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Is More Inflation Coming?§

The word "inflation" has been used for so many different economic developments that it is almost useless for communication unless one carefully describes what he is naming. In the discussion that follows, I shall apply "inflation" as the name for the money-credit relation existing when excess purchasing media are in use; and the name "inflating" will apply to the Government or business and banking processes that create such excess purchasing media. The name "deflating" will be applied to the reverse processes that remove from circulation some or all of the excess purchasing media.

What do we mean by purchasing media? These are the currency that you carry in your pockets plus the checking accounts against which you and business write checks. Why don't we use a more simple name, such as "money"? The answer is that we have yet to find an economist or any other writer who could demonstrate his ability to write coherently and consistently when using the word "money."

Some of you may recall that the celebrated Irving Fisher announced, early in September 1929, that there would "not be anything in the nature of a crash"* in the stock market; but in April 1932 he declared "that the speculative boom of 1929 and the subsequent collapse were not due to the question of gold, but to topheavy national and international debts."** At some time in the intervening years, if memory serves me correctly, Professor Fisher also stated that only a dozen or so men in the world understood about money, the implication being that he was one of them.

Now the point of this historical comment is: apparently one of the world's self-admitted few experts on "money" not only was about as wrong as one can be but also required more than two years to learn about matters that were discussed in the New York Times Annalist in August and November 1929.† Of the first article the editor said "***the reader may study the striking article ***on another page, where are set forth certain typical conditions of the American banking portfolio, which approximates, on the vital comparative basis of ratios, the inflation conditions in 1920." The article referred to concluded, "***that the time may not be far distant when the country will realize, in the light of a 'cold gray morning after,' that it has just been on another credit splurging spree." And the second article included the prediction that banks would fail "in wholesale lots,"‡ a relatively optimistic prediction as everyone realized by March 1, 1933.

The scope of this discussion obviously cannot include the two additional years of education Professor Fisher obtained on the subject of money (not to mention what he may have known before), yet it somehow must communicate in the short space available a better understanding of money-credit matters than Professor Fisher had in 1929, better in fact than by far the most of the Nation's bankers seem to have today.

Gold Production, Purchasing Media, and Prices

Most people readily can follow a discussion about one variable such as the changing speed of an automobile or rising or falling prices. Some people have little difficulty in understanding a relation between two variables, such the movement of one's foot on the accelerator and the changing speed of an automobile. But when three variables and three relations among them are concerned, the limits of comprehension for nearly everyone including supposedly astute economists seem to have been passed. Nevertheless, that is what must be understood as the foundation for this discussion.

These three things we are talking about are gold production, purchasing media, and prices, as well as the triangular relations among them. These comments are applicable to all nations that use a gold monetary unit, regardless of whether or not gold coins are in general circulation. (As many of you who have traveled in Europe know, gold coins and bullion are freely available in most western European banks, and all of the leading industrial nations have a monetary unit consisting of a specified weight of gold.)

Gold is produced in many nations of the world and in thousands of mines having widely varying gold content in the available ores. Even in a single mine the amounts of gold found in the many different veins of ore vary over a wide range. Moreover, the costs of extracting the ore vary with changes in prices generally including prices of mining machinery and supplies as well as wages of the labor employed. Necessarily wages must reflect to some extent changes in living costs.

§An address by E. C. Harwood given at The Contrary Opinion Forum on October 2, 1964.

* *The Commercial and Financial Chronicle*, September 14, 1929, p. 1645.

** Ibid, April 30, 1932, p. 3185.

†E. C. Harwood, "Deterioration of the American Bank Portfolio," and "The Aftermath of Getting Something for Nothing," *The Annalist*, August 2,1929, p. 203 and November 29, 1929, p. 1055, respectively.

‡The editor deleted this phrase from the manuscript and explained in a letter to the writer that it was a little too blunt a statement for publication.

An obvious result of this situation is that rising prices (including wages) discourage gold production, because mining the ores containing lesser quantities of gold becomes unprofitable; and, on the contrary, falling prices (including reduced wages) encourage gold production, because mining even the less rich ores then becomes profitable.

Of course, gold production also is influenced by new ore discoveries, technological improvements in mining machinery or methods, and other factors. But the relations between prices (including wages) and gold production are clearly evident, and their consequences affect gold production even if sometimes discernible only in the relative amounts of gold produced rather than the absolute amounts. (In other words, rising prices may result in a decreasing rate of increase in gold production long before an absolute decrease occurs in the amount of gold produced.)

All of the gold produced each year, except for that used in industry and the arts, or hoarded, becomes purchasing media in the forms of circulating coins, currency, or checking accounts (demand deposits) if the gold becomes part of the reserve of some nation's central bank.

Prices generally (including average wages) necessarily reflect the amount of purchasing media "chasing goods," that is, the effective demand in the world's markets. Therefore, if purchasing media are increased in total amount beyond that needed to represent gold and other things being offered in world markets, prices are bid up by eager purchasers. Such increases in total purchasing media result to a negligible extent from counterfeiting, but the major increases are attributable to what is called monetizing Government debt and/or monetizing private debt that does not represent things currently offered in the markets after the additional purchasing media have been created. In this "age of inflation," as the present century might well be called, excess purchasing media have been created in nearly all nations of the world. A direct result has been the bidding up of prices generally that, from the converse point of view, is called depreciation of the monetary unit (as the dollar is now said to be worth only 45 cents in buying power compared with the pre-World War II dollar).

Anyone who has understood the preceding discussion will easily see how gold production has been discouraged in recent decades. The relative decrease (failure to increase as rapidly as it otherwise could have) in gold production accounts for the world "liquidity" crisis, so-called, or the lack of a sufficient amount of acceptable international purchasing media to finance the increasing volume of trade. Thus we see the effects of the triangular relations among gold production, purchasing media, and prices (including wages).

As long as nations persist in misusing their money-credit systems (primarily the commercial banks) to monetize either or both Government debt and private debt that does not represent goods currently being offered or about to be offered in world markets, excess or inflationary purchasing media will be created and used to bid up prices (including wages). This, in turn, will discourage gold production (relatively if not absolutely). Then the gold reaching the nations' banking systems will fail to increase as rapidly as it otherwise would; there will appear to be shortages of gold everywhere, when there actually will be "shortages" of common sense and of sound commercial banking procedures.

Devaluation (reduction in the gold weight of monetary units) can temporarily alleviate the situation by enabling gold producers to get a higher "price" for their product until upward spiraling commodity prices and wages eliminate the temporary advantage and make another devaluation seem necessary. Only if unsound banking (monetizing of government debts and monetizing of private debts that do not represent things in or en route to markets) is ended can devaluation do more than temporarily alleviate the situation. This has been demonstrated so many times in so many countries, even during the present century, that we cannot imagine how anyone who claims to be an economist could dispute it.

Sources of Purchasing Media

What are the facts about purchasing media in recent decades and today?

The first source of purchasing media is the money commodity. In most of the world today the money commodity is gold.

Gold produced in the United States, or imported, ordinarily is sold to the Treasury. The seller receives a check drawn on the Treasury's account, and (except when the gold sterilization program was attempted) the Treasury counterbalances this draft against its checking account by depositing certificates representing the gold with the Federal Reserves banks. When the seller of the gold deposits the Treasury check for credit in his own local bank, his demand deposit (checking account) is increased. The local bank in turn deposits the Treasury check in the nearest Federal Reserve bank and thereby increases its reserve account.

This procedure makes available to the seller purchasing media equivalent to the dollar amount of the gold sold to the Treasury. Furthermore, the reserves of the member bank involved are increased by the new credit to its deposits in the Federal Reserve bank. When used to buy something desired, the purchasing media pass on to others and thus remain in circulation.

The Treasury's gold stock reached a record high of $24.7 billion in August 1949. Since then it has decreased to $15.6 billion. Moreover, the net amount of foreign short-term claims against U.S. gold are about $6 billion more than the $15.6 billion we have.

A second source of purchasing media is commercial, industrial, and agricultural loans. The extension of credit by the banks in order to finance the production and movement of agricultural and industrial products is a function of the commercial banking system. Borrowers whose notes are discounted receive credit to their demand deposit or checking accounts. These credits were not previously deducted from other accounts. Therefore, the borrowers have at their disposal new purchasing media over and above those previously existing. If, during the short period that the loans are outstanding, the borrowers are offering goods in the market place equal to or greater in value than the amounts of the loans, the equilibrium between the supply of goods on the one hand and the effective demand on the other is not disturbed.

Inflationary Sources

The other and inflationary sources of purchasing media are silver and the credit of the United States Government, monetized as Treasury currency; and investments and noncommercial loans of the commercial banking system, monetized as demand deposits and Federal Reserve notes. These sources are inflationary because the purchasing media derived from them do not represent either gold or goods en route to markets.

Investments and noncommercial loans of the banking system are monetized directly through the extension of bank credit as demand deposits of commercial banks and as currency (Federal Reserve notes) of the Federal Reserve banks and indirectly through deposits (reserves) of member banks with the Reserve banks. Investments and noncommercial loans of the commercial banks involve both Government (United States) and non-Government credit. The former is represented by securities; the latter by credit instruments (bonds, notes, etc.) of private enterprise and individuals and of State governments and their subdivisions.

Investments of the Federal Reserve banks involve almost exclusively the credit of the United States, represented by the Treasury securities held by the Reserve banks. These investments have added purchasing media directly in the form of Federal Reserve notes and demand deposits and indirectly in the form of reserve deposits for member banks, on the basis of which member banks have created additional purchasing media through their own inflationary loans and investments.

From the early 1930's until 1946, purchasing media derived directly from Government credit in the form of Government securities were an increasing part of total purchasing media. By early 1943 about half of all purchasing media outstanding was derived from this source, and by mid-1946 the proportion had increased to two-thirds. Since then the proportion of purchasing media derived from Government securities has decreased, in part as a result of the substantial liquidation of the commercial banks' investments in Government securities.

An Index of Inflation

Of course, if purchasing media in excess of those required to represent goods produced and on the way to market are added to the flow of circulating purchasing media, the balanced relationship between the amount of goods becoming available and the effective demand for them is disturbed.

Inasmuch as the total quantity of purchasing media is expected to increase more or less as the amount of gold in the Treasury and of goods in the markets increases, the importance of a given amount of inflationary purchasing media will depend on its relation to the amount of noninflationary purchasing media in use. We have developed an index number that is intended to show this relationship.

The index of inflation is the ratio of total active purchasing media in use to that which would be left if all inflationary purchasing media were withdrawn from circulation.

The amount of inflationary purchasing media may be found by subtracting from the investment-type assets of the commercial banking system the total savings-type liabilities. The former include the system's investments in real estate and securities (Government and other), loans secured by real estate and securities, and other loans that are noncommercial including primarily personal accommodation loans and installment loans. The savings-type liabilities are primarily the capital accounts of the banks (including the Federal Reserve banks) and their time (savings) deposits.

The commercial banking system is able to acquire investment-type assets greater in dollar value than the total of its savings-type liabilities, because the commercial banks and Federal Reserve banks can create the purchasing media (demand deposits) with which to buy such assets. The inflationary purchasing media thus created are initially in the form of credits (bookkeeping additions) to the accounts of depositors, including the United States Treasury. As these inflationary purchasing media are spent by the original recipients, the funds flow into channels of trade and are indistinguishable from other demand deposits and currency that represent gold and the goods being offered in the Nation's markets. Thus great additions to the purchasing media used to buy goods can occur without corresponding increases in the goods available in the markets. The effects of these increased purchasing media in the market place are to induce higher prices and to trigger the related developments of an inflationary boom.

Investment-Type Assets

Included in the commercial banking system's investment-type assets are the direct holdings of real estate, including office buildings, etc.

Two major types of investment by the commercial banks are (1) obligations of private enterprise and of State governments and subdivisions thereof (bonds, for example), and (2) securities of the Federal Government.

Investments of Federal Reserve banks in U.S. Government securities create new purchasing media by providing additional reserves for the commercial banks, thus widening the base for credit extension by those banks.

Real estate loans of the commercial banks have increased markedly since World War II.

Loans on securities have not been an important part of the commercial banks' investment-type assets for many years.

The "other loans" extended by commercial banks consist primarily of consumer installment and other personal accommodation credit.

Savings-Type Liabilities

Savings-type liabilities include the capital accounts, time deposits, and all other liabilities of the banking system except demand deposits and Federal Reserve notes.

The capital funds of the commercial and Federal Reserve banks vary little over periods of several years. Therefore, changes in this item never have caused marked fluctuations in the index of inflation.

The time and savings deposits of the commercial banks likewise change gradually, although the dollar amount of the changes in recent years have been large.

Inflationary Purchasing Media

The difference between total investment-type assets and total savings-type liabilities is equal to the amount of purchasing media created by the commercial banking system that may be inflationary.

Such are the facts revealed by the ratio analysis of the Nation's commercial banks in 1929 and kept up to date by continued extensive research. The obvious fact is that the commercial banks have been misused for the purpose of inflating the purchasing media to a far greater extent than they had been in 1929. Consequently, the Nation's banking system today is more vulnerable than it was then.

What Can We Guess About Future Trends?

This being an election year, any guess as to future economic trends, especially as to whether more inflating or some deflating will occur and when, requires consideration of the possible election results.

We have no adequate scientific basis for forecasting the election results. Consequently, we must consider the probable economic consequences of victory for either party.

Probable Long Range Consequences

We are dealing, at this point, with the probable long range economic consequences of a victory for either party. Many able obervers assume that the United States is well along in a retrogression that has become irreversible. They have forecast further departure from the status of a constitutional republic with the powers of the Federal Government strictly limited, through a kind of democracy wherein the majority would ride roughshod over all minorities to socialism, to an inevitable end in a dictatorship, in fact if not in form.

Of course, the departure from a constitutional republic having strictly limited powers began long ago in the United States. Whether one should mark the beginning by the Constitution's lack of provision for limiting monopoly privileges in some way, or by the first so-called "protective" tariffs, or by some other development may be debatable; but that the centripetal flow of power to the central government has been greatly enlarged and expedited in recent decades surely is obvious.

In our own writings we have said, "Western civilization seems to be at or near a critical time in man's progression. He would be a bold prophet indeed who would predict that the counterrevolution (socialism and its militant twin, communism) within Western civilization would fail and that the original great revolution, which perhaps reached its point of farthest advance with the adoption of the Constitution of the United States, would succeed in the long run. The unpleasant fact is that the counterrevolution has been succeeding in one country after another. Even in our own country we have adopted measures that have turned backward from the goals of our own great revolution."

What will the election results tell us about the probable consequences for the Nation in the long run? We suggest that an overwhelming victory for Mr. Johnson would be quite convincing evidence that the trend toward more inflating, socialism, and ultimate dictatorship has gone so far that only the exceedingly optimistic could hope any longer that it would be reversed. Victory by a narrow margin for either Mr. Johnson or Mr. Goldwater would leave the question here considered unresolved. Perhaps it would reflect the fact that a counterinfluence usually labeled conservative, simply had not as yet reached the peak of its potential strength. In that event, the basic long run issue might remain undecided for at least another 4 years. But if Mr. Goldwater is elected by a decisive margin the evidence would suggest that the retrogressive trend would at least be halted and might be reversed.

The United States, after a brief respite in the first quarter of 1964, is experiencing an increasingly adverse balance of international payments. Application has been made to the International Monetary Fund for further credits in order to avoid revealing to the public, in the form of additional gold outflows, that the basic problem of several years standing remains unsolved.

Only recently, Mr. Robert Marjolin, the leading economic expert of the European Economic Community, the so-called "Common Market," has strongly urged that the nations concerned should resolutely apply the classic remedy for inflation, tighter credit; and several European central banks have raised their discount rates. Moreover, Mr. Marjolin has argued that they should be given absolute priority to insuring financial stability even at the cost of some business contraction and unemployment. Present indications are that the nations concerned will heed this advice rather than continue down the primrose path via more inflation.

As these nations consider the possibility of Mr. Goldwater's election they no doubt will reflect on the probability that lavish foreign aid would end. In that event, those nations would have little reason to hope that they could acquire more claims on U.S. gold by the sale of their exports to recipients of U.S. aid and therefore would have less reason to hold the dollar claims they now have. (As long as those nations have been willing to hold increasing claims on U.S. gold, instead of demanding gold, the Government of the United States has been encouraged to continue giving, or at least not discouraged as it soon should be if gold flowed out in large quantities.)

The general character of life without inflation would be markedly different. In recent months, consumers generally have saved about half of the tax reductions enacted earlier this year, and half has been spent supplemented by extensive borrowing for purchases on the installment plan. Under circumstances such that saving would be even more rewarding, with lower rather than higher prices anticipated for many "big ticket" items such as homes and automobiles, we should expect even more savings and some contraction rather than further expansion of the ratio of installment purchases to disposable incomes.

The next few months promise to be unusually interesting to all who are concerned with business, investments, and economic problems generally.

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