

This PDF is a selection from an out-of-print volume from the National Bureau of Economic Research

Volume Title: The Korean War and United States Economic Activity, 1950-1955

Volume Author/Editor: Bert G. Hickman

Volume Publisher: UMI

Volume ISBN: 0-87014-363-8

Volume URL: <http://www.nber.org/books/hick55-1>

Publication Date: 1955

Chapter Title: Introduction and Summary

Chapter Author: Bert G. Hickman

Chapter URL: <http://www.nber.org/chapters/c2908>

Chapter pages in book: (p. 1 - 5)

Introduction and Summary

This paper is a part of a comparative study of peacetime and wartime business cycles. One of the first questions to be faced in any such comparison is whether wartime cycles are sufficiently similar to be compared as a class with peacetime cycles, assuming that the latter are also sufficiently alike to be grouped as a class. This calls for systematic analysis of economic developments during each wartime episode, and the present paper attempts this for the Korean period. Some comparisons with the developments of 1940–1941 are also included that serve to place the Korean experience in historical perspective and help to isolate the influence of particular forces at work during the period.

A major war has a noticeable impact on economic activity even in countries that are not belligerents. Thus United States economic activity was markedly stimulated by the hostilities in Europe in 1915–1916 and again in 1940–1941, but with this difference: In the earlier period the stimulus was almost solely the result of orders for goods placed in this country by the belligerents, whereas in the later period an added stimulus resulted from the defense mobilization undertaken by the United States itself. In neither period was the economy on a true wartime footing; it was not until 1917–1918 and 1942–1945 that the claim of the government on the nation's resources became so large as to create the economic problems associated with an all-out war effort. It is clearly essential, then, to distinguish neutrality and belligerency phases of the expansions that took place during the two world wars.

But how to classify the Korean period? In one sense, it was not comparable to the years of belligerency during the earlier wars, since the mobilization program was not of "wartime" magnitude. On the other hand, it differed from the earlier neutrality periods in that United States armed forces were engaged in hostilities overseas and there was a definite possibility that the conflict would

assume larger proportions. Finally, in important respects the behavior of the economy in 1950–1952 was very different from that during either the neutrality or the belligerency phases of the world wars. How can the rather surprising economic developments of 1950–1952 be accounted for?

The outbreak of the Korean War in June 1950 was followed by eight months of strong inflationary pressure, due largely to abnormally heavy buying by consumers in anticipation of possible future shortages. However, the anticipated shortages did not develop, and early in 1951 consumer demand fell off. This had a deflationary effect that largely counterbalanced the inflationary influence of defense spending. Hence it was possible to increase defense expenditures substantially without serious inflationary consequences.

Government controls and monetary and fiscal policies exerted some anti-inflationary influence in 1951, but on the whole the effects of government fiscal operations were mildly inflationary. The government's major contribution to economic stability was to slow the growth of disposable personal income as defense expenditures mounted; this helped to prevent a rapid growth in consumer expenditures.

The balance between defense and civilian needs that was struck in mid-1951 was maintained through 1952. Excessive stocks had been accumulated by distributors during and shortly after the inflationary phase of the expansion, and the relaxation of consumer demand in early 1951 was followed by a period of inventory liquidation that was in large part responsible for the ease with which the government share of the gross national product was increased.

In the period covered by this study the key to an understanding of trends in economic activity is to be found in the behavior of consumers—that is, in the private, rather than the public, sector of the economy. The wide fluctuations in consumer spending that occurred during 1950–1951 were largely independent of variations

in income and were strongly influenced by changing short-term expectations. Memories of wartime shortages were still fresh in 1950, and the beginning of hostilities in Korea touched off a wave of forward buying in July and August. Retail sales then declined for several months as the military situation improved, only to spurt once more during the winter as the military reversals that followed the entry of the Chinese Communists into the war led to renewed expectations of shortages. The second buying wave was as short-lived as the first. The anticipated shortages failed to develop—it became apparent early in 1951 that retail stores were plentifully stocked with goods—and a prolonged period of depressed sales ensued as consumers absorbed their increased household stocks and replenished their holdings of liquid assets.

Fluctuations in inventory investment (net change in inventories) accounted for a large proportion of the fluctuations in private investment, and hence in total private expenditures, during 1950–1951. The fluctuations in inventory investment were in turn intimately related to those in consumer expenditures, since the buying practices of businessmen paralleled those of consumers. While it could be argued that businessmen were merely acting to adjust stocks to changes in the level of sales during the buying waves, it is virtually certain that they shared the expectations of consumers, since they were exposed to the same general stimuli as consumers and in addition possessed the concrete evidence afforded by the behavior of their own sales and stocks.

The relaxation of consumer demand in 1951 was reflected in an abnormally high ratio of personal saving to disposable income, but attention should be focused on the circumstances in which the rise in the ratio occurred rather than on the size of the ratio. The decision of consumers to save a larger portion of their incomes was made at a time when disposable income was increasing, but slowly; hence this decision involved a decline of consumer expenditures. Furthermore, the abrupt rise in the rate of saving followed a period of equally abrupt reduction, which had resulted from heavy consumer buying. This had stimulated investment in retail stocks

—investment that could be justified only if retail sales continued to increase at a substantial rate. When retail sales declined, the resulting decline of inventory investment moderated the growth of income and expenditures and helped relieve the pressure on prices. Thus the increase in the rate of personal saving had significant effects because it represented a sharp reversal of the previous trend and it occurred when disposable income was growing only slowly.

The developments of the Korean period take on heightened interest when compared with those of 1940–1941, the years of defense mobilization that preceded the entry of the United States into World War II. During the earlier mobilization inflationary pressures were at first mild, but they increased sharply after the expansion had been under way for eight or nine months; thus the pattern of development was the exact opposite of that during the Korean period. The difference lies partly in the behavior of consumers and partly in the relative degrees of slack in the economy in the two periods. There was no extensive forward buying in 1940–1941: Consumer expenditures merely rose along with income, and the rise in income was in turn the result of increased defense expenditures. Furthermore, the expansion began from a much lower level than in 1950, so that defense expenditures could be increased without serious interference with the production of civilian goods.

Unemployment was larger even at the end of 1941 than at the beginning of the Korean expansion, and yet inflationary pressures were strong in 1941 and weak in 1951. In 1941 there was no relaxation of consumer demand comparable to that which followed the buying waves of the Korean period. The rapid growth of income induced additional consumer expenditures, notwithstanding the fact that the ratio of personal saving to disposable income was considerably larger than in 1951. On the other hand, supply bottlenecks developed in 1941 despite large-scale unemployment, so that rising expenditures exerted a powerful upward pressure on prices.

The major lesson to be learned from a study of the Korean period is that consumers provided with sizable holdings of liquid

assets and easy access to consumer credit can markedly influence the course of economic activity if, as a group, they develop expectations that lead them to make advance purchases on a large scale. The hypothesis that consumer expenditures are primarily a function of real income has been widely accepted, but the instability of consumer spending during 1950–1951 shows that, under some circumstances, psychological variables may for a time assume positions of equal or greater importance as determinants of consumer expenditures. However, it is important to remember that this instability was the result of generalized changes in expectations that were induced by dramatic military developments, and in no way demonstrates that peacetime cycles are regularly influenced by shifts in consumer expectations. Whether that is the case is a question that can only be answered by further investigation.

The Korean Expansion: 1950–1952

The Korean War and the associated defense mobilization strongly influenced the trend of economic activity in the United States during 1950–1952. The specific nature of these influences will be analyzed presently, but a brief survey of the position of the economy at the outbreak of hostilities, and of the magnitude of the mobilization program, will provide a useful background to the subsequent discussion.

Economic Activity Prior to the Korean War

The level of economic activity was high and rising prior to the outbreak of hostilities in Korea in June 1950. A vigorous recovery from the mild recession of 1948–1949 had been under way since late in 1949. Gross private domestic investment and gross national product increased more rapidly in percentage terms between the last quarter of 1949 and the second quarter of 1950 than in any subsequent interval during the period with which we are concerned (Chart 1). Consumer expenditures also increased, but at a more modest pace, while government expenditures and net foreign investment declined (Charts 1 and 6). Industrial production,