AMERICAN INSTITUTE *for* ECONOMIC RESEARCH

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RESEARCH REPORTS

NOTE.—The outstanding importance of the forthcoming decision of the Supreme Court on the gold clause cases has resulted in numerous inquiries by clients as to the effects to be expected. In the two preceding weekly bulletins, we have discussed the legal aspects, but have given little space to the effects which may be anticipated. Believing that readers will approve, we have decided to postpone to next month the description of our Index of Industrial Production, and to devote the major portion of this monthly bulletin to a discussion of the effects to be anticipated, whatever the Supreme Court's decision may be.

Summary

Industrial production and volume of distribution are not yet affected by pending gold clause decisions. Basic industries show continuation of the recent upward trend.

Charts showing production, purchasing power, and prices appear on last page of this bulletin. Data covering the final month of 1934 show a sharp rise in the industrial production index accompanied by increases in the indexes of inflation and commodity prices.

Latest reports of the Federal Reserve Member Banks reveal new highs since the depression for net demand deposits (checking accounts) and reserve with Federal Reserve Banks.

An administration bill introduced by the Chairman of the Ways and Means Committee provides for basic rearrangement of the Federal debt. Implications contained in this bill will be discussed in the next issue.

The effects of the forthcoming gold clause decision are discussed in the light of several possible courses of action which the Administration may adopt. A summary of our conclusions appears on page 3.

Effects of the Gold Clause Decision

There seem to be two sharply differing schools of thought, one of which contends that a decision adverse to the Administration will mean chaos, whereas the other group asserts that such a decision would make little or no difference. Among the former are the strong supporters of the present Administration who feel that anything which tended to restrain the party in power must necessarily restore the chaotic conditions which existed when that party went into office. The members of the other group are ably represented by Colonel Ayres and the editor of the Annalist, both of whom seem to feel that, except for a temporary shock, the longer term results of a decision adverse to the government would be favorable.

We are unable to agree with either of the extreme views mentioned above. In order to present the situation as we see it in the clearest manner possible, it seems best to deal separately with the possible decisions which might be made, and the action which might be taken subsequently thereto, by the present Administration. By thus exploring all possibilities involved, it will be practicable, not only to present our reasoning in full, but in addition to forewarn clients of the effects which may reasonably be expected under any of the possible developments.

The simplest aspect of the problem is that which assumes a decision unqualifiedly favorable to the government. Supposing, then, that the Supreme Court approves the devaluation of the dollar, confiscation of gold certificates giving only Federal Reserve notes in exchange, and abrogation of the gold clause in both private and Federal obligations, what will the outcome be?

If the Administration Is Supported

The most obvious effect of a decision of this character will be the retention of the 60 cent dollar and its establishment as our monetary unit for some time to come. Certainly, no one would believe that there was any possibility of an upward revision in the gold content of the dollar, although it is possible that many people might expect further devaluation at some indefinite future time. In general, however, uncertainty regarding the monetary unit would be eliminated.

Readers are familiar with our views on the price situation and the reasons therefor. We have pointed out that the maximum effects in terms of a rising price level, because of the existing degree of devaluation, have not yet been seen. The removal of uncertainty would almost surely result in firming prices and a resumption of the upward movement toward levels which may be considered normal under present circumstances. For a more complete discussion of normal prices, readers are referred to the preceding monthly bulletin.

In view of the known condition of retail and wholesale inventories and the fact that buying for purposes of replenishing those inventories has in most cases been postponed (because of the uncertainties at present prevailing), it is believed extremely likely that there will be a scramble for goods, with resultant sharp increases in prices. This applies to both wholesale and retail markets.

The recent focusing of public attention on the Supreme Court's consideration of the gold clause cases

has resulted in a substantial decline in the price of many common stocks. Everyone realizes that the railroads and utilities, in particular, as well as those industrial issues preceded by bonds bearing the gold clause, will be in a most unfavorable position if the gold clause is held valid. It is believed that the recent hesitation in security markets has been due to the uncertainties involved. Therefore, it seems probable that a decision favorable to the Administration would serve as the initial impetus for a substantial upward movement in the security markets.

It is believed that the forward movement would not be confined to the market for common stocks alone, inasmuch as many second-grade bond issues and preferred stocks are in a position somewhat similar to the equity issues. A favorable decision would not necessarily imply further inflation, and therefore seems unlikely to affect adversely the market for high-grade bonds.

The attempts on the part of wholesalers and retailers to replenish normal inventories, augmented by the efforts of consumers to make purchases in the face of rising prices, seem likely to stimulate industrial production. Under such circumstances, the chances favor a minor boom similar to that which was witnessed in the late spring and early summer of 1933.

If Repudiation Is Disallowed

It may be that the Supreme Court will render a decision favorable to the Administration on all points except that involving the gold clause in the public debt. In other words, abrogation of the gold clause in private debts, confiscation of gold and gold certificates, and devaluation itself may be considered powers delegated to Congress, in that they are necessarily implied by the power to regulate the value of United States money and foreign coin. The 14th amendment to the Constitution, which specifically provides that the validity of the public debt shall not be questioned, might well be considered grounds for differentiating between the cases along these general lines.

The question which then arises is: what would the present Administration do under such circumstances? It is conceivable that Congress might do nothing, and that the Treasury would simply consider that it was obligated for 67 per cent. more par value than is actually stated in dollars on the gold clause bearing bonds. Apparently, the amount of such securities actually outstanding is approximately $14,000,000,000. It follows that the indebtedness of the government would thereby be increased by approximately $9,000,000,000.

The other alternative open to the Administration is an introduction of new legislation and possibly a constitutional amendment which would provide the necessary legal sanction for abrogation of the gold clause in government bonds. Possibly, special taxes would be authorized by Congress in order to offset the effect of the Supreme Court decision, but here again it might be necessary to amend the Constitution.

It hardly seems likely that the Administration will take no steps to counterbalance the effects of an adverse decision. However, this unlikely contingency must not be disregarded. The primary effect would be substantially to increase the Federal debt but not to effect private contracts in any way whatsoever. Such an increase in the Federal debt might lead to an inability on the part of the government to sell its bonds on the scale at present contemplated. This, in turn, might bring about the inflation by means of currency issues which has long been threatened, but that is certainly not a possibility of the near future.

Inasmuch as the decision we have now assumed would not force a return to the former gold standard dollar, the beneficial effects on prices of commodities and securities resulting from a removal of present uncertainties would apparently be more or less as previously described. However, the larger federal debt, with its more burdensome interest charges, would probably necessitate higher taxes, and in general might be regarded as having a dampening effect on business enthusiasm. Resumption of the upward movement in prices and a continuation of business recovery in more orderly fashion seems likely to follow a decision along these lines. Of course, it is barely possible that the Administration will decide to restore the former gold dollar if the Supreme Court should refuse to permit repudiation of the government debt. This is perhaps the most unlikely step of all, but it will be dealt with in a subsequent portion of this discussion.

There remains to be considered, under the present assumption, the possible effects if the Administration should take steps, either by special taxation or by a Constitutional amendment, to offset the effects of the Supreme Court's decision with respect to government bonds. Action along these lines would presumably leave the general situation in very much the same status as under the first assumption discussed above. It seems probable, however, that there would be a brief period of uncertainty and hesitation pending such measures as Congress might take to meet the situation.

If Abrogation Is Unconstitutional

The third general assumption which it seems advisable to discuss is that the Supreme Court will decide that Congress' action in abrogating the gold clause was unconstitutional with respect to both public and private debts. This would not question the right of Congress to devalue the dollar, nor the validity of the gold confiscation measures.

Following such action by the Supreme Court, the Administration might proceed along any of several lines. In the first place, a "do nothing" policy might be adopted which would leave devaluation as at present and would pass the entire problem along to the debtors involved; secondly, the Administration might restore the gold dollar to its former weight; thirdly, special taxes might be levied with a view to counterbalancing the effects of the gold clause; and fourth, an amendment to the Constitution might be introduced with a view to making the action taken legal. Each of these contingencies will be discussed in turn.

The "do nothing" policy, which would immediately result in the bankruptcy of practically all railroads, most utilities, and many industrials, is hardly likely to be adopted by the present Administration. That this would mean the wholesale elimination of values in the stock market is a foregone conclusion. The shock to the business world would be severe, and it is conceivable that a brief but substantial recession in business would occur.

An important point to remember is that commodity prices would not be affected over the long run. Of course, sharp breaks, and possibly a decline lasting several months, could be expected in the prices of most commodities. However, the basic relationship between a given weight of gold and a given quantity of goods

would not have been changed by the decision, so that the present long term upward trend of prices would presumably reassert itself.

The second contingency, under the assumption now being considered, is that the former gold weight of the dollar might be restored. This would prevent the sudden enlargement of public and private debts involving the gold clause in terms of dollars, thereby avoiding wholesale bankruptcies. However, such action would destroy the foundations of the existing price level, and it is believed that a castastrophic decline would follow.

This is a point concerning which there has been a marked difference of opinion. It has been asserted that the man in the street does not know what the gold weight of the dollar is anyway; that a dollar is a dollar, and that it is idle to suppose that there will be any sharp decline in prices merely because the former gold weight of the dollar is restored. With this viewpoint we definitely disagree, and in fact feel so certain of the soundness of our views in this respect that we unhesitatingly advise clients to expect a substantial decline in wholesale and retail prices if the former gold weight of the dollar is restored.

It is true that the man in the street little realizes the significance of any definite weight of gold in the dollar. It is also true that at least part of the rise in prices since 1933 is directly traceable to federal spending, to inflation in fact, and that the restoration of a 100 cent dollar would not automatically remove the present degree of inflation from business channels. Nevertheless, we feel that the man in the street does realize when the trend of prices is downward, and that he is apt to wait for a bargain. Furthermore, the reversal of the long term trend of prices (which would necessarily follow a restoration of the former gold dollar) would certainly make it dangerous to count on anything other than severe declines.

The third possibility mentioned is that the Administration, by means of special taxes, may offset the effects of upholding the gold clause. Presumably such taxes would contemplate a return to the debtor of the funds thereby collected, in order that wholesale bankruptcy might be avoided.

Inasmuch as this action would not involve restoring the 100 cent dollar, it is to be supposed that commodity prices, possibly after a brief period of hesitation, would resume the long term upward trend, although business and securities might be unfavorably affected until such time as the special taxes and their effects had been made clear. It seems probable that no serious harm would result, and that the possibilities first described, albeit of somewhat less marked extent, might be anticipated.

The final possibility is that the Administration would seek by constitutional amendment to nullify the Supreme Court's decision. There seems to be little doubt that such an amendment to the Constitution would be quickly passed and promptly ratified. That, at least, is the opinion we have formed in viewing the situation objectively. Assuming this to be the case, it seems probable that commodity and security markets as well as business would be affected unfavorably only for a short period of time. Admittedly, the initial effects might be severe, but it seems probable that the subsequent recovery, when it became evident that such an amendment was to be passed, would quickly restore the status quo. Once the Constitutional amendment has been ratified, or as soon as that became a certainty, it seems probable that the forward movement in business, securities, and commodities would rapidly gather momentum.

Other Possible Assumptions

It is conceivable that the Supreme Court may uphold the right of Congress to abrogate the gold clause in government and private contracts, and yet deny the right of the government to confiscate gold, giving in return a paper money shortly thereafter devalued. This would be a very fortunate decision for the holders of gold certificates and gold who had turned their holdings over to the government under protest. However, it could not affect the general economic situation.

The worst result which could follow a decision along these lines would be the loss by the Treasury of a substantial portion of the so-called profit resulting from the devaluation process. This "profit" would presumably have to be paid to the individuals from whom the gold and gold certificates were originally taken. The principal beneficiaries of such action would be the Federal Reserve Banks, and, inasmuch as their profits above six per cent. must be shared with the Federal government, a large portion of the gold "profit" would come back to the Federal Treasury.

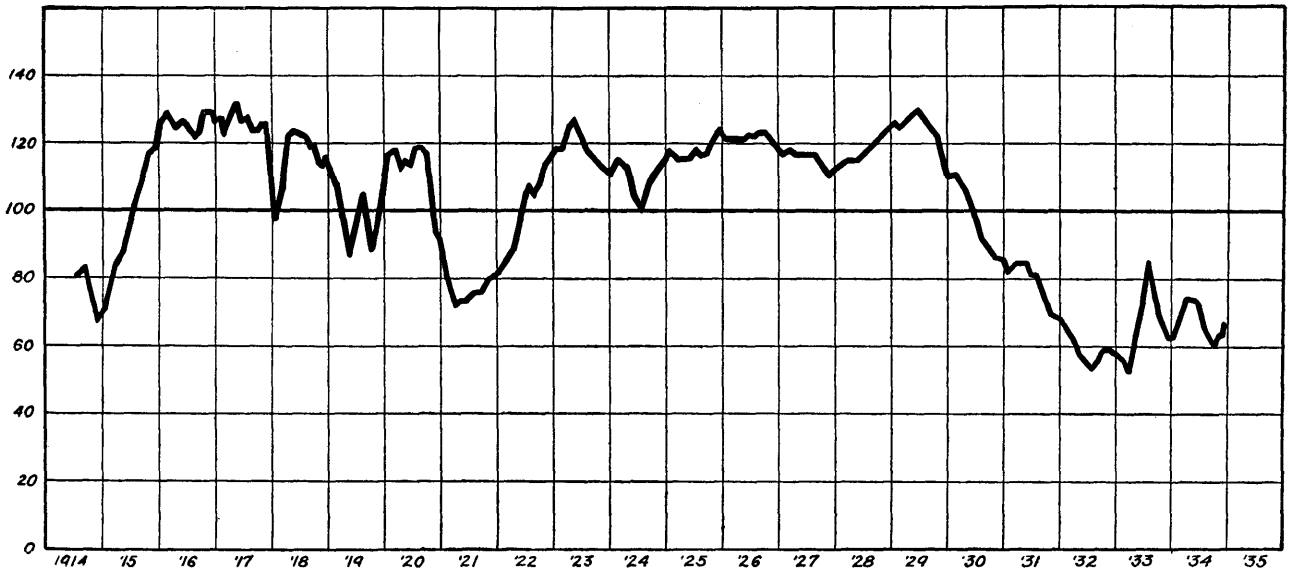
It hardly seems probable, however, that Congress would fail to take action circumventing the effects of such a decision. In any event, the results would not be such as to disturb business in general, and the removal of the uncertainty which has existed for months would permit the freer operation of forces creating recovery.

Conclusions

It may be well to emphasize the fact that in these bulletins we have not attempted to say what should be done by either the Supreme Court or the Administration. We are primarily interested in foreseeing what will be done and the effects thereof. In our opinion, it is too late to do that which would have been most desirable: namely, adhere firmly to the former gold standard dollar, even at the expense of numerous bankruptcies, in order to re-establish the country's commerce and finance on a firm foundation. We greatly fear that it will be many years before that desirable situation will exist. In the meantime, we do not expect the present Administration to abandon one of its favorite courses of action, devaluation, merely because the Supreme Court rules against it.

Those who are guided by advice given herein are necessarily incurring a small degree of risk, since it is possible that the Administration will not attempt to offset an adverse Supreme Court decision. On the other hand, to adjust investment funds and business inventories in the expectation that the former weight of the dollar will be restored involves far greater risk. We feel that the balance of probabilities favors an early resumption of the upward movement in both security and commodity markets, even though there may be a brief period of hesitation or even temporary declines before such movements get underway. We cannot attempt to forecast whether or not there will be further temporary declines, nor their extent, and we feel that it would be running unnecessary risks to count on them. It should hardly be necessary to add, however, that any position taken with a view to profiting by price advances should be well protected against extensive declines.

INDUSTRIAL PRODUCTION.



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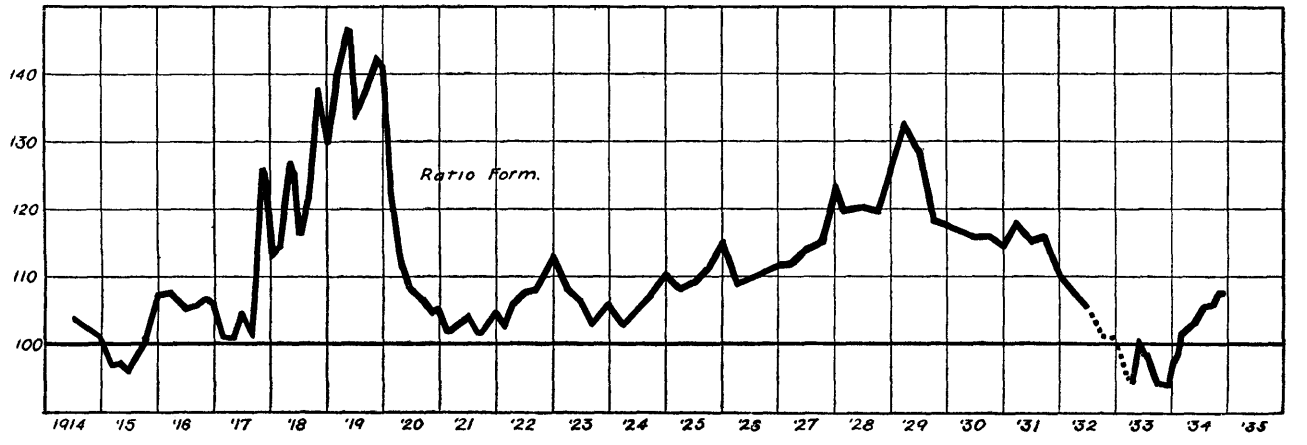

COMMODITY PRICES.