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Will the Boom Be Resumed?

(From the *Research Reports*, November 2, 1953)

In this eighth year since the end of World War II the economic situation is similar, in many important respects, to that in the eighth year after the end of World War I. In fact, the similarity has become so marked, in view of the Federal Reserve Board's actions during recent months, that one is invited to wonder whether the great speculative boom that characterized the closing years of the earlier decade will shortly be repeated. Apparently, the principal question is, Can we do it again?

Before attempting to answer this question, a brief review of the similarities of developments in the past 10 years and those of the earlier period will be helpful. Presumably there is no need to explain in detail to readers of these bulletins how the deficit financing of World War II resembles that of World War I. The two inflationary procedures were identical as far as the mechanisms were concerned; they differed only in that the process was continued twice as long during World War II and the relative magnitude of the later inflation was greater than the earlier one.

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Like the recession that began in 1923 and continued into 1924, the recession of 1949 was small in magnitude and of brief duration. In 1924 the Federal Reserve Board, through open-market operations, intervened at an early stage of the recession. By purchasing about $500,000,000 of Government bonds, the Federal Reserve authorities initiated in 1924 the easy-money policy that facilitated the great boom of the years that followed. These open-market purchases equaled about 25 percent of the reserves of the member banks of the Federal Reserve System and were about 2½ percent of the Nation's demand deposits.

In late 1949 the Federal Reserve Board's intervention was comparable to that of 1924. In the succeeding 18 months of 1950 and 1951, the open-market purchases of Federal Reserve banks were nearly $6,000,000,000. These purchases equaled about 30 percent of the reserves of the member banks and were about 6½ percent of the Nation's demand deposits.

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However, 1953 seems in many respects to be similar to 1927. Then, as now, commodity prices had been declining slowly for 2 years; industrial production had reached a peak early in the year; but perhaps the boom of 1953 was somewhat greater in its effect on minimizing unemployment and in some other respects than that of early 1927.

As in 1927, the Federal Reserve authorities were faced again this year with the necessity of deciding whether to continue a relatively firm money policy or to create once again the artificially easy money that has accompanied the prolonged inflation of many years. And as in the earlier instance, the Federal Reserve Board has chosen, through open-market and other operations, to try easy money.

In 1927 the Federal Reserve purchased some $300,000,000 of Government securities, which equaled about 13 percent of the reserves of the member banks and nearly 2 percent of the Nation's demand deposits. During the present year the Federal Reserve authorities have reduced the reserve requirements of the member banks by $1,200,000,000 and have purchased $1,500,000,000 worth of Government securities in the open market. The combined total, $2,700,000,000, has been counterbalanced to some extent by an increase in Federal Reserve note circulation and by an outflow of gold during recent months; but the net aid to member banks has approximated $1,700,000,000. This is nearly 10 percent of the required reserves and somewhat less than 2 percent of total demand deposits, adjusted. Thus the recent actions of the Federal Reserve authorities repeat the general order of magnitude of the similar operations of 1927.

The easy-money policy of 1927 was followed by a business expansion as well as by speculation in securities primarily, but also in real estate, apartments, new hotels, etc., all of which were significant elements of the great boom. After the minor recession of 1927, industrial production recovered in early 1928 and then increased greatly until mid-1929. Commodity prices, which had been declining steadily, leveled off until the fall of 1929.

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Conclusion

We conclude that a resumption of the boom conditions of late 1952 is possible in the next several months if the Federal Reserve and the Administration continue their easier money efforts. Its continuation for many months thereafter will be improbable unless there is a major speculative boom in the stock market or elsewhere, perhaps in real estate. That the general situation would become more vulnerable and that business risks would be greatly augmented if such a speculative boom develops seems unnecessary to emphasize.

Can We Do It Again?

(From the *Research Reports*, August 2, 1954)

Nine months ago we discussed the possibility that, as in 1927, the Government's easy-money policy might make possible a resumption of the boom. After outlining in detail the similarity between the great inflations of 1917-20 and 1942-46, we pointed out that the

immediate aftermaths likewise had been similar in some respects. The parallel between Federal Reserve action in 1924 and in 1949 was especially noted.

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In the nine months that have intervened since that article was written the recession that was then under way has continued, but in the last several weeks the downward trend seems to have ended. Especially interesting have been the trends of the 8 leading indicators since November.

The rise in prices of industrial common stocks has been markedly similar to that in the latter part of 1927. In general, the trends of 6 other leading indicators have been similar during the past 18 months to the corresponding trends in 1926 and 1927. The trend of new incorporations recently has been somewhat similar to that in the earlier period, but the month-to-month fluctuations have covered a wider range and there is a question whether this series passed through a specific cycle in 1953-54 as it did in 1926-27.

As far as the leading indicators are concerned, there seems to be no development incompatible with the supposition that 1953-54 will be a repetition, in substantial part, of 1926-1927.

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Conclusions

We find no important developments so markedly different from those of 1927 that resumption of the boom seems highly improbable. On the contrary, several of the factors that have seemed to be most influential in the past seem once again to be affecting the course of business as they did in 1927.

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Ordinarily we should not expect a repetition within three decades of a speculative boom such as that of 1928-29. One must go back more than 200 years to the Mississippi and South Sea Bubble days to find a comparable frenzy of speculation in common stocks. Therefore, although the Federal Reserve authorities have done much to encourage a repetition of the 1928-1929 fiasco, they may react more quickly than they did in those years if speculation does develop on a large scale. Also to be considered is the fact that many individuals now living have bitter memories of their experiences a quarter century ago. The combination of restraint induced by individual fears and earlier action by the Federal Reserve Board may inhibit continuation of developments paralleling those of the Great Boom. If so, the recovery phase of the present business cycle may extend over a longer period than the brief but marked upsurge of business activity through 1928 to mid-1929.

Significance of the Stock Market Trend

(From the *Research Reports*, November 15, 1954)

On several occasions, we have pointed out that for decades the trend of industrial stock prices has been one of the more consistent leading indicators of business-cycle changes. Therefore, although the trend of stock prices apparently is of little use in forecasting its own future, it is of interest to those who are attempting to foresee the future of business activity.

The marked upsurge of prices and activity in the stock market that has occurred in the days since the elections presumably is of more than casual significance. Unless an early and marked reversal occurs, the average prices during November will have continued the general upward trend that began in October 1953. This might well be an important clue to the future of business activity and would reinforce our belief that the upturn of business now in progress probably will be sufficiently great in magnitude and duration to be classified ultimately as a cyclical recovery.

In some respects, as *The Wall Street Journal* (of November 8) has pointed out, the situation seems similar to that of late 1924.

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Rather than a comparison in detail with 1924, however, we believe that consideration of the parallel between post-World War I and post-World War II may be more illuminating. For the purpose of such a comparison, we divide the postwar periods into three major parts as follows: (1) initial readjustments, (2) expanding prosperity, (3) the major business and speculative boom.

After the Armistice in November 1918, there was about a year of extreme prosperity followed by a severe but brief recession, which in turn was followed by a period of readjustment that continued through 1923. After the Armistice with Germany in the spring of 1945, there was an initial marked decrease in business activity followed by recovery during a period of readjustment that continued through early 1949. In each instance, the initial postwar readjustment period lasted about 4½ years.

The second period, that of expanding prosperity, began after World War I in 1924 and continued nearly 4 years. The easy-money policy of the Federal Reserve System, especially the large open-market purchases in 1924, no doubt facilitated the expansion of business activity. The corresponding period after World War II began in late 1949 and continued nearly 4 years. An easy-money policy facilitated the expansion of business activity, which was further augmented by the Korean War and the rearmament program.

The third period, that of a major business and speculative boom, began after World War I in late 1927 and continued for 2 years. The easy-money policy of the Federal Reserve System, which was made effective by large purchases of Government securities in the open market during 1927, again presumably was an important influence. And in 1953-54, the Federal Reserve System once again intervened with its easy-money policy. Present indications are that a third stage of the post-World War II period has begun.

The trends of industrial stock prices during the periods discussed above also are of interest. In the initial readjustment phase after World War I, industrial stocks first rose about 35 percent, then declined an equal amount and ended the 4½-year period only about 10 percent above the Armistice Day level. Similarly in the post-World War II period, stock prices rose about 25 percent, then declined a like amount, and ended the 4½-year period nearly at their Armistice Day level.

In the second period after World War I, stock prices first rose 75 percent, then declined 15 percent before beginning the next prolonged rise, which was under way well before the 1927 business recession ended. Similarly, from late 1949 through early 1953 prices of industrial stocks rose more than 80 percent, then declined less than 20 percent before beginning a rise that is still in progress and was under way well before the 1953-54 recession ended.

Industrial stock prices rose another 75 percent during

1928 from the low point of a late-1927 reaction of roughly 10 percent. From the lows of the late-1954 reaction, reached just before the elections (a reaction of roughly 3 percent), an upward surge of prices began following the elections. In 1929, the peak reached by the average prices of industrial stocks was more than double the late-1927 lows. We assume that the Federal Reserve authorities would become seriously concerned and take decisive action long before prices of industrial stocks reach a peak double the pre-election levels, if a parallel with the earlier period continues.

Viewing the two post-World War periods in their longer ranges, they seem to have much in common. Each has reflected a great wartime inflation followed by more inflation in peacetime. Each apparently has been maintained by that great "engine of inflation," the Federal Reserve System. Will the outcome in the long run, the depression aftermath, be much different? Before that question will be answered, however, recent stock-market trends suggest that we shall first experience what may prove to be the third and major boom phase of the post-World War II period.

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

(From the *Research Reports*, November 22, 1954)

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 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, un-

less 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."[1] 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 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.[2]

We conclude that the differences 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.

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

[2]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.