

The Recession of 1948-1949: The Most Important One of All?

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The provocative question mark in the title allows us an oblique way of introducing the theme of the paper at the very outset. It is this: was the revolutionary ideological and policy shift that was Keynesianism, born in extraordinary and disparate times, going to survive and function as an economic linchpin in the more “normal” environment of post world war II America? As obvious as the answer to the question is today it was by no means a given in the late 1940’s. A major and at times acrimonious debate took place because, as hindsight makes clear, of a sea change, a turning point in the relationship between the public and private sectors.

It was indeed a turning point because the events of that period shaped the role of government economic policy that continues to the present day, Its fundamental contours have survived Republic and Democratic administrations (recall Nixon’s statement that we are all Keynesians now”), liberal, conservative and centrist ideological and all kinds of domestic and global events. These varied forces have included the notions of “fiscal drag” of the late fifties and early sixties, the Kennedy “New Economics”, intractable inflations and “stagflation” of the seventies Reagonomics, OPEC, the end of fixed exchange rates, the era of the Clintons and the Bush ascendancy .

This new view of the public-private connection must be understood in the most unusual context of its birth and initial acceptance in the period from 1933 to 1945. This is essential for our focus on the 1948-1948 recession, a half-century ago. Otherwise it makes little sense. President Franklin D, Roosevelt came into office in March, 1933 at the darkest time in American economic and political history. The depression that began in 1929 - and called Great Depression for good reason - hit its nadir in 1933. Gross domestic product in 1929 was \$104 billion and plummeted to \$55 billion in 1933. Deflation racked price levels and forced them down by a third in the same period. An aside: this helps to explain our contemporary connotation about deflation that verges on panic. Hence the concept of budget deficits and activist fiscal policy emerges out of necessity in disparate times.

These realities of deficits and fiscal activism gain widespread acceptance during World War II with minimal resistance because there was simply no alternative. The cost was enormous; greater by far than could be funded by taxation even with a top rate of 91 percent on personal income. Thus in the extraordinary theater of World War II public debt incurred was an ordinary event and it rose from insignificant levels to over \$200 billion by war’s end. This latter figure by the way was slightly larger than gross domestic product in 1945.

The backdrop for our focus has several dimensions. These include an awareness that Keynesian type fiscal policy had not been utilized in anything even remotely considered normal or conventional; economic collapse and the cauldron of war do not fit those adjectives. Also on the list is the uncertainty of what a peacetime economy would bring. A survey of members by the American Economic Association indicated that most expected the “Depression of 1946.” A popular view at the time, absurd as it seems to us now, held that the American economy has reached its nature stage and had entered into a stationary state (to use John Stuart Mill’s term). Growth had ceased and the spectacular growth rates of the war years were a blip, a temporary deviation from the long-term trend of stagnant performance. In addition, population growth had ended and U.S. population was projected to level off at about 160 million in 1960.

How quaint these numbers and views sound to us now, but they were the conventional wisdom then. They allow us to see how pivotal that period really was. There were many issues to be sorted out: how would the nation deal with the end of economic growth. Would we allow the big government of the Depression and World War II to continue on peacetime; how was the free-market enterprise ideology to be recast (if at all!) without political and cultural violence?

We know of course, how all this turned out, but certain unexpected factors emerged to bring this about. It is important to remember that the Keynesians model was still very new and not completely understood. The now familiar $Y = C + I + G$ framework was uncharted territory. The neo-classical model, which was based on the premise that economy was either at full employment or inevitably moving towards it, died hard; the idea that the economy could settle at an equilibrium at less than full employment based upon aggregate demand was slow to be adopted.

Another new element that was not appreciated was the role of the enormous public debt, some \$200 billion worth. Debt of this magnitude was unknown and unimaginable prior to 1946. It was thought to be catastrophic in its impact because a key support block of the classical model was the similarity of the debt of the household with that of the government. Neither could survive living beyond its means, the distinction between private and public debt was not yet fully grasped. Yet the debt was held by individuals businesses, banks etc. And was viewed as a financial asset.- An asset that was to be used as down payments for motor vehicles (unavailable during the war), houses, appliances and for the revival of capital spending by firms. We now know that the purchasing power embedded in these private assets was major factor in bridging the rocky transition from wartime to peacetime aggregate demand in 1946, and in eluding the expected depression of the year.

Much was going on in the mid 1940's as far as the public-private interface was concerned, and all of it was significant. The passage of time has inevitably dimmed the enormity of it but in today's ideologically edgy world it bears reexamination. Alvin Hansen (1964), sometimes known as "the American Keynes" for his early espousal of Keynes's General Theory, introduced useful distinctions in his little book, The Postwar American Economy. First he distinguished between two time periods: 1948-1956 and 1956-1963. The breakdown works because the first period was characterized by high growth averaging 4.25 percent per year and low unemployment of only 4 percent per year. The latter period 1956-1963 saw slower growth rate averages- 2.75 percent per year- and a higher unemployment rate at a 6 percent average. (Hansen, p.23.)

His second distinction was equally insightful. In the first time frame "powerful spontaneous forces were at work automatically generating a high level of aggregate demand. These forces were weaker in the second period." (Ibid, p. 23.) Thus higher levels of demand had to "be contrived" by deliberate policy. Hence our highlighting of the first postwar recession-1948-1949- becomes more complex and nuanced because of these "spontaneous" factors.

What, in fact, were they? Hansen proposes three autonomous developments which unexpectedly provided an enormous propulsion to aggregate demand after the war, but whose impetus to growth was spent by the mid-1950's. The first is the backlog of demand for producer durables, construction goods, housing and especially consumer durables. Most of these were either totally unavailable (e.g. cars) or in limited supply due to wartime priorities The second was the build-up of demand for military and defense items due to the eruption of the Cold War. The third spontaneous element was truly so: the sharp increase in the birth rate and desired family size. Households which had been average 1.7 children per couple suddenly increased to 2.7 children by 1948 boom which was to last until about 1966. This "bump" in the birth rate population, by the way, has traveled through the age cohorts of the population resulting in the construction of grammar schools and high schools to handle the influx of students and later on the closing or reduction in the size of the same schools. The first wave of these baby boomers will reach retirement age in 2012.

All three are spontaneous
In the sense that they are not
the product of heated partisan
debate and political discussion.

The first two are determined
By market forces, the third
Essentially by external
International forces which
Only military experts can even
Pretend to evaluate. (Hansen, p. 24.)

These three drawing forces for expansion for 1948-1956 were powerful forces and can be measured by increases in gross private domestic investment, spending for consumer durables and defense expenditures. The average increase (in real terms) for the period in the three categories per year were 3.1 percent for investment, and 6.8 percent for consumer durables and 22.4 percent for defense spending (the Cold War and the Korean War) (Hansen, p. 24.)

A word of caution is necessary here, however, while these spontaneous forces were indeed powerful propulsive elements for a decade after the war, there was a downturn in 1948, and this brings us to the heart of our investigation. What, in fact did the Truman administration do when confronted with the first postwar recession? Were the Keynesian type fiscal initiatives of the Great Depression and World War II to be applicable in a normal peacetime atmosphere? Was the downturn going to be a modest weakening or a return to depression as had been expected? It is useful to recall that the expected depression following World War I was delayed in coming until 1920-1921. Would the 1948 decline be history repeating itself? Would the presence of these three “spontaneous forces (although not acknowledged as such at the time, but intuitively recognized) forestall any attempts at major discretionary policy shifts?

While these questions seem silly to us now, they convey the conflicting forces that swirled around at the time. Fortunately the answers that surfaced in response to “the most important recession of all” were positive and appropriate. We now looked at fiscal policy through two prisms; automatic stabilizers and deliberate policy.

Quite apart from discretionary
action is the automatic
stabilizing effect of new
mechanisms built into the
social structure- new
mechanisms tending to promote
stability... Indeed it is
the change in the ratio of
expenditures and receipts that
constitutes in essence the so-
called built-in stabilizers.
(Hansen, p. 13)

This refers to the now familiar pattern where tax revenues decline and unemployment compensation and other spending areas rise. In the recovery phase the pattern is reversed so that “a cushion is thus placed under a recession and restraint is imposed on the upward management. The economy is more or less stabilized.” (Ibid.)

Hansen (and many others) came to the conclusion that built-in forces are not powerful enough by themselves to bring about full recovery and full employment. Discretionary economic policy decisions involving spending and tax revenues are needed. This too was a lesson from the 1948-49 recession, and the lesson was learned well for that cycle. The following figures are noteworthy: the change in federal spending from the peak of the expansion to the trough in 1949 was an increase of \$3.4 billion. The change in receipts to the federal government was a decline of \$6.5 billion from peak to trough.

For the same 1949 cycle; if we focus on the spending changes from trough to the next peak, they rose by \$37.2 billion. Receipts for the government rose \$33.8 billion from trough to peak. (national income account figures quoted in Hansen, p. 14). Hansen says flatly, “these cushions prevented the cumulated downturn which characterized ‘pre-New Deal’ depressions.” (p.15)

Hence the 1948-49 recession gives us two important insights about counter-cyclical fiscal policy. First, countercyclical policy in the recession stage (spending increases and declines in tax revenue) works powerfully and well because of automatic and discretionary stabilizing forces. Congress and the Executive branch became comfortable with the political benefits of the economic shifts. Little risk was seen in running a deficit in a down turn. The second insight, however, was that there was little political will to curtail the “emergency spending of the downturn during the resulting expansionist upturn. This would have meant outcries from the House and Senate constituencies as programs would have been cut back or eliminated. As the national income accounts showed, for the 1949 cycle from trough to peak of the succeeding cycle, tax receipts, fueled by economic growth and taxes on recovering personal and corporate income, rose by \$33.8 billion. Expenditures from trough to peak rose by \$37.2 billion. (quoted in Hansen, p. 14)

Here was the first visible wedge or flaw in the theory of countercyclical fiscal policy. The theory was that the budget should be balanced over the full course of the business cycle—deficits in recession and surpluses in recovery. Political reality overshadowed economic theory. Congress realized that it could allow the blunting of the “need” for surpluses in the recovery and get away with it. The budget didn’t balance, the government didn’t implode, financial markets didn’t collapse and the sky didn’t fall. The awareness that tax structures have a long-term or secular dimension, that progressive tax rates must be reduced over time to avoid “fiscal drag”, that the proper economic time frame is not the business cycle but the long term, was some years away. The key point, however, was that the government thrust itself aggressively into the first cyclical down turn after the end of World War II. For the first time there was neither global conflict nor economic cataclysm to demand interventionist fiscal policy. The new reality was that it was expected and to deny it was to court political suicide.

Some additional change factors need to be mentioned. These include The Full Employment Act of 1946 (the date is significant), and the creation of the Council of Economic Advisors. All of these can be interpreted to mean that the post war economy was to be one of growth not depression and was to be prodded and guided to achieve it. The language of the Employment Act was general but clear:

The Employment Act of
1946 declared the federal
government continuing
responsibility to promote
“maximum employment
production and purchasing power”
(quoted in Okun (1970),p. 37)

The Act has proven to be highly influential over the years and the language meaningful, especially after the battle over its wording. The latter was the result of compromise between those who wanted a specific commitment by the government to ensure full employment and those who saw that as an unacceptable ideological change whereby the federal government would intrude into and disrupt private markets. The creation of the CEA brought about an explicit mechanism for economists to contribute to and help shape economic policy.

The recession that we have focused on is a half century old and has faded off the screen, but its significance and its legacy lingers on. It’s appropriate to ask why and several factors surface. First, it cemented the new public-private interface which emerged after World War II—that the public sector would play a more prominent and activist role in the economy. This was a key question as the economy hit its first downturn in more normal times: would fiscal policy intervene in the of absence intense exogenous forces? Second, it changed the political landscape for policy making in that discretionary fiscal policy was validated for use in peacetime and in the framework of economic growth. It no longer had the connotation of emergency or desperate measures. Third, it reflected an ideological shift to a Keynesian style of market economy where full employment could be attained with appropriate economic policy, but was no longer considered as the only equilibrium point as the classical school did. Lastly, the events of fifty years ago demonstrated resiliency and pragmatism in the economic system and in its leaders. This was reflected in the political will to be flexible in the face of changing conditions.

The 1948-1949 recession does turn out to be most important. The factors just noted above proven to be long-lasting and continue to influence and impact us to the present. We have seen another ideological shift, intense financial pressures today, a major global transformation over the past thirty years and extraordinary American macro performance. In all of these and other changes some of the lessons learned long ago continue to apply.

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