AMERICAN INSTITUTE *for* ECONOMIC RESEARCH

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RESEARCH REPORTS

COMING EFFECTS OF CURRENT EVENTS

Harmful Rumors

Rumors that have effects harmful to the national interest are by no means confined to those relating to military and transportation dispositions. The recent "scare" buying of commodities that fed on rumors could scarcely be avoided, because it is a natural human attribute for individuals to protect their future means of existence. The extent of commodity hoarding movements can best be limited by authoritative statements promptly made concerning the existing and future supply situation. Quick action in the establishment of control measures is required for commodities of which supplies are inadequate. A similar policy is advisable in respect to the people's savings.

It is unfortunate that some delay is necessary in determining the extent to which the Nation's income must be subjected to taxation. The situation creates difficulties in planning for the future that interfere with the economic system on which the war effort must ultimately depend. The same difficulties are encountered with respect to the individual's savings program.

The Board of Governors of the Federal Reserve System have performed a service in clarifying as far as possible the Government's position regarding individual's bank deposits and cash holdings. A discussion of currency hoarding in the April issue of the *Federal Reserve Bulletin*, states: "There are some reports of persons holding money in currency rather than on deposit because they have heard somewhere that deposits will be investigated and their holders required to subscribe to Government bonds. That this is false has recently been stated officially by the Secretary of the Treasury. It reflects, moreover, a curious misunderstanding. People do not seem to realize that currency and Government bonds are both based on the credit of the Government, that Defense bonds are convertible into cash without market risk, and that the main difference is that the bonds earn interest for the holder, while currency does not."

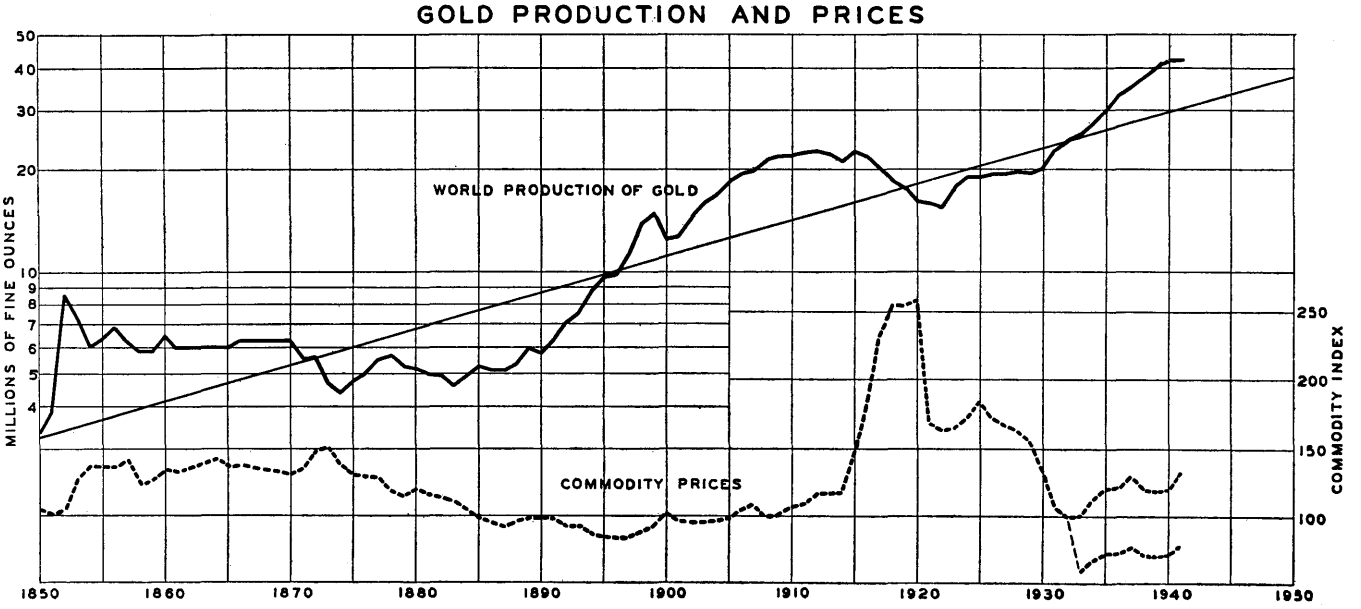
There have recently been rumors that the Government intends to seize currency hoarded in safety-deposit boxes and force its investment in Government bonds. Although the Federal Reserve authorities do not state definitely that such action will not be undertaken by the Government, the following excerpt from the same article suggests that this action is not imminent: "Withdrawal of currency has been the principal cause of the decline in member bank reserve balances during the past year. It has contributed to bringing the reserve position of banks more nearly within the range of the controls of Federal Reserve authorities. In theory currency withdrawals could be carried to the point where the reduction in excess reserves would tend to prevent banks from extending adequate credits to war producers and from buying Government securities in amounts sufficient for financing the war effort. But as a practical matter Federal Reserve authorities are in a position effectively to prevent this by the use of their powers to provide the banking system with such reserve funds as may be needed. There is no reason to expect withdrawals of currency so to reduce excess reserves as to depress security markets and complicate the Government's financing of the war. The Federal Reserve authorities have all the power needed to prevent that."

WHERE ARE WE GOING?

War and Postwar Readjustments

The extensive nature of the adjustments in the economic system required by the war also imply great changes after the war is over. In the preceding discussions under the title "War and Postwar Readjustments, we have presented evidence showing that production problems are extremely serious in a limited number of important industries and that the return to a peacetime economy from a war economy should be relatively simple for the remainder. To be sure, the industries in which the war has forced serious dislocations occupy a basic position in our economy. There will inevitably be a great contraction in the activity of the shipbuilding and armament industries after the war is over. The Government will undoubtedly endeavor to relieve the difficulties of the transition period. Nevertheless, just as the beginning of the war brought its "disemployment" through the contraction of nonessential goods and services, there will be areas where unemployment will be serious after the war even though other industries provide new employment opportunities.

The three essential elements of the economic system are production (including transportation and other services), purchasing media, and prices. They are of course interdependent, but each is subject to influences not necessarily directly related to the other two. It is especially important to assess such influences that may affect the commodity-price structure, because the price trend may either greatly facilitate or on the other hand make more difficult the return to economic equilibrium following the dislocation incident to war.



What Are Prices?

In spite of the money juggling that has been undertaken by the Federal Government since 1932, the dollar has not yet become a nebulous idea nor is it a mere piece of paper or allotment of bank credit. When we speak of prices in terms of dollars, we are really discussing the exchange ratio of given quantities of gold and certain commodities. As long as the dollar is defined in terms of gold, this must continue to be the case. Monetary experimentation may introduce temporary difficulties and unusual fluctuations in the exchange relationship, but a standard for measuring purposes must consist of a definite amount of something, and for many years past the dollar has been a definite amount of gold. The mere fact that the precise amount of gold involved has been altered does not change the basic principles involved, although it does change prices in terms of dollars.

In spite of the attacks on gold as a money commodity made by the "financial wizards" of nations that have inadequate supplies of the metal to form a base for the monetary unit and by politicians who believe that the Government can conjure prosperity only by abandoning tried economic mechanisms, Congress will probably maintain gold as a yardstick even if the weight of gold in the dollar is again changed. Through centuries of experience, there has been built up a general confidence that gold more nearly measures human-effort units past, present, and future than any other substance, except possibly silver in certain parts of the world. In a sense, therefore, the mining of gold and its accumulation in bank vaults make possible all the elaborate mechanism of the present economic order. Confidence on the part of the lender is a primary requisite for obtaining the large aggregations of capital involved in capitalistic production. If the private-enterprise system is to survive, gold will probably remain the money commodity.

Gold Production and Commodity Prices

Although sometimes overshadowed by the effects of inflationary purchasing media created by the Government or by private speculators via the commercial banking system, there is normally a triangular relationship between gold production, total purchasing media in use, and the price level. Stated briefly, when commodity prices rise, costs of producing gold usually increase. Production of the metal is consequently discouraged, and annual production decreases because the price of gold is fixed in terms of dollars. Gold production is stimulated when commodity prices are low and is discouraged when commodity prices are high. The amount of gold used each year also has an influence on commodity prices, because, as long as gold production continues at a greater-than-normal rate, total purchasing media increase more rapidly than normal.

The chart at the top of this page shows the annual production of gold and wholesale commodity prices for the past ninety years. Because data for prices are not available for the United States during this period, English prices were used until 1931, when the Institute's index is substituted. As the two indexes were then at practically the same level, no break need be shown in the continuity of the line.

It will be observed that, during the period 1850 to 1873, gold production was markedly above the line indicating its long-time trend. This was attributable to the large discoveries of gold in California in the early part of that period. The flow of a greater-than-normal volume of gold to the markets of the world and to its banking systems naturally increased purchasing media, which in turn raised prices, as can readily be seen.

The rising prices that reached a peak about 1873 were accompanied in this country by paper money inflation. High prices tended to discourage gold production, and for several years thereafter production was below the trend line indicated. Prices then declined, and, although gold production turned sharply upward from 1885 on, it was not until 1897 that prices turned upward. Apparently, the effect of the rise of gold production above the long-term trend was felt at about that time, and, during the next twenty years, prices rose slowly. During the latter part of that period, rising prices caused a falling off of gold production with the result that, in 1910, we find the rate of increase of gold production approximately the same as the long-term trend.

The wartime inflation, with its consequent effect upon prices, naturally discouraged gold production, and many people thought that the available ore reserves were so limited that there was not enough gold in the world. However, shortly after the sharp price decline of 1920–21, gold production increased. It leveled off when prices rose to a peak in 1925, and, since that time, especially since the sharp decline in prices from 1929 to 1933, it has risen above the trend line indicated.

It is worth noting that, even had there been no wartime inflation of the price level, the peak of the long, gradual rise which started in 1896 must have come about 1920. This appears to be the case because production of gold had already definitely turned downward in 1913 well before the World War rise in prices began. Furthermore, prices in the United States did not take part in the wartime rise until the closing months of 1915. Inasmuch as gold production turned upward in 1915, it is possible that prices would have continued to rise somewhat further even in the absence of the wartime inflation.

The more recent operation of these relationships have been observable during the period 1933 to 1936. During this period, the rate of increase in gold production steadily became greater, but the sharp rise in commodity prices during late 1936 and early 1937 apparently discouraged gold producers because the rate of increase of gold production was lower in 1937 compared with the rate of gain for 1936. Commodity prices declined sharply late in 1937 and in early 1938, with the result that gold production was again encouraged, and the rate of gain in 1938 and in 1939 progressively increased.

Commodity prices throughout the world began to rise immediately after the outbreak of the war in September 1939. This failed to prevent an increase in gold production during 1940, but, as the chart shows, the rate of gain was smaller than it was in other post-depression years, while gold production during 1941 was stabilized at about the 1940 level. The decrease in the rate of gain during 1940 and the more recent leveling off in the rate of world gold production suggest that a turning point similar to that which occurred about a year after the outbreak of the World War in 1914 is in prospect. As the chart indicates, when commodity prices more than doubled during the inflation of 1915–1920, the rate of annual gold production decreased greatly.

Thus, although their effects are not immediately felt, the automatic controls exerted, because of the circumstances of producing the money commodity, are constantly operating to stabilize commodity prices. Unless these are unnecessarily interfered with by Government money managers, gold should continue to prove its unique value as a money commodity.

The Probable Trend

The major factors that will determine the future trend of commodity prices are (1) wartime inflation; (2) Government price controls and rationing; (3) the money-commodity supply (gold). During the war, the second two of the three major influences will operate as limiting factors, but, as we have pointed out in preceding discussions, they can only be partially effective. Further price increases must be expected, and the extreme price rise that occurred in the 1915–1920 period may be duplicated or exceeded.

Reference to the chart of commodity prices on page 51 of the March 30, 1942 bulletin shows that a large proportion of the first World War price advance occurred before the United States entered the war and after it was over. The current price advance during the war period prior to our active entrance into hostilities was less than that which occurred on the eve of our entrance into the first World War. It is possible that the postwar boom in commodity prices that followed the first World War will not be repeated in the present instance. That price advance was caused by active commodity speculation financed by inflationary bank credit. After this war, even if the public desires to engage in such an orgy of speculation, both Government officials and officers of the commercial banks presumably will endeavor to discourage such action by preventing the inflationary credit extensions that would be necessary to finance it.

Studies of commodity price averages during the period following the Napoleonic, Civil, and first World Wars show that there is a normal tendency for commodity prices over an extended period of years to return to the prewar basis. The economic mechanism has been shown to work more efficiently over the long run if commodity prices remain at a relatively stable level. Gradual price changes may occur without discernibly unfavorable effects. It is wide fluctuations in the price level that are harmful. If the wartime price rise now in progress can be restricted within more reasonable limits, the postwar readjustments will be much less disturbing.

THE FUNDAMENTALS

Supply

The steel-ingot production rate was fractionally lower last week than it was in the preceding week. The small decrease was caused by a temporary shut-down for repairs in one of the large producing plants of the industry.

	1929	*1932*	*1937*	*1938*	*1941*	*1942*
Per Cent of Capacity	96.0	22.0	91.5	32.5	98.5	98.5

(Latest 1942 weekly data; corresponding week earlier years)

Electric-power production last week was slightly less than it was in the preceding week, and followed the downward trend seasonally normal at this time. Output was 14.3 per cent greater than that in the corresponding week of 1941, compared with a gain of 13.1 per cent in the preceding week.

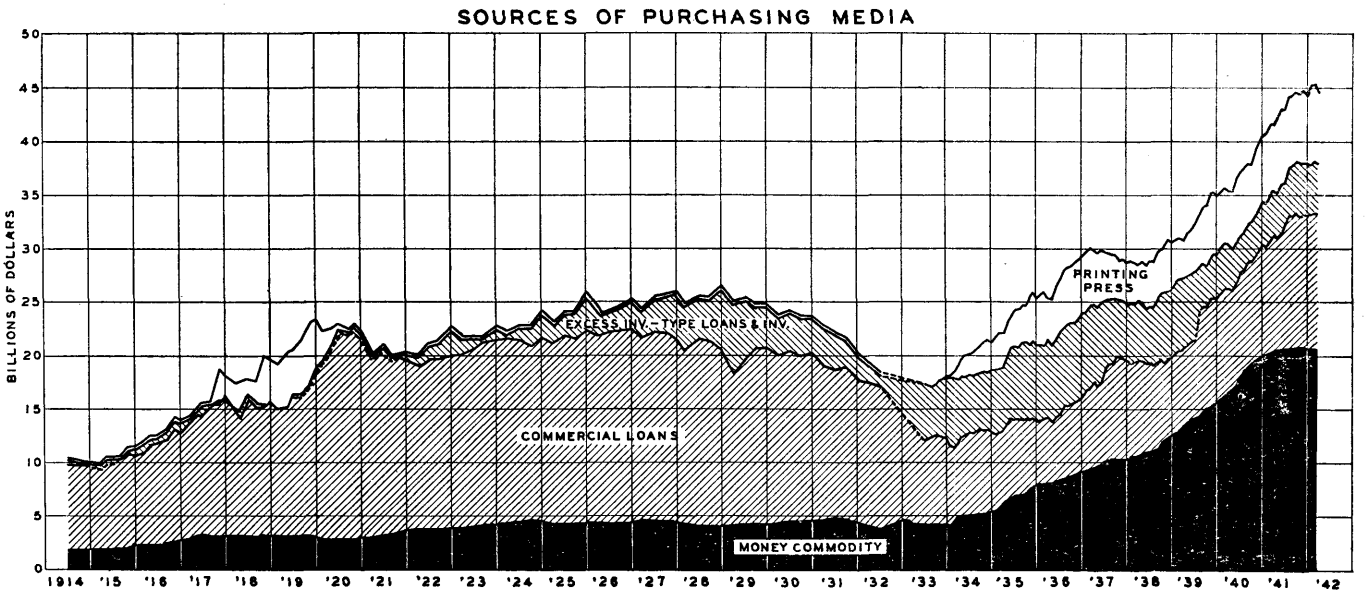
	1929	*1932*	*1937*	*1938*	*1941*	*1942*
Billion Kilowatt-Hours	1.70	1.48	2.17	1.96	2.91	3.32

Lumber production increased contraseasonally last week, and the adjusted index advanced from 118.8 to 121.5. The upward trend in the production index is expected to continue, inasmuch as there was an increase in the volume of new orders last week.

	1929	*1932*	*1937*	*1938*	*1941*	*1942*
New York Times Index	143.1	40.9	84.1	58.6	123.8	121.5

Demand

Public demand for most types of nondurable consumer goods and for a limited proportion of durable consumer goods can still be met by retail merchants, although the selections offered are becoming more and more limited. The situation is reported to be more stringent in the wholesale markets where demand from retail distributors is actively seeking the goods needed to sustain future sales volume.



Prices

The sensitive wholesale commodity price indexes were moderately reactionary last week. Moody's Spot Commodity Price Index was 234.0 on April 9 and 231.7 on April 16. The Dow-Jones Index of Commodity Futures closed at 87.64 on April 9 and at 87.18 on April 16.

FINANCE

Sources of Purchasing Media

The chart showing sources of purchasing media presented in this issue has been revised in accordance with more detailed information now available. The revision covers the period January 1941 to March 1942. It was found unnecessary to make significant changes in the chart. The minor changes that were made will be revealed by a comparison between the chart on this page and the chart on page 38 of the March 9, 1942 bulletin.

During March, there was a decrease of about $900,000,000 in the purchasing media available to the public. This resulted primarily from United States Treasury operations related to the first installment of the Federal income tax. To an increasing degree during recent years and especially now that the Nation is at war, money-credit trends are dominated by the Federal Government policies.

Purchasing media from the money-commodity source decreased about $40,000,000 during March. Since October 1941 when the Nation's monetary gold stocks reached an all-time high, there have been a series of relatively small monthly reductions. The total decrease has been only $125,000,000, a small amount in relation to the aggregate at the end of March of $20,-728,000,000. The net gold export is apparently caused by credits granted to countries sympathetic to the United Nations' cause.

There was a small decrease in purchasing media derived from commercial loans last month. This type of bank credit contributed substantially to available purchasing media during most of 1941, but has failed to be an important factor since the United States entered the war.

During March, there was a moderate decrease in purchasing media derived from the third source (an excess of investment-type assets representing tangible property with respect to the savings available to the banking system). The commercial banks sold a small proportion of their holdings of both Government-guaranteed and "other" securities.

The net decrease for the month in aggregate purchasing media was caused primarily by a decrease in the total par value of Government securities in the commercial banks' portfolios. This was the result of a deliberate policy. Treasury issues or bills aggregating nearly $500,000,000 (most of which was held by the commercial banks) matured in March and were paid out of funds provided by income-tax collections. Most of the contraction in available purchasing media was caused by withdrawal of funds from the public through income taxes, but the Treasury used a portion of the receipts to reduce its debt temporarily in order to ease the strain on the money market.

Treasury reports show that the bulk of its receipts is concentrated in the months when income taxes, which constitute the most important source of Government revenues, are paid. The most substantial withdrawals of funds from private to public accounts are made in the months of March, June, September, and December. The deflationary influences operating in these months are usually absent during the two months immediately following.

SECURITIES

Bonds

An improving trend during the latter part of last week failed to offset earlier losses in the bond market. The Dow-Jones average of 40 bonds was 90.58 on April 9 and 90.40 on April 16.

Stocks

The decline in the stock market last week coincident with Vichy's capitulation to Hitler's demands brought many stocks to new low levels for recent years. There were significant variations in the records of the three Dow-Jones groups of averages. The utility average declined to the lowest level in its history. The industrial average recorded a new low since 1935. The performance of the railroad average was better, inasmuch as it failed to break through its 1939 low.