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# A CASE STUDY: THE 1948–1949 RECESSION

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### *Introduction*

Great significance has been attached to the 1948–1949 recession because it appeared to be the first postwar test of the basic strength of the New Economy equipped as it was with a whole array of built-in stabilizers. In retrospect it is clear, I believe, that it was scarcely such a test. The 1948–1949 recession seems to have been hardly more than a warning signal that such a test could occur. The episode was far more significant as a test of what might be called the New Political Economy, viz. the capacity of government to fulfill its obligations under the Employment Act of 1946 with respect to the furtherance of "maximum employment, production and purchasing power." Even here it was a limited test with rather mixed results. But it was significant in the sense that though the problems which had to be faced were relatively minor in character they were of the same type which would have to be faced whenever the problem of recession recurred.

To understand why so much interest has been given to the 1948–1949 episode it is well to recall briefly the climate of opinion following the ending of the war. There were two main features of the 1946–1948 period, the first economic, the second psychological. There was first the boom in the economy and there were also widespread doubts as to the solidity of the boom. To paraphrase a famous remark, many felt that "Depression was just around the corner." The reasons for this uneasiness are not far to seek. For one thing, there was the carry-over of the deflationary psychology of the thirties. This found its immediate expression in two perhaps closely related events: the predictions of massive unemployment as a consequence of reconversion from war to peacetime production, and the passage of the Employment Act of 1946 enunciating the responsibility of government for maintaining a healthy and stable economy.

Even though the immediate postwar fears proved groundless, the uneasiness, though perhaps subdued, persisted. This was based on two facts: the recognition that major elements in the postwar demand were the backlogs built up during the war both at home

The opinions expressed herein are solely the personal views of the writer.

and abroad, and the sharp inflationary developments which marked the period. These were, of course, to a major extent opposite sides of the same coin. The doubts ran as follows: Once the postwar backlogs of demand for construction and durables were satisfied, would the "normal" levels of demand be adequate to maintain full employment without massive programs by government? Did not the inflationary developments intensify the seriousness of this problem by creating major maladjustments between prices and purchasing power, between prices and costs? Moreover, did not past experience indicate that major periods of inflation generally lead to major collapses in prices and production? It was true that new elements of long-run strength had been built into the economy during the thirties. But were the new shock absorbers or stabilizers sufficiently strong to minimize the degree of readjustment that would occur? No one thought that we could avoid readjustments, but could we hold such readjustments to relatively minor declines in production and employment?

Although we have not yet had a definitive answer to these questions—and they are as current now as they were then—the mildness of the 1948–1949 experience in the minds of many seemed for a time to be conclusive. In fact, the apparent success of that experience led to the development of a new state of mind: the Age of Inflation thesis. This is the notion that the long-run propensity of the economy is inflationary. As I have pointed out elsewhere, this state of mind seems to represent a typical lag reaction to developments, and such theses are generally developed on the eve of a major change in the opposite direction. There were the New Era economics of the late twenties, the Secular Stagnation thesis of the latter part of the thirties, and the Age of Inflation thesis of the early fifties.

It will be interesting to see whether the Age of Inflation thesis like the others is followed by its Hegelian antithesis. But such far-ranging speculations are beyond the scope of this paper. To keep the paper within manageable limits, I have selected as my primary focus the adequacy of the response of government to the problems created by the recession. It will, however, be necessary to sketch briefly and selectively some of the salient economic features of that experience as indispensable background to the main discussion.

In what follows I therefore concentrate on three questions: What kind of a recession was it? How adequate was the response of government? and What are the lessons of that experience? This paper does not contribute any fundamentally new answers to these questions. But perhaps in the perspective of 1954 the whole experience will appear in a clearer light.

### *What Kind of a Recession Was It?*

The commonly accepted view is that it was an inventory recession. What this means is that the forces which initiated the downturn had their major impact on the accumulation of inventories. These initiating factors have been well summarized by Professor R. A. Gordon,[1] as follows:

1. The increasing availability of goods both at home and abroad exerted increasing downward pressure on prices, particularly on farm prices.

2. The postwar abnormal expansion in consumers' demand began to level off. This resulted from the satisfaction of the most urgent backlogs of demand, the rise in consumer credit, and increasing price resistance, all leading to a more normal rate of saving.

3. Private fixed investment failed to maintain its rate of expansion and, on the contrary, developed a slight declining tendency.

The 1948 drop in the rate of growth of demand at the same time that supply capacity continued to expand was only temporary. It was only a brief pause in the postwar boom. It did not take long to complete the relatively small market readjustments called for, such as price and inventory declines. Because of that fact, the recession turned out to be very mild.

What may be a matter of interest, however, is the fact that every revision of the Department of Commerce estimates of gross national product for the years 1948 and 1949 increasingly indicates the mildness of the downturn. Thus, on the basis of yearly data, the decline between 1948 and 1949 was estimated in 1950 at $4.5 billion; at $1.7 billion in the 1951 revision of the data; and at $0.8 billion in the latest publicly available. No doubt the gap will be further narrowed if not eliminated when the results of the revision currently under way are published next July.[2] In real terms the data as of May 1954 indicate that the 1949 GNP was slightly above 1948. This is a sufficient commentary on how mild the recession was in terms of total output.

It is interesting, however, to note that the various revisions of the data have not altered the basic pattern of the changes between

[1] See his *Business Fluctuations*, Harper, 1952, p. 440.

[2] The July 1954 revision published by the Department of Commerce shows that the 1949 GNP was at about the same level as the 1948 GNP.

quarters. GNP reached a peak in the fourth quarter of 1948 and its low point a year later. It reached a new peak in mid-1950. The various revisions in the data have reduced the decline from peak to bottom from about 5 per cent to about 4 per cent. On the other hand, the rise to the second quarter of 1950 has become progressively steeper.[3]

Based on the latest data as of May 1954, the pattern of changes in GNP between quarters for the period 1947 to mid-1950 was that shown in the accompanying table.

Quarterly Changes in Gross National Product, First Quarter 1947 to Second Quarter 1950

*(annual rate in billions of dollars, seasonally adjusted)*

| | GNP CHANGE FROM PRECEDING QUARTER | |
|---|---|---|
| YEAR AND QUARTER | *Including Inventory Changes* | *Excluding Inventory Changes* |
| 1947 | | |
| 1Q | +3.6 | +6.6 |
| 2Q | +7.7 | +7.3 |
| 3Q | +1.4 | +4.9 |
| 4Q | +11.2 | +7.3 |
| 1948 | | |
| 1Q | +3.9 | +2.0 |
| 2Q | +9.6 | +7.3 |
| 3Q | +5.4 | +4.2 |
| 4Q | +4.0 | +3.5 |
| 1949 | | |
| 1Q | −6.4 | −.4 |
| 2Q | −2.0 | +2.2 |
| 3Q | −1.7 | −2.3 |
| 4Q | −.1 | +2.7 |
| 1950 | | |
| 1Q | +8.2 | +1.1 |
| 2Q | +15.3 | +7.7 |

Source: Department of Commerce data.

The pattern indicated by the table is as follows: (1) the quarterly changes in total output including inventory change were not markedly different in most of 1948 from those in 1947 except for the fourth quarter; (2) however, sales to final users increased at

[3] These constant revisions, undoubtedly inevitable, do raise serious questions for the forecaster and policy maker. So long as the basic pattern is unaltered, their usefulness is unimpaired as part of the economist's tool kit for discerning changes in the economy. But large changes in the level do create serious problems in trying to assess the quantitative significance of any change or of any policy proposed to deal with such change.

a fairly steady rate in 1947, whereas the 1948 rate of increase lagged behind the 1947 rate and definitely turned down in the second half of the year; (3) the 1949 decline in total output was concentrated in the first half of the year and then mainly in the first quarter; (4) sales to final users were on the average unchanged during the first three quarters of 1949 and thereafter began to increase; (5) in terms of total output, the second half of 1949 was a leveling-out period while the first half of 1950 marked a vigorous resumption of the upward movement. Because of the Korean outbreak, we cannot know whether and to what extent the rise would have continued beyond the first half of 1950. It seemed clear then that it would continue at least until the end of 1950, but whether 1951 would have been another period of contraction or of expansion can only be speculated upon.

Preceding the decline in total output, there was thus a weakening in the rate of growth of final sales. When the downturn got under way, final sales did not decline but tended to level out for a while before resuming their upward progress. Consequently, the fluctuations in GNP were primarily in that part of output which does not go to final sales, viz. inventory. Thus, between the fourth quarter of 1948 and a year later, the decline in GNP was $10 billion, annual rate, while business inventories declined about $12½ billion and nonfarm inventories about $10 billion. (See Table 1 for details.) There were, in addition, declines in the consumption of nondurables, producers' durables, and net foreign investment, but these were more than offset by increases in the consumption of durables and services and in government purchases of goods and services. The decline in consumers' nondurables seems to have been largely a price phenomenon, but that in producers' durables probably represented some hesitation in investment activity due perhaps to the need for reassessing the long-range outlook.

The preceding description covers the 1948–1949 recession in broad strokes. We shall now summarize briefly some of the salient points of the economic scene in 1948 as a prelude to the discussion dealing with the response of government, subsequently picking up additional details about the course of economic developments as the narrative requires. Unless specified, the reference to economic series will be to the latest available as of May 1954.

New orders, business sales, and business inventories reflected the weakening of the expansion of demand in 1948. In terms of new orders, sales, and inventories, the following facts are important: (1) new orders reached their peak in June 1948 over-all and for durables and nondurables; (2) over-all business sales reached their peak in August 1948, for durable manufacturers in December 1948, for nondurable manufacturers in June 1948, and for both types of retailers in December 1948; (3) the rise in sales in 1948 was at a lower rate than in 1947; (4) total business inventories (book value) increased steadily through 1948, reaching their peak in February 1949. The rate of increase was lower than in 1947 but represented

TABLE 1

Changes in Gross National Product, Selected Quarters, 1948–1950
(*billions of dollars, annual rates, seasonally adjusted*)

| *Component* | *Fourth Quarter 1948* | *Fourth Quarter 1949* | *Second Quarter 1950* | *Change from 4Q 1948 to 4Q 1949* | *Change from 4Q 1949 to 2Q 1950* |
|---|---|---|---|---|---|
| Gross national product | 267.0 | 256.8 | 280.3 | −10.2 | +23.5 |
| Personal consumption | 179.8 | 183.0 | 189.7 | +3.2 | +6.7 |
| Durable goods | 22.5 | 25.0 | 26.8 | −2.5 | +1.8 |
| Nondurable goods | 101.4 | 99.1 | 100.7 | −2.3 | +1.6 |
| Services | 55.9 | 58.9 | 62.2 | +3.0 | +3.3 |
| Gross private investment | 45.7 | 31.0 | 52.0 | −14.7 | +21.0 |
| New construction | 17.8 | 18.2 | 22.0 | +.4 | +3.8 |
| Producers' durables | 20.7 | 18.2 | 21.7 | −2.5 | +3.5 |
| Change in business inventories | 7.2 | −5.4 | 8.3 | −12.6 | +13.7 |
| Nonfarm only | 5.6 | −4.2 | 7.3 | −9.8 | +11.5 |
| Net foreign investment | 1.2 | −.5 | −1.6 | −1.7 | −1.1 |
| Government purchases of goods and services | 40.3 | 43.3 | 40.3 | +3.0 | −3.0 |
| Federal | 23.6 | 24.5 | 20.7 | +.9 | −3.8 |
| State and local | 16.7 | 18.8 | 19.5 | +2.1 | +.7 |

Source: Department of Commerce, latest published estimates as of May 1954.

a substantial build-up in real inventories, while the 1947 increase had been primarily the result of price changes. The build-up took place in manufacturing and retailing and was relatively larger in manufacturing than in retailing, relatively larger in durable goods than in nondurables. It was mainly a build-up in finished goods inventories. Durable manufacturers reached their peak level in February 1949, nondurable manufacturers in October 1947, durable retailers in December 1948, nondurable retailers in September 1948.

What was also important in 1948 was the sluggish behavior of industrial production compared with 1947. At the end of December 1947 the index was 103, and it reached a peak of 105 in July 1948. For manufacturers the rise was from 103 in December 1947 to 104 in January 1948 and oscillated back and forth until October when it began its decline. Durable manufactures were somewhat more vigorous than nondurables, rising from 104 at the end of 1947 to 106 in July and August 1948. Nondurables in 1948 did not exceed the peak level of 103 reached in November 1947 although they hovered about this level until June 1948. This accords with the relative build-up in durable goods inventories. At the time the behavior of industrial production was thought to reflect the fact that the increase in total production necessarily had to be small—a few per cent a year—if output were already close to capacity. In retrospect it is clear that the behavior of industrial production was due to the lessening pressure of demand. The proposition would have been correct if we had really been pressing up against the capacity ceiling.

In the investment field the most important development in the second half of 1948 was a weakening in the housing market. Housing starts fell below the level of the previous year. This fact was duly noted at the time. It was largely due to uncertainties connected with changes in housing legislation and to the fact that, with the demand for higher-priced houses largely met, demand shifted to lower-priced ones. In 1949 the housing industry, aided by new legislation, shifted to the lower-priced market, and housing starts exceeded 1 million for the first time in history.

In the case of consumers the following are the outstanding features: (1) Disposable income grew more rapidly in 1948 than in 1947, largely because of the reduction in taxes which became effective July 1, 1948. (2) The rate of growth of consumption decreased. In fact the process began in the latter half of 1947. (3) Consumers were, therefore, devoting a large part of their additional disposable income to building up savings so that the savings rate rose from the postwar low of 2.5 per cent of disposable income in 1947 to 5.6 per cent in 1948. (4) The demand for nondurables tapered off in the second quarter of 1948; for durables in the second half of the year. Re-imposition of consumer credit controls limited the demand for durables in the fourth quarter.

Price developments during the year were of major importance. Following the lifting of price controls, there had been a sharp advance on all fronts in the second half of 1946, some hesitation early in 1947, and a new considerable advance in the second half of 1947. In 1948 important divergencies in trend began to appear. Farm prices reached a peak in January 1948, broke sharply in February, and then recovered most of the loss by June. Thereafter, they began a new decline which gathered momentum. Processed foods followed much the same pattern except that they reached a new 1948 high in

August and then began their decline. Industrial commodities hesitated slightly in the first quarter of 1948, then advanced steadily under the impetus of metals and metal products to a new postwar high in November 1948. Consumers' prices under the influence of foods declined in the first quarter, rose to their high for the year in August 1948, and thereafter declined.

On the labor front, unemployment in 1948 averaged slightly less than in 1947, about 2.0 million or 3.4 per cent of the labor force compared with 2.1 million or 3.6 per cent of the labor force. At the same time the civilian labor force expanded by over 1.3 million in 1948 compared with 1947. However, in the fourth quarter of 1948, layoffs began to appear in nondurable industries and in some consumer durable industries.

In retrospect, of course, the signals of a decline seem quite clear in the second half of 1948. But that is because we have the benefit of 1949 to verify the correctness of these signals. It was not so clear to those watching the scene then and responsible for recommending appropriate policy. We turn now to the principal portion of this paper, in the course of which we shall refer to additional data on economic developments where pertinent.

### *How Adequate Was the Response of Government?*

The new charter of government responsibility contained in the Employment Act of 1946 set forth "that it is the continuing policy and responsibility of the Federal Government . . . to coordinate and utilize all its plans, functions and resources . . . to promote maximum employment, production and purchasing power." This was to be done "in a manner calculated to foster and promote free competitive enterprise and the general welfare."

The problem of carrying out this responsibility is aptly characterized by the following quotation from *The Testament of Beauty*, by Robert Bridges: [3a]

> "Mortal Prudence, handmaid of divine Providence,
> hath inscrutable reckoning with Fate and Fortune:
> We sail a changeful sea through halcyon days and storm,
> and when the ship laboureth, our stedfast purpose
> trembles like as the compass in a binnacle.
> Our stability is but balance, and conduct lies
> in masterful administration of the unforeseen."

[3a] Oxford, 1929, p. 9.

To see how "masterful" was the "administration of the unforeseen" by government during the 1948–1949 recession the subsequent discussion will revolve around the following key questions: How effectively did government diagnose the change in the trend of the economy? How effectively did it appraise the seriousness of the change? How effectively did it prescribe for the malady? and How consistent were government actions in achieving the desired goals? In speaking of government I mean, under the first three questions, the Administration position as expressed principally in the President's Economic Reports and by the Council of Economic Advisers, and, under the fourth question, all the agencies of government including Congress.

To anticipate, the record of government was poor on recognizing the turning point, very good on appraising and prescribing for the malady, and fortunately quite inconsistent on actions to implement the desired policy.

The failure to pick the turning point was a blot on an otherwise good postwar record. The Council, for example, while warning about the dangers of inflation, had maintained a generally optimistic view on the ability of the economy to maintain full employment in the postwar period at a time when unfounded pessimism was quite rife. It had rendered a signal service by popularizing the notion of an expanding economy.

Before beginning the analysis of the factors responsible for the Council's failure to recognize the turning point, we shall summarize the major steps taken and proposed by government to deal with the postwar problem of inflation. This is necessary to recapture the climate of opinion of the period.

### INFLATION CONTROL POLICY: 1946–1948

Following the collapse of price controls after mid-1946, there was a sharp upsurge in prices in the second half of the year. There was little government effort to deal with this problem then. Little action to cope with inflation seemed needed in the first half of 1947 although there was some government concern in the spring about price and wage developments.[4]

The picture changed dramatically in the second half of 1947 with the resurgence of inflation. The mounting public concern with this problem led the President to call a special session of Congress in November 1947 to deal with inflation and European aid. It will be recalled that at that time there was great fear of the inflationary

[4] E. G. Nourse, *Economics in the Public Service*, Harcourt, Brace, 1953, p. 177.

implications of a substantial foreign aid program. In preparation for the President's message, the Council was asked to submit suggestions on the control of inflation. These suggestions stressed a budget surplus and restraints upon credit expansion as "the policies which should now be adopted," but they also included extension of export controls and selective stand-by price and wage control.[5]

The Board of Governors of the Federal Reserve System also advocated a strong anti-inflationary program with a somewhat different emphasis. The Board was caught in what appeared to be a very difficult situation. Consumer credit controls had expired on November 1, 1947. The Board had begun to tighten up short-term rates in mid-1947 but in November it had entered the market to support the price of long-term government bonds. Consequently, it was extremely concerned with the inflationary implications of this problem. It recommended: (1) increased productivity; (2) suspension of wage demands; (3) the largest possible surplus to pay off government-held debt; (4) legislation granting the Board the authority necessary to restrict further expansion of bank credit including a device such as the special reserve plans; and (5) expansion of the Savings Bond campaign. Price controls were regarded merely as curbs and not as cures.[6]

The President in his message to Congress set forth a ten-point program which largely embodied the recommendations of the Council. It included, in addition to the items mentioned above, requests for authority to impose rationing, to bring about the efficient use of grains in marketing livestock (this appeared then as an acute problem), to impose allocation and inventory controls, to control the commodity exchanges and some others.

Congress, then controlled by the Republicans, granted the President only three of his ten points, the less important ones: an extension of export controls, extension of allocation authority over transportation facilities and equipment, and expansion of the agricultural conservation program. It also granted him authority to make voluntary allocation agreements and for the voluntary regulation of commodity exchanges. These agreements when approved by the Attorney General would be exempt from antitrust laws. In addition, the Board of Governors of the Federal Reserve System issued a statement asking bankers to "exercise extreme caution in their lending policies." Thus the President's basic anti-inflationary program was not passed.

[5] *Ibid.*, p. 211.

[6] Statement by Chairman Eccles before the Joint Committee on the Economic Report, November 25, 1947.

I have recited this program in some detail because it was, with some modifications, the same program the President presented to Congress up to and including January 1949.

The President repeated his request for his anti-inflationary program in January 1948. The Economic Report emphasized strongly that Public Enemy Number One was inflation. It stated, "The first objective for 1948 must be to halt the inflationary trend." This report was published on the eve of the great break in agricultural prices. Congress ignored the President's request in the first half of 1948 but did take certain actions that seemed to increase the inflationary dangers: it reduced taxes by $5 billion; it passed the Marshall Plan; and it provided for a step-up in defense spending. The cut in taxes weakened what had been the major weapon against inflation in 1947 and 1948, the accumulation of a substantial cash surplus.

By midyear an upward movement in prices and the development of a third round of wage increases were under way. The President, in what has been regarded as one of his shrewdest political moves, called a special session of Congress in July to deal once again with his anti-inflationary program. This time he was more successful. Temporary authority was granted for the reimposition of consumer credit controls and to increase reserve requirements. Consumer credit controls were reimposed on September 20, 1948. The Board had in February and June of 1948 raised reserve requirements at New York and Chicago. With the new authority all reserve requirements were raised 2 percentage points on demand deposits, and 1½ points on time deposits, about half of what was permitted by law.

Thus, just when the boom in the economy was tapering off and the trend changing, new anti-inflationary controls were imposed. It was a case of locking the barn after the horse was stolen. It should not be thought that the Board accepted its new responsibilities with dismay. It had been keenly concerned about its yardstick of inflationary pressure, the large rise in bank credit in the postwar period. It had not lost its concern by the summer of 1948. An article in the August 1948 *Federal Reserve Bulletin* declared: "In view of the current tight situation in supplies of labor and materials, further expansion of installment credit can neither increase output nor put more people to work. It can only add more purchasing power to the already swollen spending stream and reinforce inflationary pressures. International developments, moreover, inevitably cause added pressures in the market for consumers' durable goods." [7] This

[7] Page 903 of that issue.

certainly indicates that in August 1948 the Board regarded the economy as being stretched as tight as a drum and extremely sensitive to any additional purchasing power.

The final attempt of the President to have his anti-inflationary program passed was in his State of the Union Message of January 1949. The portion asking for his anti-inflation program was much more moderate than in the past as to the dangers of inflation. He dropped his request for rationing but added a request to deal with inadequate capacity in basic industries such as steel. He also asked for $4 billion in additional taxes, mainly corporate, to provide a substantial surplus to offset inflationary pressures. Shortly after this message went to Congress, the country became much more concerned with deflation than with inflation.

### THE FAILURE TO DIAGNOSE THE CHANGE IN THE ECONOMY

The most interesting and paradoxical phase of the record is the first one: that dealing with the faulty diagnosis of the situation. This is all the more paradoxical because of the repeated warnings by the Administration that the end result of inflation could well be a downturn. Yet signs of weakening were discounted throughout 1948 even as the signs of a turn became more numerous, particularly in the second half of the year; warnings against the dangers of inflation continued into the first half of 1949.[8] Perhaps even more incredible at first sight to some—an additional anti-inflationary program was instituted just as the postwar round of inflation was uttering its last gasps in the fall of 1948. Yet it was not until the spring of 1949 that the anti-inflationary program began to be eliminated. This was obviously an intriguing but not a unique episode.

What makes it more intriguing is that a rereading of the Economic Reports for January 1948, July 1948, and January 1949 makes clear that the lessening impact of inflationary pressures through the year was clearly recognized. In January 1949 the divergent trend in price movements was duly noted as was some weakening in consumer demand and some softening in investment. This was in sharp contrast to the July 1948 Report. However, government was

[8] Mr. Nourse reports that in the April 1949 Quarterly Report to the President, the Council considered that another spurt of inflation was one of three possibilities, although the least likely. Another possibility was a serious downturn, but the most likely was the "process of price readjustment in a manner to facilitate the clearing of markets with only moderate temporary departure from maximum levels of employment and production." Nourse, *op. cit.*, pp. 237–238. This was a very good forecast but it is interesting to note that there was still some concern with the problem of inflation.

seen as further contributing to expansion of demand. Inflationary pressures were seen as active in only a few sectors. It was quite a *non sequitur* to infer from that the need for a rather drastic anti-inflationary program. Yet there seems to have been no dissent in the basic diagnosis of the continuing danger of inflation.[9]

There were differences in the second half of 1948 as to degree or as to control methods but not as to the nature of the disease. The misjudgment developed out of a series of factors that put the error in a more reasonable light. The fact that, almost a year after the beginning of the current downturn, there is still no consensus as to whether we are witnessing the same kind of downturn as the 1948–1949 recession or something more serious should incline us to be charitable toward the earlier experience. It merely confirms the validity of the Hegelian dictum, "Was wirklich ist, ist vernuenftig." This may be freely translated as "That which happens has a rational explanation." The cynic may retort that Freud taught us that the irrational, which also happens, has a rational explanation. But the error may be adequately explained by simpler, more obvious reasons than the dark subtleties of Freud and therefore is preferred by Occam's razor.

Through mid-1948 few would have said that the diagnosis of inflation was incorrect and that strong measures were not needed. I have already quoted a Federal Reserve statement made in August 1948. The business analyses of the period that I have read in the main took the same position. But increasingly after mid-1948 there were signs of a tapering off in the economy. Increasingly, skepticism grew with respect to inflationary pressures, particularly in the fourth quarter. I wrote a memorandum on September 21, 1948, to the Council with the title "No More Inflation in 1948." In dealing with the outlook for the next six to nine months, I wrote: "Since the end of price control in 1946, there have been three successive major waves of price increases, each subsequent wave diminishing in intensity . . . the outlook for the next six to nine months is for no further significant advance in over-all wholesale prices but rather for some slight downward trend. Subject to the qualification that no one at this point can predict the trend of armament expenditures or the crops of 1949, one can go further and state that the postwar inflation is over." Others, including some members of the Council staff, shared my view. It was based on three factors: the easing of supply in major markets; the divergence in trend between farm

[9] See Mr. Nourse's discussion of his role as chairman of the Cabinet committee for an anti-inflation program in November 1948. Nourse, *op. cit.*, p. 228 *et seq.*

prices and industrial prices on the one hand and between nondurables and durables on the other; and the obviously smaller degree of price rise in 1948 than in earlier years, although there were some exceptions. However, it is important to note the qualifications I added to my forecast.

But the enunciation of this view did not necessarily make it correct. It depended on a particular evaluation of the outlook, which happened to be correct although that could not have been known at the time. Moreover, certain important prices, particularly for metals and associated products, continued to advance through most of the fourth quarter.

There are, it seems to me, three major reasons that account for the failure to recognize the change in the economic climate: historical, international and budgetary, and political. These reasons would not all be considered applicable by all the major policy makers, nor am I sure to what extent they would accept any of them.

The influence of history lay in the continued frustration of the millennial expectation of an immediate severe downward readjustment. I have referred to this earlier. The sharp rise in prices in the second half of 1946 led in many quarters to the expectation of a downturn in 1947. (This was not, however, the position of the Council, which was optimistic although it recognized the unfavorable factors in the situation.) There was some hesitation in the pace of economic activity in the first half of 1947. But then there followed a new wave of inflation in the second half of the year. (Significantly enough, although its importance was not then fully appreciated, the intensity of this wave was considerably less than in the second half of 1946.) In February 1948 the break in farm prices took place. Surely, if the downturn were to come, this was the signal. (It was, but the reaction was delayed.)

On the contrary, after some delay a new and, as it subsequently developed, moderate price rise took place, sparked by a rise in steel prices. There were many efforts by business to keep prices down but these efforts increasingly failed, particularly as the third postwar round of wage increases got under way. By midyear the whole process seemed to be in full swing. These developments led to wrong interpretations. The repeated postponements of the expected decline created a false sense of security. Yet this danger too was recognized. The President's Economic Report of July 1948 warned: "I must emphasize that the course of inflation does not run according to any set schedule. Until the very eve of an economic collapse many people are apt to grow more and more confident about the soundness of the economy and the indefinite continuance of the boom." These were prophetic words indeed! But the same document saw the current danger to be still the strength of the inflationary pressures.

The second factor lay in the international and the budgetary realm. This was most significant for the situation at mid-1948. It will be recalled that 1948 was a year of great international tension. There was the setting up of a Greek Communist government. There was the Communist coup in Czechoslovakia. There was the problem of the outcome of the Italian election. There was the great conflict over Germany leading to the blockade of Berlin and the airlift, which began at the end of June. The great uneasiness of the period brought pressure for an expanded defense program, particularly for a much larger air force. How would these events affect government spending?

In addition to these potential influences on government policy a number of important actions were taken in the first half of 1948 that affected the budgetary picture for fiscal 1949. These were, as pointed out earlier: some step-up in defense spending; the adoption of the Marshall Plan; and, most important in its immediate impact, the $5 billion tax reduction made by the Republican Congress, overriding the veto of President Truman.

Thus federal government expenditures were to rise in the coming fiscal year at the same time that government receipts due to tax reductions were to decline. The net effect of these budgetary changes, as it was then estimated, brought about a decline in the federal cash surplus from $12.6 billion, annual rate, in the first half of calendar 1948, to $3.9 billion in the second half, a decline of $8.7 billion.

It should be remembered that in 1947 and the first half of 1948 the major defense against inflation had been substantial federal cash surpluses. Now this defense was being seriously breached. Even had it not been thought that the basic situation was still inflationary, a shift of this magnitude by itself would strike most people as creating substantial inflationary pressures.[10]

[10] Parenthetically, I might remark that the experience of the economy then in the face of the tax reduction and recently in the face of another tax reduction suggests that for effective countercyclical action against even minor changes in the trend, we must think in terms of net budgetary changes in excess of $10 billion. This, I suspect, applies when the action is taken by government at about the time private market forces are turning from expansion to contraction. If, however, government is able effectively to forecast the turning point well in advance and

Certain other factors connected with the fiscal 1949 budget were matters of concern at mid-1948. Although the expansion in the defense program would not have too much impact in fiscal 1949, it did provide for a rising trend over the next three years. This was important, because, as pointed out earlier, 1948 was generally regarded as a year when, with the economy at full capacity, expansion in real output must therefore be limited to a few per cent each year. Given the notion that the basic situation was still inflationary, any expansion in demand from the side of government would increase the degree of excess demand and therefore accentuate the inflationary situation.

Moreover, the new government measures would have disproportionate effect upon that sector of the economy which seemed most clearly to be working at capacity, viz. the metals sector. There was to be a step-up in the stockpiling program, and the direct defense and foreign aid programs would also put pressure on the supply of lead, copper, zinc, steel, and aluminum. There would be collateral effects on electric power and the general availability of consumer supplies. In mid-1948 it was estimated that the supply of steel outside certain essential categories would be less in fiscal 1949 than in fiscal 1948. Given the strategic importance of steel in the economy, a new spiral could, it was thought, easily develop. Witness the situation in early 1946 and that in early 1948. Some of the predicted consequences did take place in the second half of 1948, e.g. the rise in the prices of metals and associated products, but these events did not have a cumulative impact on the economy.

The consequences of a rise in government spending and the mounting pressure for an expansion in the defense program following the Berlin airlift led the then Chairman of the Council to advocate, in a widely discussed talk delivered at the Pentagon in November 1948, a $15 billion ceiling on defense spending compared with the then $11 billion of spending. The alternative, he warned, was an imposition of wartime controls to suppress the inevitably large inflationary pressures.

But however valid the position at midyear may have been, why was it maintained in January 1949 when, as mentioned earlier, the

takes action at the time of the forecast, smaller changes should suffice. But such a policy suffers from an obvious defect: it implies that government should appear to be following an inflationary policy at a time when the economy appears to be suffering too much from inflation. On the other hand, it would probably not be politically acceptable to advocate at least a $10 billion decline in the surplus (or increase in the deficit) at a time when the economy is turning down though the extent of the decline is still uncertain.

Council analysis clearly showed that weakening signs in the private economy were numerous? One plus factor was the estimated shift in the federal government's cash account from a surplus of $4 billion, annual rate, in the second half of 1948 to a slight deficit in calendar 1949. But this was not such a large factor in the face of the declining trend in other factors. There were, however, large uncertainties still about the international situation.

This leads to the third major factor that played a role: the political one. I do not mean that the Council played politics. It should be emphasized, however obvious it is, that poor forecasts leading to inappropriate policies are the poorest kind of politics. In politics, particularly, Oscar Wilde's dictum is most appropriate: "Nothing succeeds like success." The political factor is something more subtle and more fundamental. It raises one of the most difficult problems that confronts government. Its essence resides in the question, How quickly can government, having taken a position publicly, admit that circumstances have changed? As one member at that time of the Council put it to me, Can government change its position every time there is some minor change in the economy? Such minor changes are always occurring. Can government policy be shifted about month by month? Given the great uncertainties that exist, government must wait until it is clear that the situation has really changed. There is also an important technical consideration. To implement a policy takes a considerable period. There are three stages: formulation of a policy by the Administration, its acceptance by Congress, and its implementation by the Administration. There is thus always the danger that a conflict will arise between short-run changes and longer-run policy. But this underscores the need for better and better forecasts. Unfortunately, if policies are to be accepted, the current situation must plainly require them, but by that time the underlying factors may already be changing. This is an unresolved dilemma of democratic society.

One other aspect of this period should be covered: the inappropriateness of the proposed anti-inflation program, particularly the direct controls feature. The postwar inflationary problem, as I see it, was not to prevent a price rise but to prevent the development of a serious inflationary spiral. A postwar price rise was inevitable for a number of reasons: (1) By keeping prices down more successfully than incomes, the wartime system of controls had created a relationship between incomes and prices that was not viable for a full employment peacetime economy. (2) The deferred demands and accumulated purchasing power would inevitably impose upward pressure on prices. (3) The return to a normal workweek, the loss of overtime, and the chafing of the trade unions under wage controls meant pressure for higher wage rates. (4) Finally, overseas demand was abnormally great.

In my opinion, and with the advantage of hindsight, the only major way to mitigate the postwar price rise while keeping the economy fully employed would have been to continue price control through mid-1947. Another year of expansion in production would have brought the supply-demand relationships to the point where the subsequent price rise, while substantial, would not have been as great as that which actually took place. I mean, of course, a liberalized and looser type of price control than in wartime. This would have permitted moderate price and wage increases. If you will, I am suggesting a policy of controlled inflation as the appropriate anti-inflation control for the postwar period.

Once, however, price controls were dismantled, the only real alternative was a vigorous budgetary policy of accumulating cash surpluses. This was in fact the basic policy that was pursued, but it was largely accidental, thanks to the effects of inflation, and least significant in 1946 and 1947 when it was needed most. The surplus was largest when the need for it was declining, i.e. in 1948.

But consider the course of postwar inflation: before 1949 there were two short but vigorous spurts of inflation. By the time government could be prepared to deal with them, they were over. Any attempt to reconstitute a price control system was a will-o'-the-wisp policy because it could not be rebuilt on a short-time basis, and by the time the system could be reconstituted, the need for it was over. A price control system can only be justified, it seems to me, for war or near-war conditions where the period of the emergency is long enough and the nature of the emergency is serious enough to warrant such controls.

But even the policy of accumulating a budget surplus has dangers of its own. There is the danger, graphically illustrated by the previous discussion, of inflexibility in changing the course of action. It was very fortunate that Congress voted a $5 billion reduction when it did. It did not stave off the downturn but it helped to mitigate it. Its effects were offset to some extent by the credit controls imposed in the fourth quarter. The melancholy conclusion must be that we are still a long way from having developed the flexibility in our policies to meet adequately the short-run problems of inflation. We can deal with longer-run problems of inflation, but other difficulties arise.

There is, however, at least one optimistic conclusion which some have drawn from our postwar inflationary experience. This is the thesis that the degree of inflation has been remarkably moderate considering the strains that have been put upon the economy. Without the impact of war, our economy when operating with full employment would show remarkably little propensity to inflation. I have a great deal of sympathy with this thesis but its test is yet to come.

### THE SALIENT FEATURES OF THE DECLINE

The year 1949 was one of recession, although as pointed out earlier, the major impact on gross national product came in the first quarter while the second half of the year was primarily a leveling-off period. Let us now examine, still briefly, but in more detailed fashion, the salient features of that decline.

The percentage declines from respective peaks to respective bottoms for selected series were: GNP, 4; consumption, less than 1; consumers' durables, 5; nondurables, 3; gross private domestic investment, 32; producers' durables, 12; new construction, 8; total business sales, under 10; manufacturers' sales, 13; retailers' sales, 4; manufacturers' new orders, 18; total business inventories (book value), 7; manufacturers' inventories, 11; retailers' inventories, less than 4; industrial production, 10.5; manufacturing, 9; durable manufacturing, 13; nondurable manufacturing, 6. On the income side the percentage declines were: national income, 7; private wages and salaries, 5; personal income, 4; disposable income, under 4; personal savings, 71; corporate profits before taxes, 29. In prices the percentage declines were: all wholesale prices, 8; farm products, 22; processed foods, 14; industrial prices, 5; consumers' prices, 4; retail food prices, 10. (See Table 2 for additional details.)

Unemployment averaged slightly over 2 million in 1948 or 3.4 per cent of the civilian labor force, 3.2 million in the first half of 1949 or 5.2 per cent, 3.6 million in the second half of 1949 or 5.7 per cent, and 3.9 million in the first half of 1950 or 6.2 per cent. In February 1950 it reached 4.7 million or 7.6 per cent of the civilian labor force. Non-agricultural employment declined about 3.1 million or about 6 per cent between August 1948 and May 1949. The decline in manufacturing employment was 1.8 million or 11 per cent between September 1948 and July 1949. (These figures are not seasonally adjusted.)

Since this was an inventory recession, let us look more closely at what happened in that area. The bulk of the change in inventories

TABLE 2

Peaks and Lows of Selected Economic Indicators in the 1948–1949 Recession

| *Indicator* | *Peak Level* | *Low Point* | *Per Cent Decline* | *Peak Period* | *Low Period* |
|---|---|---|---|---|---|
| Gross national product (billions quarterly) | $267.0 | $256.8 | 3.8% | 4Q '48 | 4Q '49 |
| Consumption | 179.8 | 178.7 | .6 | 4Q '48 | 1Q '49 |
| Durable goods | 23.5 | 22.4 | 4.7 | 3Q '48 | 1Q '49 |
| Nondurable goods | 101.4 | 98.1 | 3.3 | 3Q '48 | 2Q '49 |
| Gross private domestic investment | 45.7 | 31.0 | 32.2 | 4Q '48 | 4Q '49 |
| New construction | 18.2 | 16.8 | 7.7 | 3Q '48 | 2Q '49 |
| Producers' durable goods | 20.7 | 18.2 | 12.1 | 4Q '48 | 4Q '49 |
| Change in business inventories—total | 7.2 | −5.4 | — | 4Q '48 | 4Q '49 |
| Nonfarm only | 5.6 | −4.2 | — | 4Q '48 | 4Q '49 |
| Government purchases of goods and services | 44.5 | 40.3 | 9.4 | 2Q '49 | 2Q '50 |
| Federal | 26.6 | 20.4 | 22.3 | 2Q '49 | 3Q '50 |
| National income (billions) | 229.7 | 212.7 | 7.4 | 4Q '48 | 4Q '49 |
| Wages and salaries | 138.1 | 132.8 | 3.8 | 4Q '48 | 3Q '49 |
| Private | 118.3 | 112.0 | 5.3 | 4Q '48 | 4Q '49 |
| Farm income | 18.8 | 11.8 | 35.2 | 2Q '48 | 4Q '49 |
| Corporate profits before tax | 34.8 | 24.7 | 29.0 | 3Q '48 | 2Q '49 |
| Corporate profits after tax | 21.3 | 14.8 | 30.5 | 3Q '48 | 2Q '49 |
| Disposable income | 193.0 | 186.1 | 3.6 | 3Q '48 | 3Q '49 |
| Personal saving | 13.3 | 3.9 | 70.7 | 3Q '48 | 4Q '49 |
| Total business sales (billions monthly) | 37.1 | 33.5 | 9.7 | Aug. '48 | Dec. '49 |
| Manufacturers' sales | 18.0 | 15.6 | 13.3 | Sept. '48 | Dec. '49 |
| Durable | 8.1 | 6.3 | 22.2 | Dec. '48 | Oct. '49 |
| Retailers' sales | 11.1 | 10.7 | 3.6 | Dec. '48 | Jan. '49 |
| Durable | 3.7 | 3.3 | 10.8 | Dec. '48 | Jan. '49 |
| Total business inventories (book value, billions monthly) | 55.8 | 52.1 | 6.6 | Feb. '49 | Dec. '49 |
| Manufacturers' | 32.1 | 28.7 | 10.6 | Feb. '49 | Nov. '49 |
| Durable | 16.2 | 13.9 | 14.2 | Feb. '49 | Nov. '49 |
| Retailers' | 15.8 | 15.3 | 3.2 | Dec. '48 | June '49 |
| Durable | 6.8 | 6.4 | 5.9 | Feb. '49 | Dec. '49 |
| Manufacturers' new orders (billions monthly) | 18.4 | 15.0 | 18.5 | June '48 | July '49 |
| Durable goods industries | 8.2 | 5.9 | 28.0 | June '48 | July '49 |
| Manufacturers' unfilled orders (billions) | 29.8 | 20.0 | 32.9 | Aug. '48 | Aug. '49 |
| Durable goods industries | 26.2 | 17.6 | 32.8 | Aug. '48 | Sept. '49 |

(continued on next page)

TABLE 2 (continued)

Peaks and Lows of Selected Economic Indicators in the 1948–1949 Recession

| *Indicator* | *Peak Level* | *Low Point* | *Per Cent Decline* | *Peak Period* | *Low Period* |
|---|---|---|---|---|---|
| Index of industrial production | | | | | |
| (1947–1949 = 100) | $105.0 | $94.0 | 10.5% | Oct. '48 | July '49 |
| Manufacturers | 104.0 | 95.0 | 8.7 | June '48 | May '49 |
| Durables | 107.0 | 93.0 | 13.1 | Oct. '48 | May '49 |
| Nondurables | 103.0 | 97.0 | 5.8 | Nov. '47 | Apr. '49 |
| Index of wholesale prices | | | | | |
| (1947–1949 = 100) | 106.2 | 97.7 | 8.0 | Aug. '48 | Dec. '49 |
| Farm products | 113.4 | 88.8 | 21.7 | Jan. '48 | Jan. '50 |
| Processed foods | 109.4 | 94.0 | 14.1 | Aug. '48 | Jan. '50 |
| Industrial | 105.5 | 99.8 | 5.4 | Nov. '48 | July '49 |
| Index of consumers' prices | | | | | |
| (1947–1949 = 100) | 104.8 | 100.4 | 4.2 | Aug. '48 | Feb. '50 |
| Food | 107.3 | 96.5 | 10.1 | July '48 | Feb. '50 |
| Index of spot market prices | | | | | |
| (1947–1949 = 100) | 113.5 | 77.6 | 31.6 | June '48 | June '49 |

Note: Price indexes and unfilled orders are not seasonally adjusted. Where the series reached a peak or low more than once, the first period was selected.

was in the manufacturing field both in terms of book values and even more so after allowing for the inventory valuation adjustment. In fact, after allowance for the IVA, there was virtually no change in retailers' real inventories between 1948 and 1949, and an actual increase for wholesaling.

In manfacturing, two-thirds of the decline was accounted for by the durable goods segment. The largest drops took place in the fabricating industries, particularly machinery and motor vehicles and equipment. In nondurables, textiles and chemicals showed important drops. By stage of fabrication, the greatest relative drops were in purchased materials and goods in process. Finished goods inventories evidenced little drop. It is, however, interesting to point out that in 1947 and 1948 the greatest relative gains were in finished goods inventories (see Table 3).

To a large extent, the relative stability of finished goods inventories during the recession is accounted for by the fact that as supply becomes easy the customer shifts the burden of carrying the inventory to the supplier. The latter, to be able to ship promptly, therefore accumulates inventories. In the battle for sales, the order will go to the supplier who can, other things being equal, deliver the most promptly. To some extent also, the relative stability of finished goods inventories is accounted for by the unwillingness of the producer to dump goods on the market and by his inability to cut production fast enough to offset the decline in sales.

TABLE 3

Declines in Book Value of Manufacturers' Inventories, February 1949–November 1949

(*dollars in billions*)

| *Category* | *Dec. 1948 Level* | *Dec. 1949 Level* | *Dollar Decline* | *Per Cent Decline* |
|---|---|---|---|---|
| All manufacturing | $32.1 | $28.7 | $3.4 | 10.6% |
| Durable goods industries | 16.2 | 13.9 | 2.3 | 14.2 |
| Fabricated metals | 1.8 | 1.5 | .3 | 16.7 |
| Electrical machinery | 1.9 | 1.5 | .4 | 21.1 |
| Machinery (except electrical) | 3.6 | 3.2 | .4 | 11.1 |
| Motor vehicles and equipment | 2.1 | 1.6 | .5 | 23.8 |
| Other durables | 6.8 | 6.1 | .7 | 10.3 |
| Nondurable goods industries | 15.8 | 14.9 | .9 | 5.7 |
| Food | 2.7 | 2.6 | .1 | 3.7 |
| Textile mill products | 2.2 | 2.0 | .2 | 9.1 |
| Paper and allied products | .8 | .7 | .1 | 12.5 |
| Chemicals and allied products | 2.2 | 2.0 | .2 | 9.1 |
| Petroleum and coal products | 2.4 | 2.2 | .2 | 8.3 |
| Other nondurables | 5.5 | 5.4 | .1 | 1.8 |
| State of Manufacturing | | | | |
| All industries | | | | |
| Purchased materials | $13.0 | $11.1 | $1.9 | 14.6% |
| Goods in process | 7.7 | 6.7 | 1.0 | 13.0 |
| Finished goods | 11.6 | 10.8 | .8 | 6.9 |
| Durable goods industries | | | | |
| Purchased materials | 5.9 | 4.6 | 1.3 | 22.0 |
| Goods in process | 5.4 | 4.6 | .8 | 14.8 |
| Finished goods | 5.0 | 4.4 | .6 | 12.0 |
| Nondurable goods industries | | | | |
| Purchased materials | 7.2 | 6.5 | .7 | 9.7 |
| Goods in process | 2.2 | 2.1 | .1 | 4.5 |
| Finished goods | 6.6 | 6.3 | .3 | 4.5 |

Note: Stage of manufacturing series not adjusted for seasonal variation.

The chronology of 1949 goes as follows: Retail sales reached their low point in January and for the rest of the year fluctuated within a narrow range. Total consumption and consumers' durables reached their low points in the first quarter and thereafter rose. In the second quarter, housing starts began to shoot up very markedly although the low point for construction was in the second quarter.

Construction then moved only slightly in the third quarter and thereafter rose vigorously. The second quarter also saw the low point of corporate profits before taxes, but the recovery in the second half was only moderate. In April, nondurable manufacturing reached its low; it bumped along at that level until September, when it rose moderately. In May, total manufacturing and durables reached their lows, but they did not rise until September. The steel strike interfered with the upward movement in the fall but undoubtedly boosted the vigor of the recovery in the first half of 1950. In June, retail inventories reached their low point; thereafter they rose, especially the durables.

The third quarter witnessed further turnarounds. New orders bottomed in July, thereafter turning up again. Unfilled orders reached their low in August and rose gradually for the rest of the year. Industrial prices reached a low in July and were virtually unchanged for the rest of the year. They rose moderately in the first half of 1950. Personal income bottomed in the third quarter and rose slightly in the fourth.

The fourth quarter saw the low points for GNP, gross private domestic investment, total business and manufacturing inventories, total business and manufacturing sales, national income, private wages and salaries, personal savings, industrial production, and wholesale prices. Wholesale farm and processed food prices reached their low point in January 1950, all consumers' prices and retail food prices in February 1950.

Unemployment increased steadily from October 1948 to July 1949, declined thereafter until December although remaining well above 1948, rose sharply in the first quarter of 1950, and then declined substantially.

Government purchases of goods and services rose steadily throughout 1948 and the first half of 1949. They then declined steadily and moderately through the second quarter of 1950. Thus, while the private economy was declining, the government sector was rising, and when the private sector began to recover, the government sector began to decline.

Certain government actions in 1949 had an important bearing on economic developments. In March and April the Board of Governors of the Federal Reserve System eased consumer credit control, lengthening permissable lending periods and reducing the scope of this control. On June 30 Regulation W expired.

At the end of March, stock margin requirements were reduced from 75 to 50 per cent. At the end of April and again in August, reserve requirements were lowered, more than wiping out the previous increases. Certain actions were also taken in the housing field; these actions provided federal aid to localities for low income housing, increased the amount of mortgages that could be bought by the government from $1 billion to $1½ billion. This led to substantial purchases and aided the market for housing. In addition, during fiscal 1950 the government distributed about $2.6 billion in National Service Life Insurance dividends.

The process of decline was substantially over by midyear. The recovery was initiated by the consumer sector of the economy and by that part of investment connected with consumers, i.e. housing. The business sector of the economy, producers' durable and inventory accumulation, lagged behind. This raises the interesting question of what the recession would have looked like had there been no Regulation W to inhibit the use of installment credit and no increase in reserve requirements which probably tightened funds for residential housing.

### THE RESPONSE OF GOVERNMENT TO THE RECESSION

Unlike its poor record in diagnosing the turning point in the economy, the record of government was very good during this phase of the recession. I have already quoted from the Council's April 1949 Quarterly Report to the President. In the mid-1949 Report by the Council, there was a generally optimistic note about the outlook and the capacity of the economy to work its way out of the recession. The factors of strength which bred this confidence were: the orderly character of the readjustment; the fact that consumption was outrunning production, which meant that production would have to rise to be in balance with recent sales; coupled with the last item, the sales success which attended aggressive merchandizing efforts; the strength displayed by housing starts; the relatively favorable level of investment; the ample character of bank credit and the contribution of government through its budget expenditures, unemployment compensation, and other built-in stabilizers.

But the future was not wholly assured. The downturn had not yet been reversed (as of June 1949), and there was always the danger that public confidence might become impaired, leading to a panicky downward spiral. On this the Council said: "The weight of evidence as we see it does not support so gloomy an outlook. But we may still face an unsatisfactory alternative. While the decline may be halted or even reversed, a satisfactory expansion might not follow. Our real need is for industrial production not only to rebound to the level of present consumption but also for both production and consumption to continue to rise sufficiently to absorb a labor force which is both growing in size and increasing in productivity per man."

As aids to recovery, the Council laid great stress on proper price and wage adjustment, on the recognition by business of the need to maintain a high rate of investment, and on the maintenance of government spending without any attempt to raise taxes to balance the budget. The President presented a program which was in sharp contrast to his anti-inflationary program. It proposed measures to strengthen purchasing power by improving the unemployment compensation system, to improve social security, to encourage advance planning of public works, to increase the minimum wage, to improve farm supports, to improve the tax system without any major increase in taxes, and to promote foreign aid and trade.

The response of government to the recessionary phase was good. It saw the root cause in the liquidation of inventories; it saw from the behavior of markets that this was being done in an orderly fashion; and it concluded that there would not be a serious downturn. The downturn, it was believed, could be handled primarily by market forces; or, to put it differently, market forces should be given the major responsibility for the time being to work out the readjustments. These worked out about as anticipated.

### *Lessons of the Experience*

It would be pleasant if we could prescribe a simple method for avoiding the difficulties of the kind of period I have been describing. But that experience can easily happen again. It is true that better forecasting will be helpful, if we are able to devise such improvements. But that happy day is still a long way off. The era of scientific forecasting is still ahead of us. Until then our knowledge will have to be supplemented by the judgments, intuitions, and general good sense of those charged with making basic decisions.

The problem lies deeper than the improvement of scientific method. It is nothing less than the problem of historical development. Let me put it this way: Has our postwar economy taken on a significantly new character that renders it less susceptible to the likelihood of severe fluctuations? While my feeling is that it has, I would be hard put to justifying it, for the definitive answer to such a question always lies ahead. Even if we could answer definitively that the economy, *qua* economy, is hardier and more shock-resistant than in the past, the fact is that we are living in a world where international developments have had and will continue to have major repercussions on the economy. How can these contingencies be provided for?

The review of the 1948–1949 episode makes clear certain basic difficulties. In the first place, there is the inflexibility which tends to be built into a position publicly taken by government. As I have said earlier, it is a fundamental question as to how rapidly a government can change its position. Governments like to appear in firm command of the situation, and nothing would weaken that appearance more than frequent changes in position. It is no answer to say that government should not take a position—it must do so. The whole machinery of government grinds too slowly for changes to be made quickly. Even in emergencies where basic changes in policy can be taken quickly, the implementation is frequently agonizingly slow.

Another basic difficulty lies in the confusion of short-run with long-run problems. I think it is fair to say that, on the whole, we have not really been able to develop any satisfactory short-run policies other than our built-in stabilizers. The advocates of monetary policy may disagree on this point, but I am not personally convinced. The non-automatic types of policies we can formulate are basically longer-run in their implications. The postwar spurts of inflation have been extremely short-run in character. The result has been that by the time a program can be put into effect, a new situation has emerged. But this problem is really a facet of the problem I earlier posed: What is the long-run character of our new economy?

The public and Congress are generally aroused by short-run situations. The government, under pressure, can only propose to kill flies with heavy artillery. This is an exaggeration, of course, but the essence is correct.

The answer must lie in the continual improvement of basic long-range policies on the part of government, business, labor, and the public generally. The better those policies are—and they have been improved—the less significant may become the short-range fluctuations.

The above discussion has concentrated on the problems of inflation. The experience of 1948–1949 does not provide much of a clue to the capacity of the economy and government to handle the more serious problems of recession. It does indicate, however, that once the problem was recognized, government proved to be quite flexible in readjusting its policies. The policies proved to be adequate mainly because of the inherent strength of the economy. But that raises another question: Had the downturn proved more serious than it actually was, would the response of government have been adequate? It is to be hoped that it would have been, but the 1948–1949 recession throws little light on that question.

## COMMENT

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Caplan accepts the majority opinion among American economists that 1948–1949 was entirely an inventory depression or "Kitchin" cycle, and a mild one at that. Minority opinion in this country, expressed for example by Daniel Hamberg,[1] ascribes the recession largely to underconsumption. But this, I believe, is the majority view in Britain and elsewhere in Europe, and I wish Caplan had said a little more about it.

My personal analysis is a compromise one, which seems to fit the current (1953–1954) recession as well as the 1948–1949 recession, which is under discussion. I believe with the underconsumptionists that we should go beyond the record of accumulation and decumulation of business inventories to its cause, and that in general we can find the cause in the changing rate of growth in aggregate personal consumption. But I believe with the orthodox that the recession cannot be traced yet further back, to any shortage in purchasing power. For, indeed, consumption seems to have recovered without the stimulus of massive additions of purchasing power, and apparently only because the temporary satiety of 1948–1949 wore itself off. Perhaps the recovery came about because consumers' own inventories of soft goods were exhausted. Would it be amiss to combine the two strands of thought (inventories and underconsumption) to suggest that perhaps in this case at least we may have a fluctuation explainable in terms of inventories, yes, but of consumer rather than business ones?

The figures which lead to this viewpoint are presented on the next page. They are from the 1954 National Income Supplement to the Department of Commerce *Survey of Current Business*. The

[1] Daniel Hamberg, "The Recession of 1948–49 in the United States," *Economic Journal*, March 1952, pp. 1–14, and "1948–49 Recession Re-examined: A Rejoinder" (to Bratt and Ondrechen), *ibid.*, March 1953, pp. 104–110.

quarterly figures are seasonally adjusted, and at annual rates in billions of current dollars. Note how the rate of change in consumption leads the inventory cycle downward and again upward by two or three quarters.[2]

| Year and Quarter | GNP (gross of inventory accumulation) | Investment (gross of inventory accumulation) | Consumption | Increase in Consumption | GNP (net of inventory accumulation) | Investment (net of inventory accumulation) | Inventory Accumulation |
|---|---|---|---|---|---|---|---|
| 1948— I | 247.9 | 38.6 | 174.1 | 3.4 | 244.9 | 35.6 | 3.0 |
| — II | 255.5 | 41.2 | 176.8 | 2.7 | 251.2 | 36.9 | 4.3 |
| —III | 261.9 | 42.5 | 179.5 | 2.7 | 257.5 | 38.1 | 4.4 |
| —IV | 264.0 | 42.4 | 180.1 | .6 | 259.1 | 37.5 | 4.9 |
| 1949— I | 259.9 | 37.0 | 178.4 | −1.7 | 258.4 | 35.5 | 1.5 |
| — II | 257.2 | 32.1 | 180.4 | 2.0 | 260.3 | 35.2 | −3.1 |
| —III | 256.5 | 32.0 | 180.1 | −.3 | 259.5 | 35.0 | −3.0 |
| —IV | 255.5 | 29.1 | 183.5 | 3.4 | 261.8 | 35.4 | −6.3 |
| 1950— I | 264.9 | 39.9 | 185.2 | 1.7 | 262.4 | 37.4 | 2.5 |
| — II | 275.9 | 49.0 | 189.1 | 3.9 | 268.6 | 41.7 | 7.3 |
| —III | 294.4 | 53.4 | 202.9 | 13.8 | 289.6 | 48.6 | 4.8 |
| —IV | 305.0 | 62.6 | 198.8 | −4.1 | 290.3 | 47.9 | 14.7 |

In addition to consumption and its growth rate, I wish Caplan had given more attention to two other factors. One is international

[2] It is interesting to compare corresponding figures for the 1953–1954 recession. The pattern seems quite similar to that of 1948–1949.

| Year and Quarter | GNP (gross of inventory accumulation) | Investment (gross of inventory accumulation) | Consumption | Increase in Consumption | GNP (net of inventory accumulation) | Investment (net of inventory accumulation) | Inventory Accumulation |
|---|---|---|---|---|---|---|---|
| 1952—IV | 358.5 | 54.4 | 225.3 | 7.1 | 351.0 | 46.9 | 7.5 |
| 1953— I | 361.8 | 51.9 | 228.6 | 3.3 | 359.0 | 49.1 | 2.8 |
| — II | 369.9 | 55.9 | 230.8 | 2.2 | 364.5 | 50.5 | 5.4 |
| —III | 367.2 | 52.4 | 231.2 | .4 | 365.2 | 50.4 | 2.0 |
| —IV | 360.5 | 45.5 | 229.7 | −1.5 | 364.7 | 49.7 | −4.2 |
| 1954— I | 355.8 | 44.5 | 230.5 | .8 | 360.0 | 48.7 | −4.2 |
| — II | 356.0 | 45.6 | 233.1 | 2.6 | 359.8 | 49.4 | −3.8 |
| —III | 355.5 | 45.3 | 234.8 | 1.7 | 360.3 | 50.1 | −4.8 |
| —IV | 362.0 | 49.5 | 237.7 | 2.9 | 363.3 | 50.8 | −1.3 |

Among writers using change in consumption as an economic forecaster (and therefore implicitly as a causal factor in their cycle theories) I am impressed particularly by Stahrl Edmunds, "Plant Capacity: Too Much or Too Little?" *Harvard Business Review,* vol. 30 (July–August 1952), pp. 82–85. Edmunds' key variable is the short-term inter-temporal marginal propensity to consume, or (change consumption)/(change in income). He interprets changes in this variable from quarter to quarter as expressing changing "willingness to consume."

trade—in particular, the course of United States exports. The other is public fiscal policy. There was a $5.5 billion increase in 1949 expenditures over 1948, with a $9 billion decline in aggregate surpluses, which may have been instrumental in bringing about recovery. I share what I believe to be Caplan's doubts that these are the crucial pieces of the puzzle, but it seems necessary to dwell on them if one is to meet squarely the opinion of the man on the street, particularly on the left side of the street. The majority of the thinking public, certainly abroad and perhaps also at home, believes the 1948–1950 recession was caused by cuts in exports and military spending, and believes it was cured by the revival of exports and military spending. The public is largely unaware of the recovery that occurred in the first half of 1950, and believes implicitly that the recession would have become a major depression but for the Korean war. One cannot combat fallacies so widespread as these by ignoring them.

Caplan's discussion of the federal government as forecaster and adviser relies heavily on a few selected excerpts, not all published, mainly from the Council of Economic Advisers. These selected excerpts indicate that someone in the Council was right all the time. The staff (but not the three Council members) forecast the recession correctly. The Council members (but not the staff) called the turn on the recovery. What follows from this? With selected excerpts, one can prove almost anything, and sellers of forecasting services often do just that in reconstructing their past records. It would have been more interesting (at least to this reader) had Caplan compared the over-all forecasting record of the government (or of the Council) with the records of some of the private forecasting agencies, particularly those that were right when official Washington was wrong in 1946–1947.

It is less easy to agree with Caplan on the general conclusions he draws from the 1948–1949 episode than on his analysis of the episode itself. He is correct when he ascribes the mildness of the recession largely to fortuitous circumstances (like the Eightieth Congress tax cut and the pent-up demand for housing). He is also correct in his belief that recovery came about as rapidly as one could have hoped from monetary and fiscal policy (indirect controls). But his resulting skepticism regarding indirect controls in general, in both inflation and recession, needs somewhat more support to be acceptable.

Caplan uses $10 billion as the minimum year-to-year budgetry change that can be effective in the short period. If the figure really is that large, fiscal policy against an economic recession is like the proverbial peashooter against a tank. But I wonder whether Caplan is not neglecting multiplier effects in setting so large a figure. Perhaps the target figure might be set as $10 billion, to be reached within approximately a year by the operation of the multiplier process. Furthermore, if sufficient powers are delegated to monetary and fiscal authorities, either fully discretionary or limited by statistical indexes, the authorities can act more quickly than Caplan implies, and likewise reverse themselves more quickly if they go too far. This is not to say that they always *will* act promptly and reverse themselves promptly—but merely that they *can* and *may.*

The 1946–1948 inflation came in three short spurts, as Caplan says, but could not the last two of these have been choked off in advance had the Board of Governors of the Federal Reserve System been granted wider controls over primary and secondary bank reserve ratios, and had the Board not been committed to support of the government security markets? As to the Korean war boom, the tight-money policies of 1953 came too late to check it when it should have been checked, and it is fashionable to make fun of these policies in the light of the subsequent recession.[3] But would Caplan go so far as to deny that these same measures might not have done some good if they had been introduced during the fall and winter of 1950–1951? (Incidentally, the rapidity of their reversal during 1953 belies Caplan's thesis that reversals always come too late.)

Caplan's iconoclastic strictures against depression controls are correct for those controls which require detailed Congressional legislation to implement them, or the recruiting of large staffs to administer and enforce them. Price control and rationing, for example, seem to fall under Caplan's ban, unless they are to become permanent features of our economy. But whether monetary and fiscal policy fall likewise under the ban depends not on their nature but on the power which Congress chooses to delegate to administrative agencies and on the agencies' ability to use it with wisdom and with consistency.

Caplan does not spell out his objections to the thesis of secular inflation, although it is perfectly clear that he objects to it. This thesis is that our pressure-group-dominated "New Political Economy" lets prices rise when times are good, and then keeps them from falling to anything like the same extent when times are bad. The 1948–1949 recession is often cited as a case in point, but Caplan

[3] See, for example, Bertram Gross and Wilfred Lumer, *The Hard Money Crusade,* Public Affairs Institute, 1954.

shows that the support of the price level during the recession was fortuitous rather than intentional. In this he is correct, and he has made a contribution to our understanding of the cycle. But unless I misunderstand him, he does not deny that support would have been forthcoming fairly early in 1950 had it been required to keep the price level up. Nor does he deny that the business, agricultural, and labor communities were counting on such support in some form (just as they seem to be counting on it again in 1954). These potential matters are fundamental to the secular inflation thesis, perhaps as much as the actual record of prices and price movements.

I may be another of the economic sheep whom Caplan decries, but despite his objections I remain convinced that the trend of the American price level will continue upward for good or ill, until the New Political Economy is supplemented either by the Old or by some Newer Political Economy which includes some forthright redistributionism of a quasi-Socialist variety to keep wage and farm price increases from passing through to the consumer level.

WESLEY LINDOW, Irving Trust Company

Caplan's use of statistics in analyzing the 1949 recession raises a number of questions.

Should public policies of the past be judged on the basis of revised statistics only or also on the basis of data actually available to public officials at the time? Revisions in both gross national product and industrial production tend to show smaller declines in 1949 than the original figures indicated.

Caplan does not use industry statistics which were available for analytical purposes at the time, and which have not been extensively revised. Public officials must have been reassured by the fact that steel production rose successively in January, February, and March 1949 to new all-time highs, and by the fact that automobile production continued to rise to record levels well into the summer of 1949.

On the other hand, a slowing up of the rate of growth in certain aggregate figures might have suggested to public officials the possibility of emerging economic weakness even in 1948. For example, business loans of reporting banks were running 25 per cent ahead of 1947 in the early part of 1948, but by the end of 1948 were running only a few percentage points above the corresponding months of 1947, and early in 1949 began to show actual declines in comparison with the figures of the year before. The trend here gave some early suggestion of changing inventory momentum. Similarly, employment figures also indicated some weakening momentum in 1948. The average workweek declined in the fore part of 1948 and then leveled out in the latter part of the year when it usually rises seasonally.

The statistics cited by Caplan on saving are incomplete and point to misleading conclusions. It is true that personal saving as a whole rose sharply in 1948 as compared with 1947, which led to Caplan's conclusion that consumers were saving more. A breakdown of the saving figures, however, indicates that the entire change was due to business (unincorporated and farm) saving, which is included in the personal saving aggregate. Nonbusiness saving was 3.3 per cent of disposable income in 1947 and 3.4 per cent in 1948, indicating virtual stability.

Even if perfect forecasting were possible, should government endeavor to forestall minor corrections like the 1949 downturn? The arguments in favor would presumably hinge on the basic point that preventative action might keep a small recession from cumulating into a big depression. The arguments against would be concerned with the need, first, to let natural market forces come into play to permit corrective actions to take place in the interest of stronger markets, and, second, to let downswings in prices counteract upswings in order to avoid a cumulative upward trend over a long period of time.

With regard to the potentialities of central banking I am much more hopeful than Caplan. Monetary action is no panacea, but I believe that it can play an important role in conjunction with such other activities as fiscal policy and debt management.