices. If import prices had risen only as much as export prices the American export surplus in 1951 and in 1952 (annual rate) would have been larger than it was by over $1 billion. It is true, however, that in that case the foreign demand for American goods would have been somewhat smaller than it was and also that American imports would have been somewhat larger.

1/ A grouping by quarters rather than calendar years is more indicative of the changes which took place during that period but quarterly data showing military shipments separately are not available. The quarterly grouping, which includes military shipments, is as follows:

Trade Balance
(Million Dollars)

		Annual Rate
1949	-	5,271
January-September 1950	1,052	1,400
October 1950-June 1951	1,452	1,930
July 1951-March 1952	3,847	4,620
January-June 1952	2,470	4,940

4. Non-Commercial Current Transactions

These include all services such as transportation, travel, insurance, investment income and private remittances.

United States payments for services normally exceed its receipts by a small amount. As the following table shows, both receipts and payments have been increasing since 1950, but the causes of the much larger increase in payments during the first half of 1952 cannot yet be ascertained.[1/] It should also be kept in mind that the estimates for the second quarter of 1952, during which most of the increase occurred, are stated to be based on incomplete data:

	Payments	Receipts (Million Dollars)	Net Balance
1949	2,184	2,232	+ 48
1950	2,376	2,024	-352
1951	3,047	2,741	-306
1st half 1952	1,795	1,456	-339
1st half 1952 (annual rate)	3,590	2,912	-678

Income on investment is a large and growing item in American receipts, only partly offset by income derived by foreigners from their investments in the United States:

	Payments	Receipts (Million Dollars)	Net Balance
1949	353	1,405	+1,052
1950	437	1,743	+1,306
1951	398	1,992	+1,594
1st half 1952	189	896	+ 707
1st half 1952 (annual rate)	378	1,792	+1,414

Private remittances, although they are usually excluded from current transactions, belong properly to the current account since they are a regular feature of American foreign payments and a relatively steady source of dollar earnings for recipient countries:

1/ They may be due to increased American spending on foreign services for military purposes.

	Million Dollars
1949	522
1950	481
1951	412
1st half 1952	185 1/
1st half 1952 (annual rate)	370

Adding together these three categories of non-commercial current transactions, we find that there was an increase in the American surplus in 1951. The available estimates for 1952 indicate, however, that a sharp decline has taken place during the first part of 1952, due primarily to increased payments for services:

	1949	1950	1951	1st half 1952	1st Half 1952 Annual Rate
	(Million Dollars)				
Net balance on:					
Services	+ 48	- 352	- 306	-339	- 678
Investment income	+1,052	+1,306	+1,594	+707	+1,414
Private remittances	- 522	- 481	- 412	-185	- 370
	+ 578	+ 473	+ 876	+183	+ 366

5. The Current Account Surplus

Adding the non-commercial transactions to the trade balance we obtain the current account surplus of the United States, which is the equivalent of the current account dollar deficit of the rest of the world:

	Trade Balance		Balance	Current Account Surplus	
	Including Military Shipments	Excluding Military Shipments	On Non-Commercial Transactions	Including Military Shipments	Excluding Military Shipments
	(Million Dollars)				
1949	5,271	4,922	578	5,849	5,500
1950	1,343	872	473	1,816	1,345
1951	3,818	2,537	876	4,694	3,413
1st half 1952 (annual rate)	4,940	3,340	366	5,306	3,706

6. Private Capital Exports

Against this current account surplus must be set the export of private capital which represents a source of dollars to the rest of the world available for

1/ Based on incomplete data.

the purchase of goods and services and resulting, not from Government action, but from independent decisions of individuals or firms transacting their private business.

The export of American capital to foreign countries has been as follows in recent years:

	Million Dollars
1949	609
1950	1,317
1951	1,066
1st half 1952 (annual rate)	1,166

7. American Balance-of-Payments Surplus Requiring Official Financing

Deducting capital exports from the current account surplus we obtain the amount of the American surplus that could not be settled through normal economic processes and, therefore, required such emergency methods of financing as the liquidation of gold or dollar reserves by foreign countries or the granting of financial aid by the American Government:

American Balance of Payments Surplus
(Million Dollars)

	1949	1950	1951	1st Half 1952 Annual Rate
Current account surplus:				
Including military shipments	5,849	1,816	4,694	5,306
Excluding military shipments	5,500	1,345	3,413	3,706
Minus capital exports	609	1,317	1,066	1,166
Net balance of payments surplus requiring official financing:				
Including military shipments	5,240	499	3,628	4,140
Excluding military shipments	4,891	28	2,347	2,540

Official financing has been as follows during this period:

	1949	1950	1951	1st Half 1952 Annual Rate 1/
		(Million Dollars)		
Liquidation of gold and dollar reserves by foreign countries	57	-3,629	- 442	144
U.S. Government grants and loans:				
Economic aid	5,753	3,701	3,173	2,950
Military aid	215	583	1,491	1,600
Net official financing of balance of payments surplus	6,025	655	4,222	4,694

The negative sign in the above table indicates that in 1950 and 1951 there was a net accumulation of reserves instead of a liquidation. The accumulation resulted primarily from the fact that countries receiving American economic aid are reimbursed for their purchases under the aid programs several months after the purchases have been made. In 1950 foreign countries were receiving large amounts of American aid for imports made in earlier periods which they had financed by depleting their reserves. The increase in reserves was also due to a return of flight capital after the devaluations of September 1949 and the restoration of confidence in foreign currencies.

Comparing the availability of official financing with the actual American balance of payments surplus, we find that the size of official financing has consistently exceeded the size of the deficit:

	Balance of Payments Surplus	Official Financing	Difference
		(Million Dollars)	
1949	5,240	6,025	+785
1950	499	655	+156
1951	3,628	4,222	+594
1st half 1952 (Annual rate)	4,140	4,694	+554

The difference between the two magnitudes represents in part errors and omissions in the balance of payments estimates, but it is primarily accounted for by unrecorded capital movements and especially capital flight. This is corroborated, first, by the fact that the difference is always positive and, second, by

1/ Based on incomplete data.

the fact that the difference declines when confidence in foreign currencies is strengthened and increases sharply when confidence in these currencies is shaken. The existence of this item in the American balance of payments shows that American aid to foreign countries and a liquidation of their reserves by these countries have been required in recent years not only to finance needed imports, but also to offset the effects of capital flight. The size of this item in 1951 and 1952 indicates that, as in 1949, capital flight has again been an important factor in the deterioration of the world's dollar position during the second phase of the post-Korean period.

It should be noted that in the above estimates, which refer to the overall position of the United States vis-a-vis the rest of the world, the dollar deficits of certain areas are offset by the dollar surpluses of other areas. This means that the above estimates do not give the full measure of the dollar difficulties experienced by regions which were in deficit with the United States. During the period under consideration, countries like Canada and Belgium had a dollar surplus in their transactions with the rest of the world and were able to increase substantially their gold and dollar reserves[1/] while the sterling area experienced a decline of over $2,000 million in its gold and dollar reserves,[2/] i.e. a decline far greater than the estimates of the financing of the overall American surplus indicate.

1/ Canada's gold and dollar holdings increased from $2,641 million on December 31, 1950 to $3,086 million on December 31, 1951 and $3,303 million on May 31, 1952. Belgium's gold reserves and dollars in U.S. banks increased from $715 million to $770 and $805 million in the corresponding period, while its foreign exchange reserves, which presumably include dollar reserves, increased from $162 million to $419 and $510 million.

2/ The gold and dollar reserves of the sterling area have been as follows during the period under consideration:

	Million Dollars
December 1949	1,688
December 1950	3,300
June 1951	3,867
December 1951	2,335
June 1952	1,685

8. Prospects in the Coming Years

The deterioration in the world's dollar position which began in the middle of 1951 had not yet been arrested in the early months of 1952. There can, however, be little doubt that a substantial improvement will take place in the coming months. The tightening up of import restrictions on American goods, which was decided upon by most deficit countries early in 1952, will begin to show results in the second part of 1952. The anti-inflationary measures taken in the various countries and the fact that American economic aid is being cut will also reduce foreign demand for American goods. On the other hand, the depletion of American inventories is likely to lead to an increase in American imports of materials which will probably be accompanied by a rise in their prices. The upward trend of American prices might improve the competitive position of foreign countries, although it is probably too optimistic to expect that foreign prices will not rise at least as much as American prices.

Thus, a closer dollar balance is likely to be achieved in 1952-53 which, if coupled with a return of confidence in foreign currencies, might improve substantially the world dollar position. It is to be hoped that this time the improvement will not lead to the conclusion that the dollar problem had been solved and

that the measures which brought about the improvement were no longer required.[1/] The improvement will prove of lasting benefit only if it is interpreted as a breathing space allowing both the United States and the rest of the world to face squarely the implications of their respective positions and decide what kind of international economic system they really want to see established, a system based on freedom of exchanges and universal convertibility of currencies or a system of regional groupings enforcing restrictions and practicing discrimination against each other. The danger of false optimism will be particularly great in 1952-53 in view of the fact that an American recession is probable in 1954. Such a recession will inevitably be attended by a decline in American imports and an increase in the competitive position of American exports. It is clear that if a repetition of the crises of 1949 and 1951 is to be avoided in 1953-54, the world must be prepared for this contingency and not act on the assumption that the improvement of 1952-53 will be maintained in 1953-54.

1/ The U.N. World Economic Report 1950-51, p. 70-71, summarizes as follows the experience of recent years on this subject:

"In general, experience during the period from 1949 to 1951 suggests that the tendency to run persistent deficits on current account with the United States remains a fundamental problem facing most countries in greater or lesser measure. The period has been characterized by sharp fluctuations in United States imports —resulting from relatively much smaller fluctuations in the domestic economy of the United States—the effects of which on the dollar earnings of other countries were superimposed upon a gradually declining volume of economic aid. Most countries outside the dollar area have adjusted themselves to the resulting changes in their dollar positions by relaxation of import restrictions and restocking of dollar goods in times of high dollar receipts and renewed dollar economies when receipts have fallen. The time lags involved in the administrative decisions required for this process of adjustment, together with reinforcing rather than offsetting speculative capital movements, have caused sharp increases in the gold and dollar reserves of non-dollar countries in some periods, and equally sharp declines in others. On the whole, the effective demand for imports from the United States has been limited through the operation of direct controls rather than by the level of income in the rest of the world. Even in 1950, when gold and dollar reserves were rising, it is likely that the demand for United States goods, in the absence of controls, would have exceeded the supply of dollar resources currently made available by the United States."