Vol. VIII No.4

ECONOMIC EDUCATION BULLETIN

Published by

AMERICAN INSTITUTE for ECONOMIC RESEARCH

May 1968

Great Barrington, Massachusetts 01230

REAPING THE WHIRLWIND

(Economic Aspects of the State of the Union)

Having sown the "winds" of inflation for three decades, much of the civilized world is beginning to "reap the whirlwind," the undesired "harvest" being the inevitable consequences of inflating the money and credit of the various nations concerned. Among the industrially more advanced countries, the consequences have become most apparent in Great Britain.

Only a few decades ago, Great Britain was the wealthiest nation in the world. The possessions of its individual citizens and corporations extended over an economic empire that included even more of the world than did the political elements of the British Empire. From the earnings of those possessions flowed a vast stream of things to the homeland: wool from Australia, gold, copper, platinum, and other metals from Africa, and hundreds of other things for the use and enjoyment of the people of Great Britain.

However, prolonged inflating of the money supply has had the usual effects. Union labor was encouraged to demand more and more; featherbedding practices became general; the easy windfall profits of inflation lessened the incentive for managerial efficiency and modernization of industry, and socialistic programs now constitute a welfare-state millstone around the necks of the British people.

As the situation became worse, the Government of Great Britain chose to inflate more rather than make politically painful corrections. The foreign stocks and bonds owned by citizens were seized, and citizens were given government bonds as compensation. Then the "geese that laid the golden eggs," the foreign assets, were gradually sold abroad in an effort to maintain convertibility into gold for a currency debilitated by prolonged inflating. Finally, even the best of the profitable foreign investments, the remainder of more than a billion dollars worth of American common stocks, were sold in the fall of last year.

Only the beginning of the "whirlwind" to be reaped has thus far been seen: the devaluation of the pound sterling last November. Few citizens of Great Britain seem to realize as yet that much of the capital accumulations of the past few centuries has been sold to finance socialistic experiments doomed to failure even in the relatively short run of recent decades. Lord Keynes wittily argued that "in the long run we are all dead." Of course, some of those responsible for England's present plight, including Lord Keynes himself, are dead; but their children and grandchildren are not.

The United States has followed policies similar to those adopted in Great Britain. Thus far, the "gold rush" in the closing months of 1967 has been the most striking consequence, with nearly $1 billion of gold lost in December alone. This was only the beginning of the economic "whirlwind" that is to be our "harvest." Now, for the first time in the Nation's history, strict controls of capital exports by U.S. corporations have been ordered, and restrictions on the freedom of U.S. citizens to travel abroad have been proposed.

Few U.S. citizens apparently realize the seriousness of the imbalance-of-payments problem; and even fewer probably know about the extent to which "slick tricks" have been used to conceal aspects of the problem and to postpone the remedial action necessary. In its daily statement, the U.S. Treasury continues to report the total of gold held with no indication that substantial amounts have been pledged to preferred creditors. This is comparable with an insolvent business reporting cash on hand that already has been assigned to a preferred creditor. Such are the ingredients of a fraudulent bankruptcy for which businessmen are sent to prison.

Special U.S. bonds have been issued of longer ostensible maturity than one year but with a 48 hours or shorter "escape" clause whereby foreign central bank holders may obtain repayment virtually on demand. The amount of these bonds as issued is counted as an export in the balance-of-payments calculations, and is excluded from officially reported foreign short-term claims on U.S. gold.

Oh, What a Tangled Web

"Oh, what a tangled web we weave, when first we practice to deceive," might well be the motto of the U.S. Treasury. Since the United States first adopted the policy in 1934 of continuing to circulate a currency with the pledge, "The United States of America will Pay to the Bearer on Demand X Dollars" (a dollar by statute is one thirty-fifth of an ounce of gold) while continually dishonoring that pledge, the monetary web has become tangled almost beyond the wit of man to untangle.*

In an effort to continue holding down the "price" of gold (or to support the 40-cent dollar so that it would

seem "as good as gold," such alternative descriptions of the process being dependent on the point of view), the United States sent Under Secretary of the Treasury Deming to Basel, Switzerland, early in December. He proposed to the nations still participating in the London gold pool that they make available large quantities of their gold (for supporting the gold-exchange value of dollar claims on gold) and accept in exchange for their bullion gold certificates, which would be reported to the public as part of their gold reserves. In effect, the proposal was that members of the gold pool double count their gold so that the public would not be aware of the drain on their gold reserves used to support dollar claims.

That such a proposal was seriously made by the United States sufficiently reveals the standards of integrity, or lack of any, on the part of the U.S. officials concerned and their advisers. Perhaps it also reveals arrogant complacency that "the King can do no wrong" as well as contempt for the economic sophistication of the general public. Also revealing is the fact that not one of the European central bankers present at the Basel meeting would consider the proposal for a moment.† (Standards of integrity on their part are indicated that might well be emulated.)

Credit is Suspicion Asleep

Not only was the U.S. proposal immediately rejected, but also it aroused serious doubts. Suspicion became general among the European bankers present that the situation, already known to be bad, might, if the truth were known, be worse. Their attitude should surprise no one. If you were urged by some improvident debtor to assist him in deceiving his creditors, would not you wonder whether the debtor had revealed to you the full extent of his obligations?

Chairman Martin of the Federal Reserve Board and others have asserted that the dollar would be supported at $35 per ounce of gold even if it required the last bar of gold at Fort Knox to do so. We have reason to believe that such assertions no longer are being taken seriously by any central banker or other well-informed individual abroad. Moreover, some are so skeptical as to emphasize that the further repetition of such assertions will only increase their doubts about the redeemability of dollar claims. They are well aware that no world power such as the United States could afford to risk not having a reserve of gold, the only universally accepted means of payment. Even if American politicians and some bankers might acquiesce in dissipating all U.S. gold, foreign observers do not believe that United States military authorities would agree to that course of action, nor do we believe that the Nation's military leaders would do so.

As for the possibility that the measures announced by President Johnson on January 1 will remedy the situation, we do not see how anything more than temporary postponement of some developments, possibly until after next November, could result; and even that "breathing spell" is by no means assured. As we pointed out in Research Reports for January 8, the imbalance-of-payments problem will not be remedied by such superficial concern with present symptoms.

In a modern industrial economy with its relatively great need for continual additions to capital equipment, the full consequences of prolonged inflating become apparent only after years have elapsed.

For example, major public utilities in the United States recently have awarded contracts for generating and other equipment to one Swiss and two British companies whose bids were much lower than those of the leading American producers. (One of the three successful bidders was a foreign subsidiary of a parent United States bidder.)

The divergence of relative costs must develop and continue for years in such a highly specialized field before foreign manufacturers are even invited to bid. Design and planning of major electrical generating stations also requires years; and more years elapse before equipment ordered is scheduled for delivery.

Similarly with automobiles, a foreign manufacturer must gain acceptance on a small scale here, develop a dealer organization, plan and construct spare parts depots, and train personnel. Several years have elapsed since the manufacturers of Mercedes automobiles first began to compete effectively in the American market, and only now are they beginning to sell cars here on a scale that promises keen competition within the United States for American producers.

Thus the excess of American exports over imports of goods and services, which had prevailed for many years, is decreasing and soon the favorable balance may be reversed. Results for the last quarter of 1967 were striking. They suggest that Mr. Johnson's plan to remedy the balance-of-payments deficits is little more than a "pipe dream."

If Mr. Johnson is determined to postpone revaluing gold (raising its dollar "price," or devaluing the dollar) until after next November, and if drastic deflation is not contemplated in order to save the dollar, he will find that the controls proposed January 1 were only the beginning. Control over the export of capital funds by corporations and banks will not prevent individuals from investing more abroad. The Interest Equalization Tax is a partial barrier to such investments, but ways already have been developed for legally avoiding that tax. Experience has shown that exchange controls breed more exchange controls in a never-ending procession of scope and complexity. Many people are not stupid. The expectation of such further controls will induce thousands to shift funds abroad in order that they may retain freedom of action and travel in an economically disordered world.

Failure to go to the root of the imbalance-of-payments problem, failure to substitute deflating for inflating, failure to lessen the power of monopoly unions, failure to remove the prohibition against having a job unless some employer will pay a high minimum wage, failure to recognize that inflating drives a horizontal wedge into society raising to greater affluence those who have much and robbing those who have little, failure to correct the underlying situation (inflation-augmented special privileges) that accounts for decaying cities and metropolitan ghettos, to name some of the aspects of the problems to be solved; all these failures to act wisely coupled with continuation of economic follies, make the situation in the United States more precarious; invite those who have even moderate funds to shift them abroad; and even force those who would otherwise prefer to remain here to prepare for life abroad when and if the riots in American cities escalate further to the status of mob uprisings where

no man is safe, especially if he appears to have or is known to have somewhat more than many of his fellowmen.

For those who "sow the winds" of inflation and related economic evils, there is no escape. That the United States will continue to "reap the whirlwind" of economic and social tribulations is as highly probable as it is improbable that those in the seats of economic and political power will see the error of their ways and reverse the course of the American ship of state.

Lest our conclusions be misunderstood, we should emphasize that we do not know of any way to predict the precise timing of the unpleasant events ahead. That the process of inflating and thus "embezzling" the savings and life insurance of the American people can continue for years seems obvious. Only recently has the annual loss in buying power of such assets approximated the annual savings of the public. Much previously accumulated remains to be "embezzled," and there is no apparent reason why the United States could not continue the process as long as France did. (That country sowed inflation for nearly half a century, until the French franc finally became worth less than four-tenths of 1 percent of its original value.) However, the imbalance-of-payments problem, the riots in U.S. cities, and other troubles seem to be escalating rapidly. We find no reason to hope that subsequent phases of the whirlwind will be long postponed.

* This promise to pay apparently became a source of so much embarrassment that the Treasury began eliminating it from the currency, first, a few years ago, from the dollar bills ("bill" is one name for a promise to pay), and later from other paper currency. It remains on some currency not recently printed.

† We are aware that press reports of the December meeting in Basel gave the public a quite different impression. The gold pool nations were reported to be supporting the United States by continuing the pool's operations with their combined holdings, some $26 billion of gold. This was nonsense. Although we may not be in a position to reveal our source of information for a few years, we are confident that our report of what occurred is correct.

CRACKS IN THE MONEY CREDIT PYRAMID

Readers of these reports* presumably have not been surprised by the money-credit developments during the past week. Devaluation of the pound sterling by 14.3 percent announced November 18 has been followed by comparable or somewhat larger devaluations in 17 countries, Ireland, Denmark, Israel, Spain, New Zealand, Hong Kong, Malta, Bermuda, Cyprus, Mauritius, Barbados, Guyana, Gambia, Ceylon, Jamaica, Fiji, and Malawi, through November 21.† Other countries whose holdings of sterling are large in relation to gold reserves, such as Australia and some Arab countries, also may devalue. News commentators and the press have reported on the official actions taken, but even more interesting is the story of what went on that has been hidden from public view. From various sources of information we were able to assemble a more complete report.

The fundamental factors accounting for the partial repudiation of British debt to foreigners were ignored by most commentators as well as by Prime Minister Wilson in his speech about it. According to Mr. Wilson, devaluation was forced by the "chance of world events," including "successive waves of speculation against sterling."‡ He did not mention his party's almost continuous pursuit of inflationary and socialistic policies that have debilitated the competitiveness of British industry and left his country's international finances in shambles.

That the pound was being held at a higher level than was warranted by the relative facts of economic life

* Especially of *Research Reports* for October 2, 1967, containing the article "Probable Effects of Another Pound Devaluation."

† On Friday, November 17, the day before the devaluation, Lord Chalfont, the British Secretary of State for European Affairs, told an audience of 1,000 French bankers and businessmen in Paris the British Government had no plans to devalue. (Prime Minister Wilson subsequently stated that the Cabinet had decided to devalue at a meeting Thursday, November 16.) Such deliberate lying by government authorities is customary just before a devaluation.

‡ London bankers denied that speculators had been selling large amounts of sterling and said that selling orders came primarily from businessmen and others attempting to protect themselves against losses that would result from devaluation.

IMPORTANT NOTICE

"Reaping the Whirlwind" was published in our weekly Research Reports dated January 22, 1968; and "Cracks in the Money-Credit Pyramid" was published November 27, 1967, also in our weekly Research Reports. These articles are reprinted in this Economic Education Bulletin in order to give more extensive distribution to this educational material. Readers are invited to send for additional copies for friends and to become Annual Sustaining Members so that they may receive the Research Reports each week.

In addition to articles such as those herein, the Research Reports present the results of our continuing economic research. Each issue includes informative charts not found elsewhere. Among the more important regular features are: The Harwood Index of Inflation; Sources of Purchasing Media; The Statistical Indicators of Business Trends; and many others.

Please use the order blank on the reverse side

such as prices, wages, and productivity per man hour in Great Britain versus other countries had been evident for years. Mr. Wilson's half-hearted attempt to force some deflation last year at the cost of relatively small unemployment revealed some recognition of the situation but failed to correct it.

The deflation and resulting hardships, although relatively minor, stimulated a revolt within his own party. Consequently, the policy of halting all wage increases was discontinued, and moderate further inflating was encouraged by a lowered Bank of England discount rate. Nevertheless, both the adverse balance of payments and the business recession continued. Finally, the recalcitrant group within the Labor Party presented an ultimatum: they would force a vote of confidence, join the opposition in condemning Mr. Wilson, and thus make necessary elections at an early date unless Mr. Wilson abandoned attempts to deflate and instead encouraged further inflationary expansion of business activity.

As England's balance of payments continued to be adverse to an increasing extent, Mr. Wilson again was forced to seek aid from abroad. He found that it would be available only on conditions that he knew would precipitate a revolt in the Labor Party. A stop-gap loan of $252 million was arranged through the Bank for International Settlements (duly reported in the press), and the leading central banks were to consider an additional loan of $750,000,000. While the deliberations continued, the "run" on the pound reached staggering proportions. On Friday, November 17, the Bank of England and the Federal Reserve Bank of New York intervened in the market to "save the pound" at a cost estimated at several hundred million dollars. Clearly, the proposed additional loan would have been hopelessly inadequate.

The nations who had the necessary gold refused to lend unless severely deflationary measures, including great reductions in government expenditures, were pledged by Great Britain. Obviously, Mr. Wilson and his colleagues concluded that avoiding such measures by devaluing would provide at least a chance of remaining in office by preventing a revolt within the party that might soon cut short the term of the Labor Government.

Then the "horse trading" in the so-called group of ten (the leading industrial nations) centered on the extent of the devaluation. After his experience of the past few years, Mr. Wilson must have realized that only a drastic devaluation, at least 25 percent, could be expected to relieve the pressure by restoring more favorable trading relationships. However, U.S. authorities were adamantly opposed to a devaluation exceeding 10 percent.

We suspect that both Mr. Wilson and Mr. Johnson are doomed to disappointment. Although an interval of a few weeks may occur when both the pound and the dollar will seem strong in the world's foreign exchange markets, we believe that England's position will not be sufficiently improved, and the status of the dollar almost surely will become more precarious.

Perhaps substantial agreement already has been reached among the group of ten on a general increase in the "price" of gold. This could account for willingness to compromise on what otherwise seems sure to be inadequate half-measures.

Because this devaluation seems to be too little and too late, we doubt that it alone can restore equilibrium. Britain must have aid in the form of loans if even a creditable effort is to be made to hold the pound at $2.40. As a condition for a loan being assembled by some Common Market and other nations, British authorities raised the discount rate to 8 percent and agreed to avoid further inflation for the time being.*

Rarely has the Bank of England's discount rate reached 8 percent. Only twice in the past 100 years has that rate been equaled or exceeded. In the great panic of 1893 (when the longest depression the United States ever experienced began) the Bank of England discount rate reached 9 percent for several weeks.

To summarize, recent dramatic events are only the opening scene of the play all of us are to witness. There may be intermissions, but the play will go on through its economically painful scenes to what probably will not be a happy ending from the viewpoint of most of the audience.

---

*Unconfirmed reports indicate that French authorities have refused to participate in such a loan and have withdrawn from the so-called gold pool.

Economic Education Bulletin is published eleven times a year (monthly except January) at Great Barrington, Massachusetts, by American Institute for Economic Research, a scientific and educational organization with no stockholders, chartered under Chapter 180 of the General Laws of Massachusetts. Second class postage paid at Great Barrington, Massachusetts. Printed in the United States of America.

AMERICAN INSTITUTE FOR ECONOMIC RESEARCH
Great Barrington, Massachusetts 01230

I enclose $9 for an Annual Sustaining Membership which I understand entitles me to receive all currently printed Institute publications including the weekly *Research Reports* for a 3-month trial period.

or

I enclose $35 for an Annual Sustaining Membership for a full year.

and

Please send me_____copies of this ECONOMIC EDUCATION BULLETIN at the rate of 10 for $1. I enclose $______.

Name______________________________(Please Print)

Street________________City________________State________ZIP________

(You may send currency at our risk)

S