AMERICAN INSTITUTE *for* ECONOMIC RESEARCH

MONTHLY BULLETIN

January 1936

1200 Massachusetts Avenue - Cambridge, Massachusetts

RESEARCH REPORTS

Summary

The Institute's indexes of production, purchasing power, and prices for December all recorded increases over November and closed the year at the highest levels of any month in 1935. Changes in these indexes during the year are briefly reviewed on page nine.

The present monthly bulletin presents statistical comparisons of the Federal debt with commodity prices during the past two decades. During this period there have occurred two extraordinary expansions in the total debt burden, due to the World War and the depression. Changes in commodity prices accompanying vast increases in the public debt are discussed and other factors affecting prices are considered.

The Public Debt and Prices

There has been a great deal of argument as to how large a total debt the United States "can stand" without impairment of its credit. Much of this discussion has ignored the vital question as to the method of financing the budgetary deficits by which the debt is increased. A debt which is amassed through the sale of Government securities to the people in return for their savings will probably be deflationary in effect. On the other hand, if additions to the Federal debt are made in such a way as to add to the effective purchasing power of the nation, the effects will be inflationary in character.

The manner in which budgetary deficits were financed during the War, and again during the present period of rapid debt increase, leads to the creation of new purchasing power much more rapidly than is justified by the normal movement of goods in trade and therefore serves to increase total purchasing power in respect to the volume of trade at the current price level.

Thus while extraordinary increases in the public debt do not necessarily imply rising commodity prices in theory, in practice the inflationary devices for financing deficits lead to higher prices as a consequence. The savings of the people which are available for the absorption of Government securities are insufficient to purchase more than a fraction of the new issues made necessary by exceptional Government disbursements. This was true during the period in which we participated in the World War and is also true of the present period of Federal spending in excess of receipts.

Readers of these bulletins are aware of the relatively moderate changes which normally take place in commodity prices in response to changes in the volume of world gold production. If it were not for large scale wars and the dislocations in world monetary systems which invariably accompany them, long-term trends in commodity prices could be estimated in advance with a considerable degree of accuracy. Social crises, however, occasion extraordinary changes in the commodity price level, and these changes can be forecast with some degree of accuracy only after the acute phase is passed and consideration can be given to the effects of the special measures taken for the purpose of meeting it.

Price levels in the United States at the present time are subjected to two major factors, both operating in the direction of higher levels. These are devaluation, the dollar having been definitely reduced in weight of of gold content, and the rapid increase in purchasing power brought about by the monetization of new Federal securities through credit extensions to the Government by the commercial banks.

GOVERNMENT DEBT AND COMMODITY PRICES
1914-1936

Year Ended June 30	U. S. Gross Debt June 30 (In millions of dollars)	Price Index American Institute for Economic Research
1914	$ 1,188	98.6
1915	1,191	101.6
1916	1,225	126.2
1917	2,976	175.0
1918	12,244	196.7
1919	25,482	210.0
1920	24,298	237.4
1921	23,976	150.8
1922	22,964	150.9
1923	22,350	158.9
1924	21,251	155.8
1925	20,516	166.4
1926	19,643	162.8
1927	18,510	156.3
1928	17,604	160.2
1929	16,931	159.4
1930	16,185	145.9
1931	16,801	124.7
1932	19,487	112.3
1933	22,539	115.2
1934	27,053	132.0
1935	28,634	141.6
1936*	34,239	

*Budget estimate.

The statistical comparison shows that prices had begun to rise rapidly previous to our entry into the World War and previous to any substantial increase in our public debt. This was, of course, due to extraordinary demand for commodities by the belligerents. The Liberty Bond inflation of 1918-19 began soon after our entry into the war, when it was found that the current savings of the nation were inadequate to supply funds as rapidly as needed. The commercial banks utilized the excess reserves provided by Federal Reserve Bank purchases of Government securities for the purpose of absorbing the greater part of Liberty Bond issues in exchange for checking account credits to the Government. This new purchasing power was paid out by the Government to defray the war costs and occasioned a large and sudden increase in the purchasing power of the people. Prices rose rapidly and at the height of the post-war boom were for a brief period over two-and one-half times the pre-war level.

In making comparisons between the total of public debt now and during the World War, and commodity prices now and during the World War, allowances must be made for different conditions existing during the two periods. These will be discussed later.

Commodity Shortages

It has been argued that the scarcity factor was more important than inflation as an influence in the increase of commodity prices at that time. The factor of commodity shortages, however, was clearly only partially responsible for the commodity price increases. After the close of the War, when surpluses of many commodities amassed for war operations were released as no longer needed, prices did not return to pre-war levels, but remained more or less stabilized at around 60% above the pre-war level during the following nine years.

Normally, prices would have continued to decline during this period, but they were in this case influenced by a resumption of credit inflation due to the monetization of common stocks through huge increases in brokers' loans.

As far as this theory applies to present conditions it may be noted that, while surpluses now exist, these are confined to a comparatively limited number of commodities. These have furthermore been reduced substantially during the past year, due to world recovery, the drought in the Middle West, and war activities in the Mediterannean and the Far East. Naturally, if there exist large surpluses, price increases are not likely, but supply is a relative term and may soon be found insufficient upon a substantial increase in effective demand.

It will be seen that during these years budgetary surpluses made possible a steady decrease in the gross public debt. This would normally have been a deflationary influence to the extent that inflationary credit extensions were retired, had there been no compensating factors. During the years 1921-1929, however, the growth of brokers' loans much more than offset the retirement of debt.

The Nation's Debt

The table shows that the gross debt of the United States, amounting in 1916 to what now seems to be the insignificant sum of approximately one billion and a quarter dollars, rose to over twenty-five billion dollars in 1919. Reductions in the nation's debt between that year and 1930 were sufficient to bring the total down to slightly over sixteen billion dollars. The deficit of nearly one billion dollars occasioned by decreasing tax receipts in 1931, and subsequent annual deficits of three and four billion dollars, soon amassed a record total debt, which represented a depression debt superimposed upon a large residual war debt.

In drawing parallels between the effect of the monetization of Liberty Bonds in 1918-19 and the monetization of Government securities in 1931-1936 and some further indefinite period of years, it is essential to consider other relationships, such as world gold production, and monetary manipulations such as the devaluation of the dollar.

In the Explanation of Basic Charts, sent to all Research Report subscribers, it was shown that the volume of world gold production is now above normal, and that this has led in the past to a long-term upward trend of commodity prices. This factor is partly offset by the contrary effect of increased mechanical efficiency on prices, which tends to reduce the cost of production, not only of manufactured articles, but also of agricultural commodities.

Effect on Prices

The "new normal line" which appears on the chart of commodity prices on page ten of this bulletin indicates the point to which prices should rise in order to discount the devaluation of the dollar. It will be seen that during the three years which have elapsed since prices returned approximately to the old normal line, at the culmination of deflation in 1933, they have recovered more than half of the ground which they may be expected to retrace because of devaluation. Inflationary additions to the total purchasing power, as represented largely by checking account totals, will be more than sufficient to offset the factors of commodity surpluses and the destruction of purchasing power occasioned by bank failures during the depression.

From the foregoing discussion it becomes clear that while valuable inferences may be drawn from the actual size of the Government debt, it cannot be taken as a single indicator either of commodity price movements, or of the condition of Federal credit. As suggested above, the manner in which Government deficits are financed is of greater importance. The question, "How large a debt can we support?" cannot be answered at this time. It is likewise impossible to say how high commodity prices will go during the next few years. That further substantial increases are practically certain to take place may be assumed. Until an end is made to the present succession of budgetary deficits, there is no assurance that we can avoid a depreciation of the dollar similar in degree to the post-war depreciation of the franc.

Even if the next fiscal year will mark the end of an unbalanced budget, an increase in commodity prices which will bring the level substantially above the new normal line on the Institute's commodity price chart appears certain. On the other hand, if budgetary deficits continue to the extent which now seems likely, the price level may be expected to reach that which existed during the World War within a relatively short period.

The Institute's Basic Indexes

In 1935, the Institute's indexes of production, purchasing power, and prices recorded substantial increases. The Index of Industrial Production closed the year at a record post-depression level if the month of July, 1933, in which culminated the short lived boom of that year, is excepted. After a relative lull in production during the summer months, the pace of manufacturing activity increased steadily throughout the year from June to December. At the close of the year, the industrial production index shows a gain of 16% for the twelve months.

Purchasing power, as represented by the Harwood Index of Inflation, increased moderately between November and December, 1935. The change of nearly two points was occasioned by an increase in Gevernment securities held by the banks (the amount of other securities held declined slightly during the month) and by some increase in loans on securities. The increase of approximately $200,000,000 in the banks' holdings of Government deposits, which would normally have a temporarily deflationary effect, was offset by a sharp decrease in net demand deposits of the banks due to holiday buying. This had the effect of emphasizing inflationary credit when expressed as a ratio of total purchasing power. The Index of Inflation showed a gain during the year of 12½% and made a record post-depression high in December.

The Commodity Price Index increased nearly a point between November and December, 1935, and showed a gain of 6.7% for the whole year. The price index in terms of the old gold dollar, of course, showed a similar percentage gain.

Supply, Demand, and Prices

Little change has taken place in industrial volumes during the past week. Retail trade, however, has shown an encouraging revival following the post-holiday lull. The full effects of bonus disbursements will apparently not be felt until summer, since the present bill provides for payment beginning June 15. Recipients, however, may indulge in freer spending in anticipation of payments.

No decrease in farm purchasing power seems probable because of the AAA decision, since existing benefit contracts are to be met from the Treasury and new Federal disbursements to the farmers are being planned by Congress.

Speculative sentiment has been stimulated by the inflationary implications of the bonus bill and the prospect of farm and unemployment relief spending in excess of that anticipated in the President's budget message. No provisions for increased tax levies to meet these extraordinary expenditures have yet been considered by Congress. It may confidently be predicted that any increase in taxes voted by Congress during a presidential election year will not be applied so generally as to add substantially to receipts.

Supply

The altered automobile schedules still exert a dampening effect upon resumption of activity in the steel industry. The industry has been operating at 51% of capacity during the present month, although increasing operations are usually expected at this time of the year. Electric power output was little changed during the past week, and indicates that there is a tendency to mark time upon the part of industrial producers. It may be several weeks before a marked industrial trend is in evidence.

Demand

Demand for consumption goods, as might be expected from the increased purchasing power available, is running well above January of last year. Not only is effective demand resulting from larger checking account totals a sustaining factor, but the sum of industrial payrolls is also larger. Payrolls, which form the chief source of demand for consumption goods, have increased as recovery has progressed, and further gains should be recorded during the spring months.

The development of a larger demand by the capital goods industries should be experienced during the coming months as plans for plant expansion already announced by large industrial corporations are put into effect.

Prices

Commodity price averages advanced during the past week. Futures markets have recovered from the moderate declines which followed the AAA decision and appear to have established an upward trend.

American Institute for Economic Research is a non-political, non-commercial organization engaged in impartial economic research.

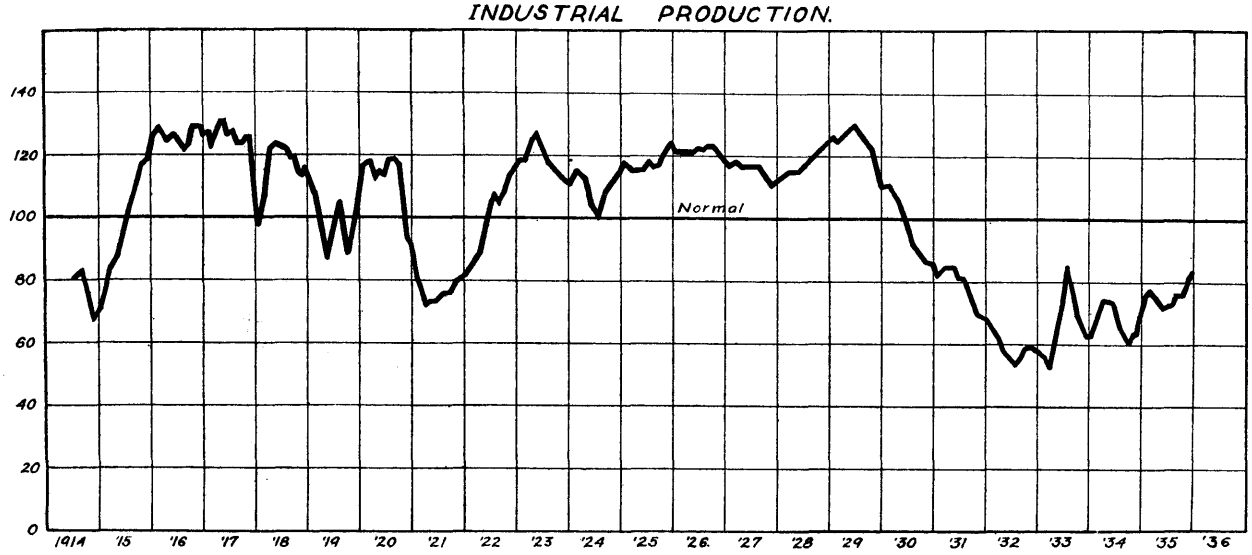
Statistical Summary

For the convenience of clients who wish a more detailed statement of the three basic indexes presented than may be obtained from the charts we make the following tabulation showing the data for the past twelve months.

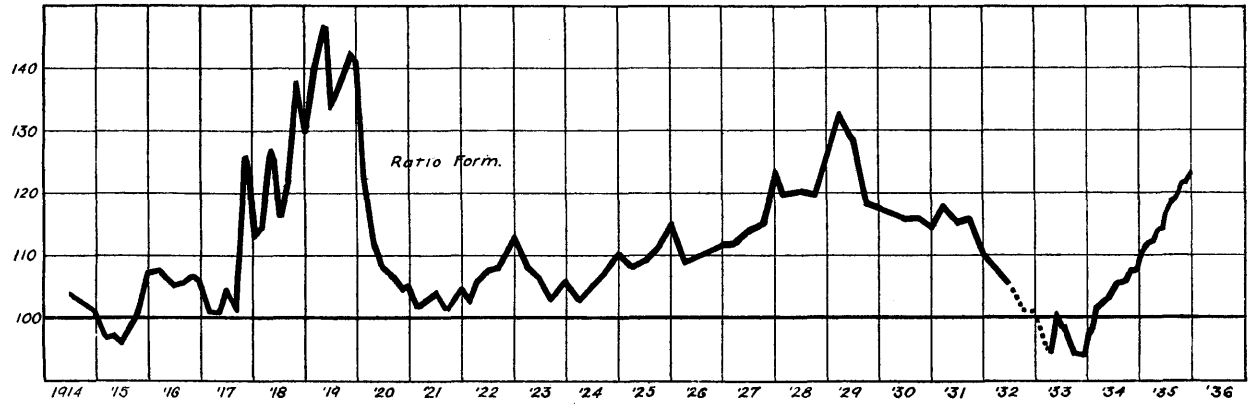
Production, Purchasing Power and Prices

	1935											
	Jan.	*Feb.*	*Mar.*	*Apr.*	*May*	*June*	*July*	*Aug.*	*Sept.*	*Oct.*	*Nov.*	*Dec.*
Index of Industrial Production	76.5	77.4	75.8	73.9	71.7	73.4	73.5	76.4	76.3	78.1	81.3	83.3
Index of Inflation (ratio form)	118.8	113.0	113.5	114.4	114.5	117.3	119.0	119.3	120.3	121.7	121.3	123.1
Commodity Price Index	138.6	141.0	140.5	141.0	141.0	139.8	139.6	141.5	144.0	143.2	144.0	144.8
Commodity Price Index (In terms of old gold dollar)	83.2	84.5	84.5	84.5	84.5	83.8	83.7	84.6	85.2	84.8	85.2	85.7

INDUSTRIAL PRODUCTION.



HARWOOD INDEX of INFLATION.



COMMODITY PRICES.