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## 2. Economics

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## 2. Economics

### Abstract

The study of the way in which man makes a living — a short definition of economics — or of how he makes use of limited resources to satisfy unlimited wants -- another definition — has been traced in this work from Aristotle through the Middle Ages and mercantilism to the nineteenth century, when the classicists and their numerous critics, under the influence of industrialization and the intellectual trends of the day, created a large body of economic thought. In Chapter XIV we saw how, at the end of the century, Alfred Marshall (1842-1924) attempted to reformulate classical theory to bring it up to date. He was aware of the criticism that what the classicists had produced was a science of wealth which was not at all a science of welfare. This, many of them had insisted, was their true purpose, to limit themselves to treating what is to the exclusion of what ought to be. [*excerpt*]

### Keywords

Contemporary Civilization, Social Science, Economics

### Disciplines

Economic History | Economics

### Comments

This is a part of [Section XXI: Meaning in the Social Sciences](#). The [Contemporary Civilization](#) page lists all additional sections of *Ideas and Institutions of Western Man*, as well as the [Table of Contents](#) for both volumes.

### More About Contemporary Civilization:

From 1947 through 1969, all first-year Gettysburg College students took a two-semester course called Contemporary Civilization. The course was developed at President Henry W.A. Hanson's request with the goal of "introducing the student to the backgrounds of contemporary social problems through the major concepts, ideals, hopes and motivations of western culture since the Middle Ages."

Gettysburg College professors from the history, philosophy, and religion departments developed a textbook for the course. The first edition, published in 1955, was called *An Introduction to Contemporary Civilization and Its Problems*. A second edition, retitled *Ideas and Institutions of Western Man*, was published in 1958 and 1960. It is this second edition that we include here. The copy we digitized is from the Gary T. Hawbaker '66 Collection and the marginalia are his.

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## 2. Economics

The study of the way in which man makes a living -- a short definition of economics -- or of how he makes use of limited resources to satisfy unlimited wants -- another definition -- has been traced in this work from Aristotle through the Middle Ages and mercantilism to the nineteenth century, when the classicists and their numerous critics, under the influence of industrialization and the intellectual trends of the day, created a large body of economic thought. In Chapter XIV we saw how, at the end of the century, Alfred Marshall (1842-1924) attempted to reformulate classical theory to bring it up to date. He was aware of the criticism that what the classicists had produced was a science of wealth which was not at all a science of welfare. This, many of them had insisted, was their true purpose, to limit themselves to treating what is to the exclusion of what ought to be.

Marshall, on the other hand, believed that a study of economics should be the most fruitful way ultimately to improve the lot of man, but he agreed with the classicists that wealth was the most reliable measure of human welfare for the economist. Therefore, he was primarily concerned with the same questions of value and price to which Ricardo and others had tried earlier to find the answers. He reaffirmed their assumptions about competition and the possibility of reaching a desirable long-run equilibrium in which the forces of supply and demand would counterbalance each other. He accepted the hedonistic belief that men act to promote pleasure and avoid pain, and thought that pleasure and pain were capable of measurement. And, since he had confined his subject largely within the classical limits, he felt little need to compare notes with either the burgeoning sociologist or psychologist.

Marshall's distinct contribution to economic theory was to provide a more refined analysis of how prices are determined under conditions of pure competition. He explained the many factors on which he believed both supply and demand are based in the short run, by definition a period too brief for any new production, and in the long run, a period long enough for changes in supply and demand to be made, and for an equilibrium to be reached. He invented the concept of a representative firm, which he defined as "one which has had a fairly long life, and fair success, [and] which is managed with normal ability." The costs of production of this firm, he argued, can be used in determining the supply that will be forthcoming in the long run from the industry of which it is a part. On the demand side, he explained how the diminishing usefulness of a thing as a person acquires more of it will influence the amount that will be purchased, and he introduced the idea of elasticity of demand to explain how the demand for some articles is more responsive to price changes than for others. Marshall cautioned that this analysis applied to a static world which never existed, but



argued that it was still the best approach there was to understanding the dynamic and real economic world, an approach comparable in value to the physicists' study of frictionless models.

Marshall's creation of neoclassical theory, together with similar efforts by contemporaries on both sides of the Atlantic, marks the beginning of modern economics. From its four great subdivisions -- production, exchange, distribution, and consumption -- there developed such familiar college courses as marketing, money and banking, value, and consumer economics. Later there appeared a related discipline, known as business administration, with its courses in management, advertising, and sales, its primary purpose being to teach the principles and techniques of operating a business.

In the twentieth century economics, along with the other social sciences, has aroused a greatly increased popular interest. Politics may indeed have established its primacy in the affairs of Western man, but there are many reasons why economics looms larger in the public mind than ever before. The business of making a living in an increasingly interrelated industrial world is highly complex. The Great Depression turned millions to the study of economics for both explanation and remedy. Both world wars, and especially the second, demonstrated that a state which wishes to survive in modern war must understand and control its economy. Leaders in the world's underdeveloped states are fully aware that one of their two or three major problems is a backward economy. The totalitarian states, and even the democracies, have either approached or outdone the mercantilists in peacetime regulation of their economic potential. These facts help to explain why today economists occupy many responsible posts in the United Nations and in governments all over the world. Present conditions seem to guarantee that economics and politics will long continue to be closely joined. It is ironic that within so short a time after Alfred Marshall announced his preference for the term "economics," this discipline should be transformed to the point where it would be more accurate to call it by its older name, "political economy," and to define it, with the mercantilists, as "the study of measures...helpful to the state."

Economists in the twentieth century have tried to make their subject both more inclusive and more exact. An example of the first of these two goals is institutional economics. The American, Thorstein Veblen (1857-1929), is regarded as its founder. In his most famous book, The Theory of the Leisure Class (1899), Veblen severely criticized what he called our pecuniary society, and especially the wealthy, whom he accused of "conspicuous consumption" of goods and services mainly to impress others. The wealthy, who are out to make money, control the levers of industry, which makes goods. They pull the levers to satisfy themselves. As a result, production is directed to the production of goods for them, and most people do not gain the purchasing power to buy what they need. All of society eventually suffers.

Inspired by Darwin, Veblen taught that man was a product of his social environment, and does what he does because of the customs, habits, and traditions of that environment. Economics, he insisted, must not dissipate itself in the meaningless study of the price of wheat in the long run, or in many other things which the classicists regarded as important. Instead, the economist must concentrate on man and his institutions as both are constantly evolving before him. Veblen defined an institution as a customary way of doing or thinking about things. The concept of long-run equilibrium, either of the classical or Marxist variety, is, he thought, a chimera. Economics, according to him, must be studied as inseparable from the other aspects of culture and must draw upon history, psychology, sociology, anthropology, and other studies. Institutional economics has had a wide appeal to those who believe that even neoclassical theory is irrelevant to the problems of the day-to-day world. It has appealed also to those who, while refusing to desert neoclassicism, have felt that Veblen added new insights to economics which they could not afford to neglect.

An example of the attempt to make economics more exact is the greatly increased use of statistics and other mathematical tools. This use stems primarily from the efforts of some nineteenth century pioneers to make it a true science. As one of them put it, economics "is a physico-mathematical science like mechanics and hydraulics," and those who study it should "employ the methods and language of mathematics." In 1930 a group of economists and mathematicians who were in complete agreement with this injunction formed the Econometric Society, which presently has an international membership of about 2000 persons, many of whom are engaged in the mathematical verification or disproof of economic theories.

The economist can use mathematics in several ways. For example, since the data of his subject are in large part quantitative, he can employ graphs and symbols, which are quantitative measures, to illustrate economic principles and show the relations between them. This procedure has been carried to a theoretical level beyond the reach of anyone who has not mastered higher mathematics, as a glance at some recent numbers of the American Economic Review will indicate. The economist also uses mathematics in the form of statistics, which help him measure the performance of the economy, make inductive generalizations about it, and sometimes make predictions.

In the United States the Departments of Commerce and Labor and the Federal Reserve Board regularly publish many series of statistics relating to production, employment, money and prices, trade, income, and the like. Among the most widely used of these statistics are the Consumers' Price Index of the Department of Labor and the Index of Industrial Production prepared by the Federal Reserve Board. The National Industrial Conference Board, a private organization founded in 1916 and supported by many business and educational institutions, performs a similar function.



An example of the possibilities of statistics in economics is the achievement of Wesley C. Mitchell (1874-1948), a student of Veblen and longtime professor at Columbia University, whose services were in frequent demand by the government for almost half a century. Mitchell became interested in the business cycle, publishing the first edition of his famous book, Business Cycles, in 1913. He continued testing the various theories advanced to explain this phenomenon against a rapidly increasing body of statistical data which he assembled and evaluated, much of it as research director of the National Bureau of Economic Research, which he helped organize in 1920. In collaboration with one of his former students, Mitchell published Measuring Business Cycles in 1946. This monumental work was the fruit of more than thirty years of careful accumulation of statistical data and the painstaking formulation of conclusions.

Mitchell's conclusions were that the business cycle is an integral part of a capitalistic economy. He ruled out the possibility of any long-run equilibrium by observing that the economy is at all times in one or another of the four stages of the cycle -- prosperity, recession, depression, and recovery -- and that forces operative in any of the stages tend to bring on the one succeeding. This so-called self-generating theory of the business cycle has gained wide acceptance among economists.

The intensive economic research presently under way in this country is largely a phenomenon of the period since World War I, and represents the efforts of several different groups. First, there are many college and university teachers, some of whom work through research bureaus that are closely connected with educational institutions, while others make use of the increasing number of research grants which are available (as, for example, from the Social Science Research Council). Second, there are many economists engaged in research who are employed by units of government, business firms, and labor unions. Third, other economists are available as consultants on special projects.

Among the numerous agencies which have promoted research in this field, four may be mentioned for purposes of illustration. The Twentieth Century Fund (1919), established to conduct "research and educational activities in the field of economic and social problems" has recently produced studies of American agriculture and of pension funds. The National Bureau of Economic Research (1920) has recently supported studies in such fields as business cycles, national income, economic growth, banking, and international economics. The Brookings Institution (1927), chartered to "engage in research and education in the social sciences," has published detailed studies on such topics as Controlling Factors in Economic Development (1949), The Cost and Financing of Social Security (1950), and Big Business in a Competitive System (1954). The Ford Foundation has given \$10,000,000 to Resources for the Future, Incorporated, for use in promoting research in the conservation and use of natural resources. In addition to the topics already mentioned in

this paragraph, economists are interested in such others as automation and technological unemployment, the impact of continuing heavy expenditures for defense, the development of underdeveloped areas and the effects of that development on other parts of the world, and the present rate of increase in the world's population.

No topic in economics in the first half of this century was more pervasive than that of the business cycle and economic growth, nor has any figure influenced economic theory and policy more than John Maynard Keynes (1883-1946). Son of an English economist and educator, Keynes was a student of Alfred Marshall at Cambridge University, where he studied philosophy and mathematics as well as economics. Civil servant, editor, teacher, businessman, and prolific writer, he represented the British Treasury at the Paris Peace Conference in 1919, was a director of the Bank of England, and after World War II was associated with the International Monetary Fund and the International Bank for Reconstruction and Development, two agencies established to promote international trade and stability.

Keynes' greatest work, The General Theory of Employment, Interest and Money (1936), which he thought would "largely revolutionize...the way the world thinks about economic problems," was a product of the Great Depression. Seeking for some explanation of this disastrous national and international collapse, he concluded that existing economic theory was of no help. He was especially critical of its assumption that there was an automatic regulator directing an economy toward an equilibrium which would provide a high level of employment for labor and all other resources. His comment about the long run on which the classicists seemed to depend so heavily was that in the long run we are all dead. The persistence of the depression in some countries led him to the conclusion that an equilibrium might be reached in which a sizeable part of the labor force would be permanently unemployed. He saw the possibility of a long-run stagnation in a "mature economy" where investment opportunities were few and where the volume of savings, provided almost entirely by the wealthy, was high. In such a society, where the money taken out of the economy by savings was not returned to it in the form of investment, there simply would not be enough purchasing power to buy the goods and services produced. The result would be chronic depression.

Claiming that he was acting as a physician to an ailing capitalism rather than as its prospective gravedigger, Keynes prescribed a program to spur recovery. Government, he wrote, must closely control the money supply. It must be prepared to "prime the pump," to spend enough money on useful projects in times of depression to insure a desired level of employment. The corollary of this was to tax enough in times of prosperity to prevent overexpansion and inflation, as well as to balance the budget, if possible, over the period of one business cycle.

Keynes believed that, whatever might have been true in the



past, capitalism in the twentieth century was a ship without a rudder to steer it between the twin perils of depression and inflation. Simply put, his solution was to socialize a part of capitalism in order to save the rest by having the government provide the rudder. Even here, he did not recommend that it act alone, but only whenever private efforts were inadequate in maintaining employment. In the 1930's Keynes believed that government action would have to be frequent, well-planned, and on a wide scale.

How much Keynes and his writings actually influenced the New Deal is still a matter of argument, but his impact on economics has often been called the Keynesian Revolution. If his book was one of the most influential of the first half of the century, it was also one of the most controversial. Keynes had many followers, some of whom have already much further developed and modified the ideas which he propounded and the mathematics which he used to express them. He also had (and still has) many severe critics, both fellow economists and others, some of whom took issue with the validity of his theories while others accused him of being a socialist.

After a quarter century it is becoming apparent that the term "Keynesian Revolution" is too strong. Even for Keynes, there was no wholesale destruction of neoclassical theory. What he did was to change radically the emphasis in economics from value, price, and individuals to the behavior of the whole economy during the course of a business cycle. It has been claimed that this was a sharper change than occurred in the theory of any other social science thus far in this century. In so doing, Keynes introduced his own vocabulary to replace classical concepts which he regarded as inadequate or irrelevant. For example, he did not believe that the classical theory explained the strongest factors in determining either the supply of or the demand for capital funds. On the supply side, he argued, the desire to have assets in cash or forms readily convertible into cash (what Keynes called liquidity preference) might discourage potential investors, even though the prevailing interest rates are high. On the demand side, the return which a businessman thinks he will get on a new investment which he is considering (what Keynes called the marginal efficiency of capital), if it is low, might discourage him from borrowing, even though interest rates have fallen far below their customary levels. In this way Keynes explained why he believed the interest rate was not the regulator of investment which the classicalists held it to be. In its place he put a subjective, psychological factor -- the marginal efficiency of capital -- and assigned it a position of highest importance in his theory.

By way of summary, we can say that the work of Keynes and others who both preceded and followed him during this century has turned the balance of economic thought away from what is called "microeconomics," with its primary interest in individuals and individual firms, in prices, value, and the distribution of income to the factors of production. The balance has swung



toward "macroeconomics," a term denoting a primary interest in the performance of the whole economy. Macroeconomics holds that the most meaningful view of the economy is one which focuses on total or aggregate income and total or aggregate expenditure of businesses, households, and government, and on maintaining that level of savings and investment which will provide full employment. This is a view which tries to encompass all of the many interdependent social, political, and psychological factors which bear upon the economy. There is still a question as to how accurately total income and expenditure can be measured. The empirical tools thus far devised by macroeconomists are at best limited in their usefulness. There is also the nagging question whether it is even yet remotely possible for the best prepared and hardest working economists to master the many imponderable factors in an economy which appears to be much more dynamic than Keynes believed possible twenty years ago. The predictions of the Keynesians regarding postwar economies in the United States and elsewhere have been uniformly proved to have been too pessimistic.

Almost wholly rejected now is the classical belief in an automatic long-run equilibrium which competition will usher in, and the belief that economic depressions are but temporary dislocations brought on by unwise government policies. The newer view in economics rejects the classical commitment to laissez faire in favor of a commitment to government intervention, although just when and how the government should step in is still not agreed upon. The purpose of this intervention is not, as it was with the New Liberals, primarily to establish economic justice, but rather to secure and maintain full employment by making up for deficiencies of one sort or another in the private sector of the economy. The political implications of taxing, borrowing, and spending to support Keynesian objectives cannot be overlooked.

This change of emphasis is now firmly entrenched in most economics textbooks used in this country, where Keynes' influence has been greater than anywhere else. As the urgency of the Great Depression fades, even in our memories, the consensus among economists is that the task now is to relate the best in Keynesian theory, which has never lost completely the stamp of its depression origin, and in neoclassical theory, which has experienced something of a revival, to form a useful tool in attacking current economic problems. Macroeconomics and microeconomics no longer appear mutually exclusive of each other, but rather, quite the reverse, mutually dependent upon each other.

The change of emphasis is also firmly entrenched in the minds of many public officials of both major political parties in the United States. In 1946 Congress passed what is known as the Full Employment Act, which declared it to be

the continuing policy and responsibility of the Federal Government to use all practicable means consistent with

its needs and obligations and other essential considerations of national policy...to coordinate and utilize all its plans, functions, and resources for the purpose of creating and maintaining...conditions under which there will be afforded useful employment opportunities...for those able, willing, and seeking to work, and to promote maximum employment, production, and purchasing power.

Admittedly, the language of this act is general enough to permit many interpretations of how seriously it is to be taken and how it should be enforced, but the point is that the federal government had made a commitment such as this for the first time in its history. The Full Employment Act also created a Council of Economic Advisers, responsible to the president. Noted economists have frequently been appointed to these positions.

The purpose of the document which follows is to illustrate how the performance of our economy is frequently described today and what type of data many economists believe is most useful in imparting meaning in the study of economics. The reader should make a comparison of this approach with that of the classical economists described in Chapter XIV. He should also compare it with the approaches of other contemporary social sciences. There are many details in the selection which need not be mastered in gaining a general understanding of this newer approach. The selection is taken from National Income, 1954 edition: A Supplement to the Survey of Current Business, prepared by the United States Department of Commerce.

#### Chronological Review: 1929-53

The year 1929 marked the end of an era of relatively full employment, business confidence, and general prosperity. Economic activity had been advancing strongly, with only minor interruptions, for eight years.

#### Business decline: 1929-33

The 1929 downturn, the ultimate causes of which are still a matter of controversy, was most clearly reflected in the collapse of investment demand. Gross private domestic investment dropped about one-third from 1929 to 1930, as new construction and producers' purchases of durable equipment were cut sharply and the accumulation of nonfarm business inventories ceased. Foreign purchases also declined in 1930, although the drop was not reflected in net foreign investment because of a matching reduction in import demand.

With employment and incomes adversely affected by the sharp reduction of investment, consumer purchases also decreased, contributing to the general contraction and inducing still further cuts in outlays for investment.

Consumer purchases, however, held up much better in 1930 than investment demand. The aggregate income flow to individuals shrank less than production and the incomes



generated by it, as undistributed corporate profits absorbed a disproportionate share of the over-all decrease in earned income. Also, consumers tended to spend a higher proportion of current income or to dissave in the attempt to preserve previous living standards.

Essentially the same pattern of cumulative decline persisted, and in fact accelerated, during 1931 and 1932. By the latter year, gross private domestic investment had fallen to the very low level of less than \$1 billion, as contrasted with \$16 billion in 1929. The further moderate decline of the gross national product in 1933 was in consumer purchases, where it reflected primarily lower average prices rather than a further decrease in volume.

Over the entire period of contraction from 1929 to 1933, the gross national product dropped by nearly one-half, from \$104 billion to \$56 billion. At the bottom of the depression less than 3 percent of the Nation's output went into business investment, as compared with 15½ percent in 1929. Conversely, consumer purchases rose from three-fourths of the old total in 1929 to five-sixths in 1933. Government purchases, although little changed in absolute dollar volume, were considerably increased in relative importance by the collapse of private demand.

More than half of the 1929-33 decline in the market value of the national product stemmed from lower prices. As measured by the gross national product in constant (1947) dollars, real output fell by three-tenths.

Foremost among the factors underlying the shrinkage of real output was the reduction of employment. At the depth of the depression, the number of persons engaged in production was almost one-fifth lower than in 1929, and unemployment was almost 13 million -- close to one-fourth of the Nation's labor force. Moreover, average hours worked per week by those who remained employed were considerably reduced.

#### Recovery: 1933-37

Some of the most serious deflationary forces underlying the post-1929 collapse were by 1932 beginning to spend themselves. Installations of new plant and equipment had virtually ceased in most segments of the economy, and such gross fixed business investment as did persist represented primarily the fulfillment of minimum replacement needs. As replacements had been cut to the bone for several years, the feasibility of further postponing them was rapidly diminishing by the end of 1932. Business purchases of durable equipment, accordingly, fell no lower in 1933. Private construction activity did continue downward, but the drop was smaller than in any of the three preceding years.

Sizable inventory liquidation continued in 1933, but as it had already carried working stocks close to a minimum even in relation to the low current volume of sales, the rate of liquidation was considerably reduced. It had previously been possible for businesses to meet the sagging

volume of sales partly out of relatively excessive existing inventories, with the consequence that production-- and hence total income -- was reduced even more than consolidated business sales. Now, however, this possibility was vanishing, and it became necessary to keep output at least on a par with current demand. Here too, then, a weighty deflationary force was exhausting itself.

With the marked retardation of income declines stemming directly from reduced investment expenditures, the fall in consumer demand was measurably slowed in 1933. The stage was thus finally set for recovery. It was evidenced in a few industries as early as the fall of 1932, but appears to have dated generally from the spring of 1933. Monthly personal income data show the low point in March, after which there was a slow and uneven rise during the remainder of the year.

With its decline arrested in 1933, fixed business investment turned up moderately in 1934, when both construction and equipment outlays began to expand again. Nonfarm inventory liquidation ceased, and a general trend toward rebuilding of stocks depleted during the depression set in. It was stimulated not only by the emerging recovery of sales, but by the rise in prices already under way during 1933.

In the meantime, the Federal Government had assumed an active role in the economy, and was making strenuous efforts to promote recovery. Along with the adoption of other measures, it entered the market directly on an expanding scale, especially in its work relief activities, and also provided substantial aid to State and local governments.

With the increase of incomes generated by the pick-up of business investment and the growth of government purchases, personal consumption expenditures also rose in 1934. Their expansion, in turn, fed the income stream and provided stimulus for a further upsurge of investment. This was at first mainly confined to long-deferred replacement of capital facilities which had deteriorated during the depression; but as profits reappeared and business confidence in future prospects was gradually restored, an increasing proportion went into wholly new plant and equipment, and inventories were expanded to meet the rising volume of sales. Residential building, spurred in part by Federal aid to homeowners, moved ahead once more, and total gross private domestic investment advanced steadily from \$1½ billion in 1933 to \$11½ billion in 1937.

Consumer purchases also continued to rise. At \$67 billion in 1937, they were 45 percent above the low mark of 1933. Although their rate of increase was proportionately smaller than that of domestic capital formation, they represented quantitatively the largest element in the upward spiral of employment, production, and incomes.

Apart from the newly expanded role of government, the whole mechanism of the recovery was thus very similar to that of the downswing, except that it operated in reverse



and also more slowly. Of the \$35 billion increase in gross national product from 1933 to 1937, about 30 percent was in private domestic investment, raising it from  $2\frac{1}{2}$  to 13 percent of the total. Consumer outlays accounted for about 60 percent of the change -- substantially less than their share of total output -- and government purchases, dropping slightly in relative importance, absorbed the remaining 10 percent of the increment.

### The recession of 1938

Incomplete as was the recovery of the economy by 1937, it was interrupted by a downturn beginning in the latter part of that year and extending through mid-1938. Although of brief duration, this downturn was relatively severe. Within a few months, unemployment rose sharply. Industrial production fell by over one-fourth from August, 1937 to January, 1938, and personal income dropped at a pace comparable to that prevailing in 1931-32. The decline tapered off thereafter, however, and production began to pick up again in the second half of 1938. For the year as a whole, the decrease in gross national product was about 6 percent.

The 1937-38 recession was much steeper in its initial descent than the previous downswing, but it was of a less basic character. Of the \$5 $\frac{1}{2}$  billion decline in gross national product from 1937 to 1938, almost three-fifths was attributable to a shift from accumulation to liquidation of business inventories. Inventory shifts accounted for only 16 percent of the drop in output from 1929 to 1930.

Business plant and equipment expenditures contracted about as sharply in 1938 as in 1930, but residential construction activity, contrastingly, continued to rise, and consumption expenditures, despite the drop in employment and personal income, declined by only 4 percent, as compared with 10 percent in 1930. The consuming public as a whole sustained its spending close to the 1937 rate by a \$3 billion cut in personal saving. Moreover, the moderate decline in consumer outlays which did occur was very largely counterbalanced by increased government buying and net foreign investment.

Altogether, purchases of goods and services by final users of the Nation's output declined by less than 3 percent in 1938, as compared with 11 percent in 1930, and the major portion of the swing in production was absorbed by the change in inventories. Curtailment of production ceased as soon as the strength of final demand became apparent. The drop in fixed business investment proved to have been instigated by short-run considerations, rather than by any fundamental lack of investment opportunities. The basic underlying situation, in fact, was that large capital requirements accumulated during the depression still remained to be fulfilled, and that many new investment opportunities stemming from technological advances remained to be exploited.

### Renewed recovery: 1938-41

Following the jar of the 1938 recession, the recovery was renewed and continued steadily into 1941, when it was merged with the first stages of military preparation for World War II.

All forms of business investment were expanding steadily during this period. Purchases of producers' durable equipment nearly doubled in dollar volume from 1938 to 1941, and private construction activity also rose strongly. Inventory liquidation ceased in 1939, when production was brought back in line with current sales, and inventories were accumulated on a mounting scale in the next two years.

By 1941, total gross private domestic investment was not far from three times as large as in 1938. For the first time, it surpassed the 1929 total, both in value and in physical volume. Net foreign investment was also sizable in the three years following 1938, being especially stimulated in 1940 and 1941 by foreign demand for munitions and other supplies required for the Allied war effort.

Responding to the increased incomes generated by expanding employment -- and contributing, in turn, to the advance of profits, business investment, employment, and incomes -- personal consumption expenditures rose from \$64½ billion in 1938 to \$82 billion in 1941. The relative rise was particularly marked -- about two-thirds -- in outlays for durable goods. Higher prices figured in the advancing rate of consumer spending, but the major portion represented enlarged quantities of goods and services. The real volume of personal consumption per capita increased 16 percent from 1938 to 1941, and exceeded the 1929 figure from 1939 on....

### The war economy: 1942-45

Preparations for war began at a time when the economy was operating at less than full capacity, with unemployed labor, plant, and equipment, and an abundance of raw materials. At first, because of the availability of these unused economic resources, war production could be superimposed upon the civilian economy. It acted as a stimulant, and civilian production increased concurrently. Gross private domestic investment proceeded at a high rate, and consumer purchases -- especially of durable goods -- were buoyant.

During most of 1941, the needs of the war program were thus compatible with expanding civilian production. Moreover, much of the capital equipment acquired during this period later proved to be readily convertible to war production. Also, the additions to the stock of capital, along with additions to the stock of durable consumer goods, subsequently permitted the diversion of more productive resources from civilian use than would otherwise have been possible except with sharper cuts in living standards.

As the dimensions of the war effort expanded, however,



serious problems emerged. Although the rising volume of war production generated a rapid expansion of incomes, it provided no goods and services to satisfy the resultant growth of civilian demand. Instead, it impinged upon their availability as soon as the slack in the economy had been taken up. Shortages of specific labor skills, capital facilities, and raw materials began to be more and more frequently encountered. After Pearl Harbor, it became obvious that the war program would take proportions of output so huge that they could not be provided by enlarged production alone, and that civilian demand would have to be restricted.

During the period of transition to a full war economy, accordingly, a succession of measures was adopted with a view to ensuring maximum war production together with the optimum functioning of the civilian economy. Rates of taxation were steeply increased, not only to help finance Government war expenditures, but also to restrict the amount of civilian purchasing power available to bid for the limited volume of goods and services remaining after military requirements had been met. Fiscal measures were supplemented by the imposition of direct controls, including priorities, inventory limitation orders, allocations, manpower regulations, price and wage controls, and rationing. In addition, individuals were urged to restrict consumption voluntarily and to invest their surplus purchasing power in Government bonds.

On the whole, the flexibility of the economy in the transition to full-scale war production proved great and total production continued to rise rapidly despite conversion.....

#### Reconversion and postwar boom: 1945-48

At the end of World War II, the Nation faced a set of economic problems which in some ways were the counterpart to those of the original mobilization. It was widely recognized that the transition from a situation in which roughly two-fifths of economic resources were being employed in war production to one in which most of the resources would again be devoted to civilian output could only be accomplished in an orderly fashion by widespread cooperation among all major groups in the economy. As in the mobilization itself, the striking flexibility of the economy was demonstrated.

A broad Government program designed to speed reconversion, and to ease its impact upon the returning soldier and upon business, was enacted. With the quick resurgence of business, personal, and foreign demands, as well as the vast Government programs undertaken to aid in the rehabilitation of war devastated areas, the immediate postwar economic decline was held to moderate proportions.

Although war purchases of the Federal Government were cut back with great speed -- from an annual rate of \$90 billion in the second quarter of 1945 to \$28 billion in the first quarter of 1946 -- much of the slack was quickly

taken up by the rapid expansion of private spending. Total gross national product dropped 12 percent over these three quarters, or by \$27 billion at annual rates; thus more than half of the drop in war expenditures was offset. Discharged servicemen and war plant workers were speedily absorbed in civilian pursuits, and at no time did unemployment rise appreciably above  $2\frac{1}{2}$  million.

After the first quarter of 1946, the buoyancy of private demand more than offset the moderate further declines in government purchases. Strong inflationary pressures characterized the 1945-46 reconversion, even before controls were eliminated, and continued to dominate the economic scene for the next two years....

Several key factors underlay the strength of private demand. During the war, both consumers and businesses had accumulated an enormous volume of savings -- much of it in liquid form. At the same time, they had built up a backlog of urgent demands for all types of civilian goods, and especially for durables.

As regards the purchasing power of consumers, it may be further noted that in the brief contraction from mid-1945 to early 1946 the flow of disposable personal income was maintained. Undistributed corporate earnings absorbed a large share of the swing in total income arising from production, and the Government disbursed mustering-out payments and other veterans' benefits in large volume and lowered the wartime tax rates. Not only did the pent-up demand for durable consumer goods materialize as expected, but an insistent consumer demand for nondurables and services also became an active and powerful force in the economy.

At the same time, business plant and equipment investment programs were pushed ahead fast in the immediate reconversion period and continued to expand strongly thereafter. Inventories, very low at the close of the war, had to be accumulated rapidly to bring working stocks into line with the heavy volume of business. The pace of residential building activity also accelerated steadily.

Moreover, net foreign investment assumed a relative importance far beyond its usual role. With financial support provided both by wartime accumulations of gold and dollar balances and by a large volume of United States Government loans, and under the stimulus of world-wide shortages stemming from the impairment of productive facilities abroad, net foreign purchases of American output reached unprecedented proportions.

In combination, these heavy demands placed a severe strain upon the productive capacity of the economy, which was reduced considerably below the wartime peak. Despite low unemployment, the number of persons engaged in production was 7 million, or 11 percent, lower in 1946 than in 1944. This was due to the withdrawal from the labor force of sizable classes of individuals -- such as adolescents, housewives, and persons past the normal retirement age -- who are not ordinarily employed, but who had been induced



by special wartime circumstances to accept employment. In addition, average hours worked per week fell off as overtime schedules were abandoned, and there appears to have been some loss during the reconversion period in real output per man-hour worked in private industries.

With the physical volume of production thus pressing against capacity, much, if not most, of the pressure exerted by intensive consumer, business, and foreign buying was reflected in price movements. Prices were already advancing, though often in covert fashion, in the early reconversion period. After the termination of wartime controls in the latter half of 1946, they spurted up very sharply, and, except for a brief interlude of hesitation in the spring of 1947, serious inflationary tendencies accompanied the postwar boom until 1948.

In that year a better balance between supply and demand emerged, and the price rise tapered off. This was brought about partly through an appreciable expansion of real output and partly through a diminution in the intensity of some of the demands, including those from abroad, from which the greatest pressures had emanated.

There was a break in agricultural prices early in 1948. Although these recovered briefly, their downward slide, influenced by the prospect of excellent domestic harvests and an improved crop situation abroad, was resumed after midyear. Agricultural prices are a substantial element in the total price picture, and their decline was an important factor shaping the course of economic developments during 1948.

More notable, however, was the increasing stability in consumer markets. The upsurge in personal consumption expenditures, stimulated by backlog demands and reinforced by large holdings of liquid assets and a low volume of consumer debt outstanding, had constituted one of the main foundations of the boom. As the more urgent demands were satisfied, and as the abnormally high spending rate of 1947 made inroads into the net liquid asset positions of many consumers, the rising trend of consumption flattened out in the latter part of 1948....

#### Business readjustment and recovery: 1949-50

Businessmen adopted more cautious buying policies toward the end of 1948, and the large inventory accumulations of that year were sharply reduced in the first quarter of 1949. Substantial inventory liquidation emerged in the next quarter, and the drain upon stocks persisted during the remainder of the year. The shift in the inventory position was reflected in a curtailment of production mainly in the manufacturing industries, where the bulk of all inventories held in the economy is produced.

By contrast, total final purchases -- that is, elements of the gross national product other than the change in inventories -- held up extremely well during 1949. Consumer spending in the first quarter dropped but slightly below its dollar volume at the crest of the postwar boom, then

climbed slowly upward again during the remainder of the year. Residential building activity decreased from a peak in the second quarter of 1948 but picked up again in the spring and advanced strongly thereafter. And government purchases, chiefly because of the expanding Federal foreign aid and farm price support programs, more than offset the moderate declines which occurred in business outlays for plant and equipment. For the year as a whole, total final purchases actually exceeded those of 1948.

That the curtailment of employment and payrolls in the manufacturing sector had no greater impact upon consumption expenditures in 1949 was attributable in part to the payment of sizable unemployment compensation benefits, and also in some degree to the cushioning effects upon disposable personal income of lower Federal income taxes as a result of the previous year's Revenue Act. It may also be noted that dividends were sustained, notwithstanding the sharp fall in profits. Perhaps more important than any of these factors, however, was the apparent willingness of the consuming public as a whole to spend increasing proportions of current income to maintain living standards during the recession.

It became apparent in the second half of 1949 that the curtailment of output had been excessive in relation to the existing stable volume of business sales. Accordingly, production was stepped back up, and the accumulation of inventories was resumed. Meanwhile, the recovery of residential construction had grown into a sustained building boom, and consumer demand, already strong, was being bolstered by large Government payments to veterans. These factors, moreover, were being reinforced by a renewed upturn in fixed business investment.

This widening resurgence of production generated increases in employment and incomes, adding further impetus to consumer purchasing. Before mid-1950, a business upswing of substantial dimensions was under way and was carrying the economy close to full-capacity operation.

#### Korean war period

It was upon this expansionary situation that the urgent demands resulting directly and indirectly from the outbreak of hostilities in Korea were superimposed, as the Nation decided upon a defense program encompassing a sharp step-up in direct military potential as well as the establishment of a broad base of productive facilities to permit quick economic mobilization in case of full-scale war.

The ensuing rise in national output continued without interruption for three years, until the second quarter of 1953, when gross national product reached a peak of \$370 billion at seasonally adjusted annual rates, one third above the rate of \$276 billion in the second quarter of 1950. About half of this rise represented expansion in physical volume while the remainder reflected the sharp advance in prices which occurred in large part during the



first nine months of the period....

While the defense buildup was the dominant factor in the economic situation throughout the three years following mid-1950, its character and impact varied considerably during this period.

In the initial stage the increase in national security expenditures was heavily concentrated in military payrolls, food, clothing, and other related outlays which were capable of rapid expansion in a comparatively short time. The strength of the Armed Forces increased by 1-3/4 million persons in the first year of the defense effort -- about four-fifths of the ultimate total increase -- and national security outlays mounted from 6 percent to 11 percent of the gross national product.

At the same time there was a strong advance in investment by businesses that were participating in the growing volume of defense orders. This included investment in inventories and in plant and equipment, the latter receiving a special stimulus from the rapid amortization provisions that had been granted for emergency facilities.

Although the demands stemming directly from the defense program contributed to expansionary developments, it was the waves of anticipatory buying, set in motion by the expectation of commodity shortages and price increases, that determined the tone of the business situation in this period. Consumer buying spurted in the third quarter of 1950 and again in the first quarter of 1951, following the further extension of the Korean conflict. Responding to sharply rising sales, as well as to the same expectations that motivated consumers, businessmen added greatly to their inventories, and fixed investment not related to the defense program was also stimulated.

Although production continued to rise briskly, demand outstripped the supply of goods, and prices bounded upward.

By mid-1951 the situation had changed significantly. Output was expanding at a rapid rate, and it became apparent that the productive capacity of the economy had been underestimated. Taxes had been raised, and the establishment of price and wage controls gave some assurance to the public that inflation would be kept in check. Other measures, including controls on credit and on the flow of strategic materials, had been introduced to ensure that the necessary resources would be channeled in an orderly fashion into the defense program.

As a consequence of these developments, and the well-stocked position of consumers after several months of extraordinarily heavy buying, spending propensities eased markedly during 1951. The rate of consumer spending out of disposable income, which had risen to 96 percent during the buying surge in the first quarter fell to about 91 percent in the succeeding quarters of the year....

In the third year of the defense effort -- from mid-1952 to mid-1953 -- the Nation's capacity to produce continued to expand substantially while the rate of growth of national security outlays tapered off. This shift in the relation

of supply and demand permitted the relaxation and subsequent removal of economic controls.

Civilian demand proved strong, particularly in the durable goods lines previously restricted by controls and material shortages. Residential, institutional, and State and local construction, business investment in plant and equipment other than in defense-connected industries, and consumer and inventory demand for automobiles and other durable goods became major factors supporting further economic growth. Together with the still rising military demand they provided the basis for a balanced economic expansion which, unlike that of the previous year, was shared by most industries.

Agriculture was the principal sector of the economy that ran counter to the generally favorable trend. As a consequence of lower farm prices, income originating in agriculture was reduced substantially during 1952 and 1953. The steady downward pressure on prices reflected the unusually heavy output of farm products -- which reached successive highs in the 2 years -- and the appreciable decline in foreign sales. Domestic consumption remained firm, however, and the full force of the other developments was not reflected in farm income, as large quantities of the chief crops and dairy products were placed under loan to the Commodity Credit Corporation, both in 1952 and 1953.

The restoration of civilian durable goods production was retarded by the steel strike which occurred in the second quarter of 1952 and affected end products mainly in the third. As a consequence final purchases and inventory accumulation of durables were particularly heavy in the fourth quarter of 1952 and were probably raised also in the opening half of 1953.

Total production reached a peak in the second quarter of 1953 and receded moderately in the latter half of the year. The major change occurred in the net flow of goods into the inventories of durable goods industries. These inventories had been replenished and the immediate need for further accumulation had thus been removed. In addition, sizable liquidations were made when it became apparent that, relative to actual and prospective demand, some of the earlier build-up had been excessive.

National security expenditures, entering a new phase, registered moderate declines, mainly in the procurement of hard goods, and consumer purchases of commodities, particularly durables, also drifted downward. The effect of these reductions on total final purchases was offset, however, by advances in other components of national expenditures, notably consumer expenditures for services, State and local government purchases, and the agricultural price support outlays of the Federal Government. Hence final purchases were maintained in the aggregate in the latter half of 1953.

While the percentage decline in total national output was small, it was heavily concentrated in durable goods



and thus had a disproportionate impact upon the durable goods manufacturing industries where it led to substantial reductions in production, employment, wages, and profits. The year 1954 opened with these developments still in progress. \*

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