AMERICAN INSTITUTE for ECONOMIC RESEARCH

WEEKLY BULLETIN

November 22

GREAT BARRINGTON MASSACHUSETTS 1954

RESEARCH REPORTS

COMING EFFECTS OF CURRENT EVENTS

Significant Differences, Post-World War I vs. Post-World War II

In the lead article last week[1] we discussed certain similarities between conditions in recent years and those of the post-World War I period. In this article, we consider certain differences between the two periods that may have a bearing on future economic developments.

Because the great speculation in stocks was one of the more striking and influential features of the earlier period, factors bearing on a possible repetition of that experience will be considered first. Until early 1927, the rise in stock prices had not been unusual, in that an average of stock prices such as the Dow-Jones Industrial Average was only near the upper limit of a gradually rising range within which stock prices had fluctuated since 1880. During 1927, however, stock prices rose well above the upper limit of the range and at the 1929 peak were 125 percent above that level.

The rise in stock prices was facilitated by an unprecedented expansion of loans on securities by the Nation's commercial banks to individuals, corporations, and brokers. From December 1926 to June 1929, such loans increased by $5,500,000,000. (The borrowing of New York Stock Exchange member firms increased by an even greater amount, but only part of their borrowing was from the commercial banks.) Such loans by the commercial banks were inflationary. The new purchasing media thus created in the form of additional demand deposits (checking accounts) did not remain in Wall Street but flowed out into the channels of business as hundreds of thousands of lucky speculators spent their easily gained profits for new cars, fur coats, new homes, etc. The $5,000,000,000 involved was substantial (20 percent) in relation to the total purchasing media available; consequently, the speculation in stocks indirectly provided the principal source of funds stimulating the business boom that seemed to justify, at least in part, the great rise in stock prices.

The situation today is different and hardly can become similar in all respects to that of 1928-29 during the years immediately ahead. The Securities and Exchange Act, passed in 1934, provided that the Federal Reserve Board should regulate margin requirements. This the Board has done through a series of regulations applicable to banks as well as brokerage firms. Today, the minimum margin required is 50 percent instead of the 20 and even 10 percent commonly used in 1928-29. Moreover, the Board has not hesitated to increase margin requirements whenever speculative activity in the security markets has increased noticeably. For example, in 1945 margin requirements were raised twice and were raised a third time, to 100 percent, early in 1946. (Nevertheless, the 1946 bull market continued for 4 more months.) We assume that the Board will raise margin requirements to 75 percent or more if the recent speculative enthusiasm continues much longer.

Thus, that there will be a repetition of the 1928-29 inflation via borrowing for speculation in stocks seems improbable. If there were not another major difference from the 1928-29 situation, we should conclude that stimulation of business activity indirectly as a result of speculation in stocks could not happen this time; but the other major difference is too great to be ignored.

Ever since the early years of the Great Depression, large amounts of purchasing media have been hoarded by corporations and individuals. That hoarded in the form of currency (now about $9,500,000,000) presumably is held largely by individuals here and abroad. The portion hoarded in the form of idle checking accounts (now about $28,000,000,000) is held by both individuals and corporations. The total of hoarded purchasing media (now $37,500,000,000) is substantially less than the maximum amount hoarded near the end of World War II, but is more than the postwar minimum reached early in 1951 at the end of the scare-buying that occurred in the early months of the Korean War.

When the scramble for goods occurred from July 1950 through March 1951, with buying especially marked in July 1950 and January 1951, about $8,000,000,000 of hoarded purchasing media was used in a short period by corporations and individuals who feared that prices would rise or that desired items might soon be unobtainable. The resulting stimulation of business at retail, wholesale, and manufacturing levels was both obvious and great.

We can discover no basis for estimating how much of the purchasing media now hoarded might be used to speculate in stocks. We do know, from requests received for advice, that numerous potential investors are

[1] "Significance of the Stock Market Trend," *Research Reports*, November 15, 1954.

among those who have been hoarding purchasing media (usually in the form of idle checking accounts) for some time. Of the total approximating $37,500,000,000 today, we should guess that from one-third to one-half *might* be used for speculation in stocks if the stock-market rise continues. Presumably, such a further advance would occur only if the recovery of business apparently under way continues. As in 1928-29, however, the potentially inflationary purchasing media (at present hoarded but much of which came into existence through the monetization of Government debt during the war) may become an important stimulus to business activity as successful speculators spend their accumulating profits. Thus purchasing media released from present hoards could become the windfall profits to business that would seem to justify a further great rise in stock prices.

Now it should be noted that neither the Federal Reserve Board nor the commercial banking system can control the hoarded purchasing media except by drastic deflation. Even 100-percent margin requirements need not have any important influence on a scramble for stocks if the buyers have previously hoarded purchasing media. We expect the Federal Reserve Board to be most reluctant to initiate a drastic deflation prior to 1956, unless forced to do so (perhaps by foreign claimants demanding gold).

Also to be considered is the fact that raising margin requirements might inhibit sales of present holdings by margin speculators. Anyone now operating on a 50-percent margin can continue on that basis even if margin requirements are increased to 100 percent, provided he does not sell his present holdings. Thus he will hesitate to sell because, on subsequent purchases, his margin requirements become 100 percent; consequently, his future potential participation in bull-market profits would be cut in half.

While on the subject of factors inhibiting sales of stocks, another important difference between present conditions and those of 1928-29 should be mentioned. During the 1920's, the maximum capital-gains tax was 12½ percent, but the *effective* rate was much less in most instances. For example, the maximum rate was only 3.5 percent for a couple having an annual income of $25,000, and only one-half of 1 percent for those having incomes of $10,000. Subsequently, in the 1930's, the effective capital-gains tax was much higher, and from the available data the National Bureau has concluded, "The disposition of the top income groups to realize or defer taking capital gains has been clearly and markedly sensitive to the tax treatment."[2] That tax considerations today are given substantial weight, we have no doubt. Many of the wealthier and older investors also realize that for holdings on which there are large gains they can avoid the capital-gains tax altogether by retaining the securities for the person's estate.

Another difference between present conditions and those of late 1927 in particular (as far as the stock market is concerned) is the relation of stock prices to the upper limits of the range in which such prices have fluctuated for seven decades with the exception of the 1927-29 rise, the 1931-32 decline, and the 1942 drop. The 1927 rise of 33 percent *began* at the *upper limit* of the range; but the 1953-54 rise, although roughly paralleling that of 1927 in duration and magnitude, has *not yet reached* the upper limit of the long-term range. The 1929 peak, which the Dow-Jones Industrial Average has nearly reached, was 125 percent above what then was the upper limit of the ascending long-term range. Moreover, today's figures make no allowance for the devaluation of the dollar in 1934. Some observers argue that the long-term effects of the 1934 devaluation should be to shift the range upward about 60 percent.

Other Factors

Turning now to factors less directly related to stock prices, the Federal debt situation was well under control, was relatively much smaller, and was being reduced rapidly during the 1920's. The situation is quite different today. Balanced budgets are no longer a matter of course; the total debt is relatively far larger, and it is still increasing. As far as the long-term outlook for further depreciation of the dollar because of the pressure of Federal debt is concerned, the situation is much less favorable today.

In the late 1920's, few people feared that the dollar might be devalued. Today, with a Republican Administration having failed to restore domestic convertibility (in spite of its 1952 platform pledge to do so), and with 50 percent of the Nation's gold already subject to the demand claims of foreign governments and central banks, we think it would be far from prudent to disregard the possibility of another devaluation of the dollar.

A factor frequently pointed to as a basis for optimism today is the great upsurge in population that began about 10 years ago. In that respect conditions are vastly different from those of the 1930's and are even somewhat different from those of the 1920's. In retrospect we can see that the declining rate of population growth began well before the depression years, although few seemed to consider it important during the "boom decade." We believe this factor is important in that it suggests the Nation's economic growth has only well begun; but this viewpoint is of course not greatly different from that which prevailed during the 1920's.

One sees frequent references to the built-in stabilizers available today, such as unemployment insurance, the possibility of a substantial and semi-automatic budget deficit during a depression that would tend to cause renewed inflation, etc. That such factors might somewhat ameliorate a depression and perhaps dampen the upper reaches of a major boom seems plausible, but we do not consider them correctives of the inflation that today is much greater than that which made possible the 1928-29 fiasco.

Another factor sometimes mentioned is the guarantee of bank deposits, which presumably would prevent successions of bank failures such as those of the 1929-32 period. However, such guarantees of course have not prevented the development of the present inflation nor does it seem probable that such guarantees will prevent the usual outcome of such great inflation. By tying all the banks together in the deposit guarantee system and stuffing them with Government bonds, we have simply made it easier for the system as a whole to expand inflationary credit farther than ever before. As long as the Nation persists in operating commercial banks more or less like pawn shops, we must expect to pay the price of such folly periodically. Of course, if and when the system as a whole fails, the means of restoring solvency

[2]Lawrence H. Seltzer, *The Nature and Treatment of Capital Gains and Losses*, National Bureau of Economic Research, Inc., New York, 1951.

presumably will be another devaluation of the dollar.

That taxes today are far higher than they were in the 1920's is well known. The increase in taxes has had the actual effect of shifting part of the economy to armament production. In other words, of the great increase in industrial production since 1929 (about 100 percent) a substantial portion is being devoted to national defense needs. However, the private sector of the economy is still perhaps 75 percent larger than that of 1929, big enough to have as bad a case of inflation-distortion as that of a quarter century ago.[3]

We conclude that the difference between the post-World War I and post-World War II periods are less significant than many observers seem to suppose. Fortunately, many of the public including numerous businessmen still appear to be wary of "another 1929." Whether that caution will be sufficient to prevent a substantial repetition of the 1928-32 experience remains to be seen.

What the Indicators Say

Liabilities of business failures during October decreased to the smallest amount for any month this year. Seasonally, October is the month of greatest failure liabilities. Consequently, our seasonally adjusted *inverted* series increased to the highest level since January 1953. Average hours worked per week were unchanged in October. The Federal Reserve Board's Index of Industrial Production, which is one of the more important roughly coincident indicators, increased in October and continued to increase in the first half of November, according to a preliminary report of the Board. Gross national product (reported quarterly) was virtually unchanged during the third quarter of the year. Retail sales increased less than seasonally during October, with the result that our seasonally adjusted series of retail sales decreased slightly during that month. Bank rates on business loans decreased slightly during the third quarter.

Recent developments among the roughly coincident indicators and especially the increase in industrial production during October and November are the first confirmation by the coincident group of the signs of an upturn in general business activity given by the leading indicators. In view of this partial confirmation, we conclude tentatively that a cyclical recovery of general business activity has begun.

[3]Inflation-distortion was reflected then in skyscrapers not economically justified, huge Florida hotels whose concrete and steel skeletons still protrude from Florida sand dunes, and various other projects as economically useless then (and in some instances subsequently) as the later WPA leafraking. Just what the monuments to our post-World War II inflation will be is not yet apparent and may not be obvious until the next depression.

SUPPLY

Industrial Production

Steel-ingot production of 1,882,000 tons during the week ended November 20, as indicated by operations scheduled at 78.9 percent of capacity, compares with 1,874,000 tons during the preceding week and 2,040,000 tons during the corresponding week last year.

The New York Times seasonally adjusted index of lumber production was 129.3 for the week ended November 6, compared with 124.5 a week earlier and 124.3 for the corresponding week last year.

Electric-power production of 9,197,000,000 kilowatt-hours during the week ended Novemer 13 compares with 9,357,000,000 kilowatt-hours for the previous week and 8,460,000,000 kilowatt-hours for the corresponding week last year.

Automobile and truck production in the United States and Canada, estimated at 140,900 vehicles for the week ended November 13, compares with a total of 116,600 for the previous week and 115,700 for the corresponding week last year.

These data compare with those for corresponding weeks of earlier years as follows:

	1929	*1932*	*1948*	*1949*	*1953*	*1954*
Steel						
Operating rate—percent cap.	71	19	99	54	91	79*p*
Ingot prodn.—million tons	.98	.29	1.78	.99	2.04	1.88
Lumber						
New York Times Index	127	36	101	101	124	129
Electric Power						
Kilowatt-hours—billions	1.79*	1.52*	5.57*	5.43*	8.46*	9.20*
Automobiles						
Vehicles—thousands	49*	11*	116	115	116*	141*p*

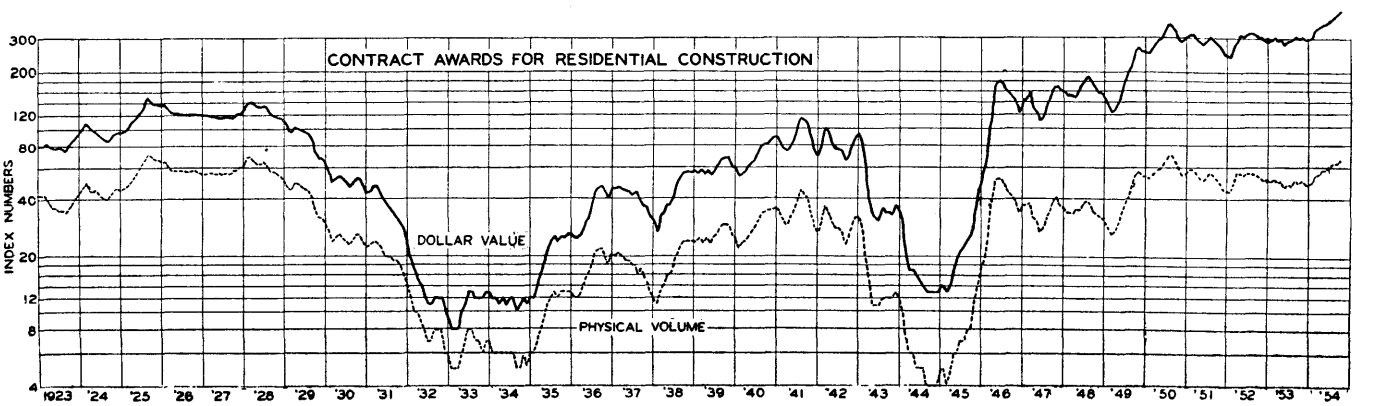
p Preliminary; *Holiday week

Residential Construction

The seasonally adjusted index of the dollar total of residential-construction contract awards reached an all-time record in September. The September index was 4 percent greater than that of August and 40 percent more than that of September last year; it was 14 percent higher than that of the record month, July 1950.

The *Engineering News-Record* index of construction costs at the beginning of November was virtually unchanged from its record level reached in August. At that level the index was about 5 percent higher than it was a year ago.

The index of the physical volume of residential construction, because of higher construction costs, did not



reach a record level in September, but was 5 percent below that of the record month, July 1950. However, the September index was nearly 35 percent more than that of September 1953.

There were 106,000 new nonfarm dwelling units started in October, compared with 114,000 in September and 90,100 in October 1953. The total number of units started in 1954, according to a joint estimate of the Departments of Labor and Commerce, is expected to be between 1,160,000 and 1,165,000.

We believe that the impact of (1) liberalized VA-guaranteed mortgages and FHA-insured loans and (2) easy money on residential construction is now largely reflected in the volume of contract awards. For this reason, we expect that the seasonally adjusted index of contract awards will fluctuate within narrow limits during the remainder of 1954. However, the percentage of vacancies in rental properties has increased substantially in the past year, although still less than pre-World War II figures. When the pressure of increasing vacancies finally forces rent reductions in order to attract tenants, prospective home buyers may find that the easy terms on which houses can be bought no longer will be as easy as paying rent. If such a situation occurs before the new marriage boom due in the 1960's, a marked decrease in new residential construction would be probable.

DEMAND

Department-Store Sales

Department-store sales for the week ended November 13 were 2 percent more than sales in the preceding week but were 2 percent less than sales in the corresponding week last year.

PRICES

Commodities at Wholesale

	1953	*1954*	
(August 1939=100)	*Nov. 18*	*Nov. 10*	*Nov. 18*
Spot-Market Prices (22 basic raw materials)	269	281	278
Commodity Futures Prices (Dow-Jones Daily Index)	334	364	363

FINANCE

New Capital Issues

New capital issues of private corporations totaled $3,844,000,000 during the first 7 months of 1954, compared with $4,446,000,000 during the corresponding period last year. Our 7-month moving average of the value of new corporate issues continued throughout the first half of 1954 the downward trend begun in May 1952 after the average had reached its alltime record in April of that year. The average fluctuated rather erratically during the 12 months through June 1954. Its maximum for this period, reached in September, was only 6 percent less than the alltime record of April 1952, and the minimum for the period recorded for May was the smallest average since that of December 1951.

The amounts include all new corporate securities, domestic and foreign, offered in the United States publically or placed privately with institutions, such as life-insurance companies and trust funds. The amounts exclude refundings and the issues of investment trusts. The latter are subtracted in order to eliminate duplications.

The last of the 7-month averages plotted on the accompanying chart is for June and is based on data for the months March-September, with the data for August and September estimated.

There were only four offerings of $100,000,000 or more during the first 7 months of 1954. These were issues of Aluminum Company of America ($100,000,000 in June), General Motors Acceptance Company ($100,000,000 in June and $150,000,000 in July), and United States Steel Corporation ($225,000,000 in July).

According to data reported in the August joint survey of the Office of Business Economics of the Department of Commerce and the Securities and Exchange Commission, business expects to invest $26,800,000,000 in plant and equipment in 1954, compared with a record $28,400,000,000 invested in 1953 and with $27,200,000,000 as the 1954 expenditures forecast by business early in the year. McGraw-Hill's survey of industry's plans for capital spending in 1955, published recently, indicates that "U. S. industry (all manufacturing, petroleum, mining, railroads, other transport and communications, utilities) has preliminary plans to spend about 5 percent less for new plants and equipment in 1955 than in 1954."

Plans for smaller capital expenditures by industry in 1955, larger reserves for depreciation (because of greater investment in plant and equipment in recent years), and the termination of the excess-profits tax in December 1953 suggest that new capital needs of corporations will be somewhat less in 1955 than they were in 1954. Consequently, our 7-month moving average of new corporate issues probably will continue its moderate downward trend during the next several months.