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RESEARCH REPORTS

COMING EFFECTS OF CURRENT EVENTS

How May the Next Depression be Different?

Although the several major booms during the Nation's history have had much in common, each has differed from the others in some important respects. The principal differences have been important because in successive instances they have fostered the widespread illusion that a severe depression could not occur. The unsoundly based optimism thus engendered usually has encouraged speculation and excessive expansion with borrowed funds; consequently, the subsequent depressions have been even more serious than they otherwise might have been.

A striking example is provided by the boom in the late 1920's and the severe depression that followed. The major boom that immediately preceded was characterized by extreme speculation in commodities during 1919 and 1920. The accompanying upward movements of commodity prices were great, and the subsequent declines during the depression were equally noteworthy. Therefore, it is not surprising that the leveling-off of commodity prices from 1922 to 1929 was widely accepted as proof that a "new era" of permanent prosperity had arrived. Because the most striking feature of the previous major boom was not repeated, other less apparent but fundamentally more important similarities were disregarded.

Speculation in real estate frequently has been a characteristic of major booms. Earlier in the Nation's history the western lands that successively became available to settlers played a part in various real-estate booms, and the Florida land boom during the 1920's was the latest noteworthy example. By 1928 and 1929, however, speculation in securities reached such vast proportions as to overshadow the earlier speculation in Florida land and became the most memorable feature of the boom.

Just as the decline in commodity prices was an outstanding feature of the 1921 depression, the decline in security prices was a striking feature of the depression that began in late 1929. It happened that the speculation in securities of the later 1920's was of extreme proportions. One must search the records for 200 years in order to find a similar speculation of such great magnitude. In the early 1700's the Mississippi Bubble in France and the South Sea Bubble in England were comparable to the great stock-exchange boom of 1929. But in spite of the fact that such extreme speculation in securities has been so rare an accompaniment of business booms, many observers today cite the lack of speculative enthusiasm for stocks as one reason for believing that the situation is so different from the boom years of the 1920's that at worst there can be only a minor recession.

Some Changes for the Better

To some extent, we should agree with those who are optimistic about the present situation and probable future developments. For example, with reference to stock prices generally, we see no reason to fear such cataclysmic declines as those from 1929 to 1932 when the stocks of many leading companies decreased to less than 10 percent of their peak values. Unless extreme speculation in securities does occur before the end of the boom, we fear no such aftermath. This is not to deny that severe but much less extreme declines are of course well within the range of probable developments.

Moreover, there seems not to have been, as yet, speculation in real estate comparable to the Florida boom or the real-estate speculation that featured so many earlier periods of great prosperity. Possibly this time the Canadian boom will prove to have been the nearest approach to a frenzy of land speculation.

Also worth mentioning is the fact that the banks apparently have not been made vulnerable by widespread speculation in land and securities and the banks have been strengthened by the insurance of bank deposits. Consequently, the commercial banks are in a less vulnerable position than that characteristic of earlier major booms. Widespread bank failures, which had long been a feature of major depressions in the United States, may not occur during the next depression.

Finally, the important part played by the Federal Government as tax collector and consumer is markedly different, in degree, from its role during previous periods of boom prosperity. Conceivably, Government-induced inflation could more or less counterbalance substantial deflation in the private-business sector of the economy. At anything like the present level of Government spending, such an inflationary counterbalance might result from a marked reduction in tax collections rather than the initiation of new spending programs.

Credit Expansion Limits

For readers of our bulletins, there presumably is no need to emphasize that the present business boom, like all others in the Nation's history, has been made possible by an inflationary expansion of credit. An important factor influencing the duration of the booms has been

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the extent to which such inflationary credit expansions could have been or were permitted to be carried.

In the days of "wildcat" banking, prior to the establishment of the national banks in 1863, the credit expansion was limited in some instances by State laws; but in many instances the only limit was the greed of the bank managers or the gullibility of their depositors and the holders of their banknotes. The expansion possibilities of the national banks were limited by rule-of-thumb reserve requirements that virtually assured a financial panic as the terminal feature of every boom. When the limits of expansion were reached in relation to the reserves held, the bankers could lend no more and the enthusiastic borrowers whose activities made possible the rapid expansion of business activity were forced to stop, usually with devastating results for those whose marginal borrowing operations had been least conservative.

When the Federal Reserve System was under discussion in Congress, its proponents fully understood its great credit-expansion possibilities. In one of the outstanding speeches on the bill,[1] Elihu Root pointed out that "* * * a crash inevitably comes from the kind of process that easy money produces," but his and other similar warnings were heeded only to the extent of adopting certain rule-of-thumb reserve requirements that would place a limit on the credit-expansion possibilities of the commercial banks under the Federal Reserve System.

In 1920 the expansion limits of the Federal Reserve System were reached; consequently, the actions that resulted in the subsequent deflation of bank credit were virtually forced on the Federal Reserve Board. In 1928 and 1929, on the other hand, the limits of credit expansion were not even approached; but the extreme speculation in securities was such an obvious warning signal that the Board of Governors of the Federal Reserve System could not ignore the situation. Actually, they never were *forced* to act as they had been forced to deflate in 1920-21; the great speculative boom collapsed after a moderate rise in interest rates, and the liquidation of unsound marginal speculations in real estate and business as well as securities constituted the deflationary aftermath of the boom.

In 1945 the reserve ratio required of the Federal Reserve banks was greatly reduced, and this with other changes increased the expansion possibilities of the System by roughly 60 percent. At present the actual reserve ratio of the Federal Reserve banks is the same as it was in late 1919 when they were practically forced to deflate, but the change in the reserve ratio required leaves them free to expand credit much more (unless the recent gold outflow increases markedly).

Judging by recent actions of the Federal Reserve Board, that agency seems unlikely to *force* deflation unless circumstances beyond its control make any other course virtually impossible. If foreign holders of deposits in this country and other dollar assets choose to convert them to gold, the resulting outflow could be so great that the Federal Reserve Board would feel obligated to force deflation. This development is a possibility that should not be ignored; but what if it does not occur, might substantial deflation be initiated by other developments?

Three Doubtful Sectors

Obviously there is no vulnerable speculative position pyramided on a margin basis in the stock market as in 1929; nor has there been extreme speculation on borrowed funds in commodities as in 1920; nor is there anything like the Florida land boom in the Nation today. However, there are three sectors of the economy where inflationary credit expansion may have reached or soon may reach dangerous proportions.

Inventories of manufacturers, wholesalers, and retailers reached the unprecedented total of $77,300,000,000 a few weeks ago and had expanded by $4,800,000,000 in the preceding 12 months. An unknown portion of these inventories has been financed by inflationary bank credit in recent years as the total has risen from the 1949 low of $51,500,000,000.

Real-estate loans have increased from $37,000,000,000 just prior to World War II to nearly $100,000,000,000, and the commercial banks have provided about $12,000,000,000 of the gain in the form of inflationary credit expansion.

Consumer loans likewise have increased greatly from about $9,000,000,000 in 1941 to nearly $28,000,000,000 today. Of the increase, the commercial banks have provided about $8,000,000,000 in the form of inflationary credit expansion.

The precise total of private inflationary credit expansion (as differentiated from the monetization of Federal deficits) can only be estimated. Apparently, it exceeds $25,000,000,000 and may be more than $30,000,000,000 today.

From one point of view, the excess business inventories may be considered as augmented by the consumers' inventories of new homes, new cars, and other items to the extent that such items have been bought with inflationary credit. From the broader viewpoint of the economy as a whole, the consumers' inventories financed by inflationary credit expansion are "undigested" or excessive inventories like those similarly financed in the hands of business.

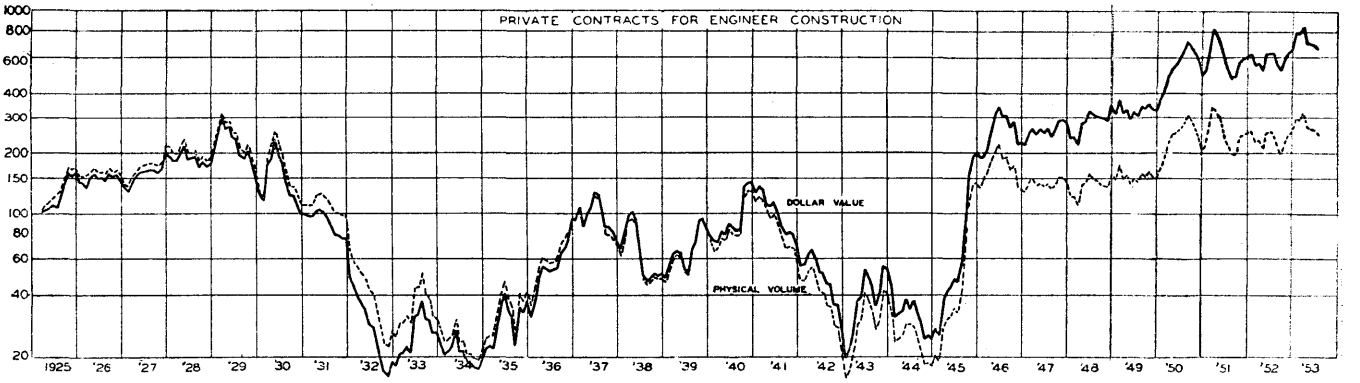
As the total of installment loans increases, monthly repayments increase and ever-increasing purchases on the installment plan are required to cause further gains in the total. For example, assuming average maturities of 12 months, the monthly repayments on an $18,000,000,000 total would be $1,500,000,000. On a $30,000,000,000 total, the monthly repayments would be $2,500,000,000. Therefore, the time may come, and perhaps is not far distant, when even a moderate lessening of new monthly purchases would result in some net deflation as the total decreased. The effects of such deflation could "snowball" rapidly with obvious further adverse effects on installment buying. If such a development were extended to real estate and if it also induced a reduction in the inventories now held by businesses, as it probably would, substantial deflation could occur.

Also to be noted is the fact that even large Government deficits after a few months (resulting either from tax reductions or increased spending) would not *necessarily* be inflationary. For a time, institutions receiving new savings (largely the life-insurance companies and the savings banks) and individual savers might prefer short-term Government issues, savings bonds, etc. In that event the Government deficits would not be monetized by the familiar process of sale of Government securities to the commercial banks. Thus deflation might proceed for many months without any effective counterbalancing inflationary action by the Government.

Conclusions

The economy is vulnerable today and will be increasingly vulnerable as inventories, real-estate loans, and in-

[1] In the Senate of the United States, 1913.



stallment credit expand, in that substantial deflation could occur over a period of several months in spite of Government attempts to prevent such a development. We suspect that, as has occurred during booms in the past, unwise expansion of inventories (both by business and by consumers) and of capital facilities has occurred. Of course, there is little statistical evidence of such errors, and the fact that such errors have been made will become apparent only during the next recession.

The moderate additional inflation expected in the remaining months of this year may further stimulate the boom and may even encourage more speculation in stocks and commodities. However, any such development would only augment the maladjustments to be corrected and might precipitate an outflow of gold that in turn could force drastic deflation. In our opinion, the assumption that the Government certainly *can prevent a substantial deflationary readjustment is no more warranted than were the "new era" assumptions of 1929.*

SUPPLY

Industrial Production

Steel-ingot production, scheduled at 96.3 percent of capacity for the week ended August 22, 1953, was 1 percent more than that in the preceding week and was 7 percent more than production in the corresponding week last year.

	1929	*1932*	*1937*	*1938*	*1952*	*1953*
Percent of Capacity†	90	16	81	42	97	96p
Weekly Cap. (Million Tons)	1.38	1.52	1.51	1.54	2.08	2.25
Production (Million Tons)	1.24	.24	1.22	.65	2.02	2.16

Automobile and truck production in the United States and Canada during the week ended August 15, 1953, was estimated at 152,733 vehicles, compared with a revised total of 137,671 vehicles during the previous week.

	1929	*1932*	*1937*	*1938*	*1952*	*1953*
Vehicles (000 omitted)†	116	27	103	14	37	153p

Electric-power production in the week ended August 15, 1953, increased to 8,513,782,000 kilowatt-hours from 8,463,616,000 kilowatt-hours in the previous week.

	1929	*1932*	*1937*	*1938*	*1952*	*1953*
Billion Kilowatt-Hours†	1.73	1.42	2.36	2.20	7.63	8.51

Lumber production in the week ended August 8, 1953, decreased. *The New York Times* seasonally adjusted index was 1 point below that for the preceding week and was 8 points below that for the corresponding week last year.

	1929	*1932*	*1937*	*1938*	*1952*	*1953*
The New York Times Index†	131	36	92	91	111	103

†Latest weekly data; corresponding weeks of earlier years
p=preliminary

DEMAND

Department-Store Sales

Department-store sales for the week ended August 15, 1953, were 3 percent more than sales in the preceding week but were unchanged from sales in the corresponding week last year.

PRICES

Commodities at Wholesale

	1952	*1953*	
(August 1939=100)	*Aug. 20*	*Aug. 13*	*Aug. 20*
Spot-Market Prices (22 basic raw materials)	293	271	274
Commodity Futures Prices (Dow-Jones Daily Index)	367	329	326

BUSINESS

Private Contracts for Engineering Construction

The 3-month moving average of the dollar value of private awards for engineering construction decreased 5 percent during July. The July figure was nearly 3 percent greater than that of a year ago but was 22 percent less than the 1953 peak reached in March.

The dollar value of contract awards for private engineering construction during the first 7 months of 1953 totaled $5,263,000,000, compared with $4,185,000,000 during the first 7 months of 1952 and $4,597,300,000 during the corresponding period of 1951, when the previous alltime peak had been reached. Approximately 22 percent of the total contracts during the first 7 months of 1953 were awarded during January, when an alltime monthly record of $1,177,500,000 was established. During the first half of 1953 (actually the first 27 weeks) highway awards reached a record $925,000,000, about 18 percent above that of the corresponding period of 1952; and bridge awards totaled $395,000,000, 94 percent greater than those during the first half of last year. Mass-housing projects remained at high levels during this period; industrial building slackened off.

The *Engineering News-Record* index of construction costs increased 1 percent during May and increased an additional 2 percent during June to an alltime high. The June cost index was 6 percent above that of June 1952 and was nearly 3 percent greater than that at the beginning of the year. The 3-month moving average of the physical volume of private engineering construction (which is calculated by dividing the dollar value of contract awards by the construction cost index) decreased nearly 2 percent during June and decreased nearly 6 percent further during July. The physical-volume index had increased 62 percent from the 1952 low reached in September through March 1953, when the monthly 1953 peak was reached. The decrease since March has been 24 percent.

According to an article published recently in *Barron's*, total private construction (based on data compiled by

the Department of Commerce) totaled $13,091,000,000 during the first 7 months of 1953, compared with $12,017,000,000 during the corresponding period of 1952.[2] During this period industrial and commercial building construction totaled $1,354,000,000 and $894,000,000, respectively, a 1-percent *de*crease and a 10-percent *in*crease compared with the corresponding type of construction during the first 7 months of 1952. Other nonresidential building outlays in the first 7 months of 1953 increased, compared with those in the corresponding period of 1952, as follows: religious, 18 percent; educational, 19 percent; and social and recreational, 27 percent. Hospital and other building construction decreased 22 and 8 percent respectively.

The Wall Street Journal recently reported that the Commerce and Labor Departments expect private outlays for construction to reach a new record of $23,100,000,000 in 1953, compared with $21,776,000,000 during the corresponding period of 1952. The *Journal* states that "* * * prospects of smaller spending for plant, farm, and hospital construction in the last half of this year are chiefly responsible for the fact that July-to-December construction outlays in 1953 will not increase over outlays for the first half of the year as much as might be expected."

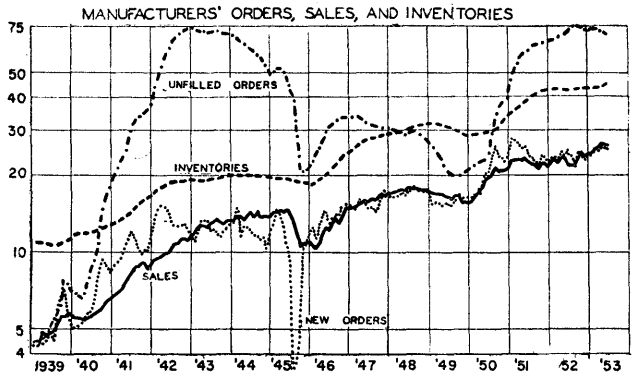
Apparently the upward trend of private engineering contract awards during late 1952 and early 1953 was attributable to a large extent to increases in construction other than industrial building. Thus, our 3-month moving average has remained at an unusually high level in spite of our belief that the peak of industrial building related to the defense program was passed some time ago. The more recent downturn suggests that a peak in commercial and other building also has been reached or is being reached. Consequently, we suspect that a leveling-off or some further decrease in the next several months is the most probable development.

Manufacturers' Orders, Sales, and Inventories

The seasonally adjusted dollar value of manufacturers' new orders, which decreased slightly during May, decreased 2 percent further during June to $25,112,000,000. The June figure was slightly more than that for June last year. The gradual upward trend of new orders, which started in September 1952, has been interrupted, at least temporarily.

The seasonally adjusted dollar value of new orders for durable goods (one of the eight "leading" statistical indicators of business-cycle changes chosen by the National Bureau of Economic Research) decreased 4 percent during June to a level 8 percent below that of a year ago. The greatest decreases during June were reported in the following industries: electrical machinery, 29 percent; fabricated metals, 22 percent; machinery (excluding electrical), 5 percent. New orders for primary metals, transportation equipment, and other durable goods increased slightly during June. New orders for nondurable goods increased nearly 2 percent during June to approximately the record reached during April 1953.

The seasonally adjusted dollar value of manufacturers' sales decreased slightly during June to $26,118,000,000. The June figure was 19 percent above that of a year ago but was 3 percent below the alltime high reached in April 1953. Sales of durable goods decreased 2 percent during June; sales of nondurable goods increased 1 percent during the month. Among the durable-goods industries the greatest decrease occurred in sales of the primary-metals industries (3 percent); decreases were reported also in sales of fabricated-metals, machinery, and motor-vehicle industries. Among the nondurable-goods industries, decreases in sales of the food industries were more than counterbalanced by the increases in sales of the textile and chemical industries. Total sales during the second quarter of this year were 5 percent more than those during the first quarter and were 15 percent more than those during the second quarter last year. The trend of sales has been more or less upward since as far back as September 1951.



Unfilled orders (this series is not adjusted for seasonal variations), which decreased 1 percent during April and 1 percent during May, decreased an additional 1 percent during June. The June figure was nearly 3 percent less than that for June last year and was 6 percent less than the alltime high reached in September last year. Almost the entire June decrease occurred in the durable-goods industries (especially fabricated-metals and machinery industries). Unfilled orders for nondurable goods have not changed greatly during the past year.

The seasonally adjusted dollar value of manufacturers' inventories, which increased 1 percent during April and 1 percent during May, increased an additional 1 percent during June to an alltime record of $45,496,000,000, 6 percent above that of a year ago. The relative increase in the durable-goods industries was somewhat greater than that in the nondurable-goods industries. During the 12-month period ended in June 1953, almost the entire increase in inventories has occurred in the durable-goods industries.

Inventory data broken down according to stage of fabrication reveal that increases in inventories of purchased materials during May and June had counterbalanced approximately half of the decrease that occurred from December 1952 through April 1953. Inventories of goods-in-process leveled off during May and June after a 10-month gradual increase; inventories of finished goods, which reached a low in September 1952, continued to increase during May and June.

The ratio of manufacturers' inventories to sales increased 2 percent during June but was 11 percent below that of a year ago. In view of the erratic fluctuations in this ratio, it is too early to regard the May and June increases in the ratio as a definite interruption of the downward trend that has occurred since early 1952.

A continuation of the downward trend in unfilled orders, the increase in inventories, the decrease in new orders, and the decrease in sales during June suggest that a peak of manufacturing activity may have been, or soon will be, reached.

[2]These data are not strictly comparable with private-engineering contract awards, but they provide further information on construction.