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The State of the Union Message

WHAT THE PRESIDENT DIDN'T SAY

Today the United States is in the 24th year of the most prolonged period of inflating in its history. (We use "inflating" as the short name for the issue of purchasing media, i.e., currency and checking accounts, in excess of those needed to represent gold and the gold exchange value of other things produced.) The process of inflating has not been continuous, and in recent years some deflating has occurred, but the proportion of inflationary or excessive purchasing media in relation to the total in use still is about twice as great as the corresponding proportion in 1919 and about three times the corresponding proportion in 1929.

Inflating was pushed most rapidly during the years of World War II, but was resumed on three later occasions, 1949-50, 1952-55, and 1958-59. During the past 4 years some deflating has reduced by nearly 10 percent our Index of Inflation from the peak of 225 reached at the end of 1959 to about 205 at the end of 1963.

Commodity prices generally now fully reflect the great inflation of the purchasing media. One average of prices at wholesale is nearly double the 1933 level after allowing for the devaluation (reduction in gold content) of the dollar. The more familiar index of consumer prices recently was 220 percent of the 1940 level.

World War II and the Korean War were aspects of the situation that, in the opinions of many, account for most of the inflating. The so-called "cold war" still is with us, and the recent "January thaw" in that aspect of our Nation's problems should delude no one; the long winter of the "cold war" still is ahead, with many critical problems such as Berlin, Cuba, and Southeast Asia still unsolved.

Moreover, domestic problems are numerous, ranging from the desegregation issue to the plight of the aged whose savings no longer provide the self-support for which the individuals involved had planned. This latter problem, however, as well as that of the large low income group who nevertheless are taxed heavily and the plight of the unemployed, reflect, to a substantial extent, the money-credit follies of nearly three decades.

Thus we return to a fundamental problem of our times, the prolonged abuse of the Nation's money-credit system that has fostered economic distortions of which we have only begun to experience the consequences. Today, however, no one can say that the nature of the problem is hidden from those who will look at the facts.

Most prominent among the obvious facts is the record of the gold "thermometer." For the past 4 years it has been warning the United States about the great inflation "fever." A sick economy loses gold. Only by the most strenuous efforts and by resort to all imaginable varieties of economic expedients, somewhat akin to putting ice on the fever patient's thermometer, has the United States managed to hold the gold it now has left, which is the least in relation to Federal Reserve bank liabilities since the Federal Reserve System began operations in 1914.

Although the Federal Reserve banks' reserve ratio (of gold to Federal Reserve notes in circulation plus the reserve deposits of member banks) is only three-fourths of the lowest figure ever reached heretofore, even this unfavorable comparison fails to reveal the full extent of the problem. Allowing for the foreign demand claims on U.S. gold, the United States, instead of having a gold reserve, owes more gold than it has. The greatly inflated money-credit system rests on a gold base that in a sense is a mirage. It appears to exist only because of a polite fiction acquiesced in for the time being by several nations whose leaders must be greatly concerned about how much longer they dare postpone presenting their claims on a vanishing asset.

Space is not available here to catalogue all the consequences of the great inflation. One surely is the distortion of wages and other costs in major industries where monopoly unions with the consent of complacent management have "grabbed while the getting was good." As one result, even the automobile industry, which should be a stimulating influence accounting for a major part of the Nation's economic growth, has been unable to achieve a new annual production record since the 1955 model year. No wonder the number of unemployed is one of today's problems.

Of course, from the politician's point of view, the major problem is primarily a short run affair. It may be summarized in the question: Can the "jerry built" structure of borrowed foreign currencies, currency "swaps," the gold "pool," and other temporizing devices somehow postpone a crisis until after November 1964? As for the answer, who knows?

But from the longer range viewpoint of the American people who already observe the crumbling of some of the over-expanded speculative empires, as in aspects of real estate and the recent failure of a concern that had become involved in commodity speculation, what is the outlook? Fortunately, there is not today a repetition of the great speculation in stocks on thin margins that occurred in 1929, nor is an exact duplicate of the ill-fated Florida real estate boom of the mid-1920's discernible. Nevertheless, the Nation's commercial banking system once again has repeated on a huge scale the mistake of borrowing at short term and lending at long term, the more generally understood description of basically unsound commercial banking.

Although a few of the Nation's bankers (such as Mr. John Exter, Senior Vice President of the First National City Bank of New York) have clearly revealed understanding of and concern about the situation described here, most of the Nation's so-called commercial bankers seem to have become little more than pawnbrokers in marble halls. Such is not the basic function of sound commercial banking.

No easy remedy is in sight. If ever there was a time for economic statesmanship, 1964 is that time, but it cannot be said that the prospects are bright that such leadership will be found. The Federal Reserve Board seems to be awakening to the facts of the situation; but it moves like a sleepy giant, unsurely and timidly, apparently fearful that it may be blamed for the necessary readjustments ahead.

What the President Did Say

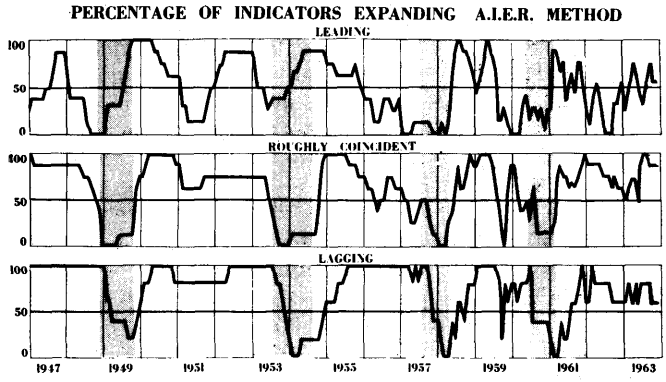
As for what President Johnson did say in his State of the Union message, it was, we believe, one of the most significant such messages in recent decades. The outstanding feature, from the economic point of view, was the promise of a budget that would reduce expenditures to $97.9 billion and involve a deficit of only $4.9 billion. (Even the most optimistic recent newspaper reports had suggested only that budget expenditures might be held to $100 billion instead of the $102-103 billion range predicted earlier.) If this promise is carried out by economies in spending and if estimated receipts come up to expectations, the danger of more inflating by monetizing Government deficits will be negligible. Almost certainly, the deficit indicated could be financed from current savings. This is the most hopeful viewpoint justified by the President's assertions. A business contraction might result in a much larger deficit, and in any event, President Johnson has yet to prove his good intentions by deeds as well as words. For the time being, however, we take his assertions at face value.

Few will quarrel with the goals of peace, prosperity, elimination of poverty, jobs for all, and equality of opportunity that the President emphasized. But the roads toward those goals are many and varied, and the differences will become apparent in the months ahead. Discussion of them can be useful only after the President's subsequent special messages indicate more clearly the routes he will choose.

Also significant, if it reflected determination rather than mere hope, was the President's pledge to preserve the present gold value of the dollar, as well as his promise to reduce the number of Federal employees. How these objectives will be achieved remains to be seen, but we believe that the President has revealed his astuteness as a politician, in the best sense of that word. He seems to suspect that at long last the American people have become "fed up" with more and more inflating and a depreciating dollar. If such is the situation, the State of the Union message of 1964 may well be the first clear indication that the tide has turned, that the end of the most prolonged period of inflation in the Nation's history has been seen.

Statistical Indicators

Percentages of the three groups of indicators expanding are plotted on the accompanying chart, with periods of cyclical contractions as determined by the National



Bureau of Economic Research indicated by shaded areas.*

The percentage of primary leading indicators expanding remained at 56; minor offsetting revisions in the employment and construction series left the group average substantially unchanged. As last reported, the cyclical statuses of the average workweek, the accession rate, and the inverted layoff rate, were indeterminate. The construction group averaged moderately favorable, a decrease in residential housing having been more than offset by the large November increase in nonresidential contracts. Although new orders for durable goods decreased in November, they remained at a relatively high level; and the trends of raw materials and common stock prices continued upward through December. The leading group therefore still suggests that business expansion will continue.

Further current business expansion was reflected in the roughly coincident indicators, of which 88 percent were appraised as expanding. The inverted unemployment rate is the exception to otherwise uniformly favorable appraisals in this group.

The current moderate rate of business expansion probably will continue a few months, at least.

DEMAND

Purchasing Media

Total purchasing media increased from the revised amount for November by $3.2 billion to $157.3 billion late in December. This was 3 percent more than that at the end of December 1962. Subtraction of an estimated $11.9 billion of inactive purchasing media† indicates that purchasing media actively in use at the end of December totaled $145.4 billion, about 3 percent more than the total of a year earlier.

Inflationary purchasing media increased $2.2 billion in December to $80.7 billion, about the same as that at the end of December 1962. The greatest part of inflationary purchasing media (derived chiefly from real estate, security, and consumer loans granted by the commercial banks, and from the banks' investments in obligations of corporations and State and local governments) increased $3.2 billion during the month to $55.3 billion, 16 percent more than that at the end of December last

*The cyclical status of each indicator is determined by visual inspection and by appraisals of related series. The indicators are grouped as "leading," "roughly coincident," or "lagging," according to their past relationships to peaks and troughs of business cycles.

† Inactive purchasing media comprise hoarded currency and idle checking accounts. Such purchasing media are those in excess of the amount ordinarily in active use in effecting business transactions. Because this portion of total purchasing media is not used in taking goods and services off the market, it is subtracted from the total.

year. The next largest component of inflationary purchasing media, that derived from monetization of the Federal debt by the commercial banking system, decreased $1.0 billion in December to $21.6 billion and was 26 percent less than that of a year earlier. The remaining relatively small and stable amount of inflationary purchasing media, derived from silver and from the general credit of the U.S. Government and circulating as Treasury currency, was unchanged in December at $3.9 billion and equal to that at the end of December last year.

Noninflationary purchasing media, derived from gold and from commercial, industrial, and agricultural loans, increased $1.0 billion in December to $76.6 billion, 7 percent more than the total at the end of December 1962. The amount derived from commercial, industrial, and agricultural loans increased $1.0 billion during the month to $61.1 billion, 10 percent more than that at the end of December last year.

The gold stock of the United States was $15,513 million at the end of December, compared with $15,583 million at the end of November and with $15,978 million at the end of December 1962. Gross foreign short-term claims against the U.S. gold stock were last reported at $26,270 million at the end of October, partly offset at that time by short-term claims against foreigners of $5,568 million. If these totals were unchanged in November and December, net foreign short-term claims would exceed the U.S. gold stock by $5,189 million. This compares with $3,866 million a year earlier.

In the first half of 1964 the possibility of inflationary financing of private indebtedness probably is greater than the possibility of similar financing of governmental indebtedness, especially if the present rate of business activity continues or increases. During this period the full effect of the prospective tax cut will not have been realized, and large revenue receipts in the spring and early summer probably will make "new money" borrowing by the Treasury from the banks unnecessary. However, under "boom" conditions increased borrowing by private individuals and firms, partly for speculative purposes, probably would be accompanied by a general tightening of credit and rising interest rates. The Federal Reserve Board probably would permit or even foster credit restraint, both because higher interest rates would tend to curb an inflationary "boom" and because they would encourage foreign holders of interest-bearing dollar claims to retain their claims rather than convert them into gold.

We expect only seasonal changes in the amount of purchasing media in use during the next few months.

Department-Store Sales

Sales of department stores reporting to the Federal Reserve banks compare with those of corresponding periods a year earlier as follows:

Period	*Percent Change*
Week ended January 4	+ 8
Four weeks ended January 4	+11
Year ended January 4	+ 4

SUPPLY

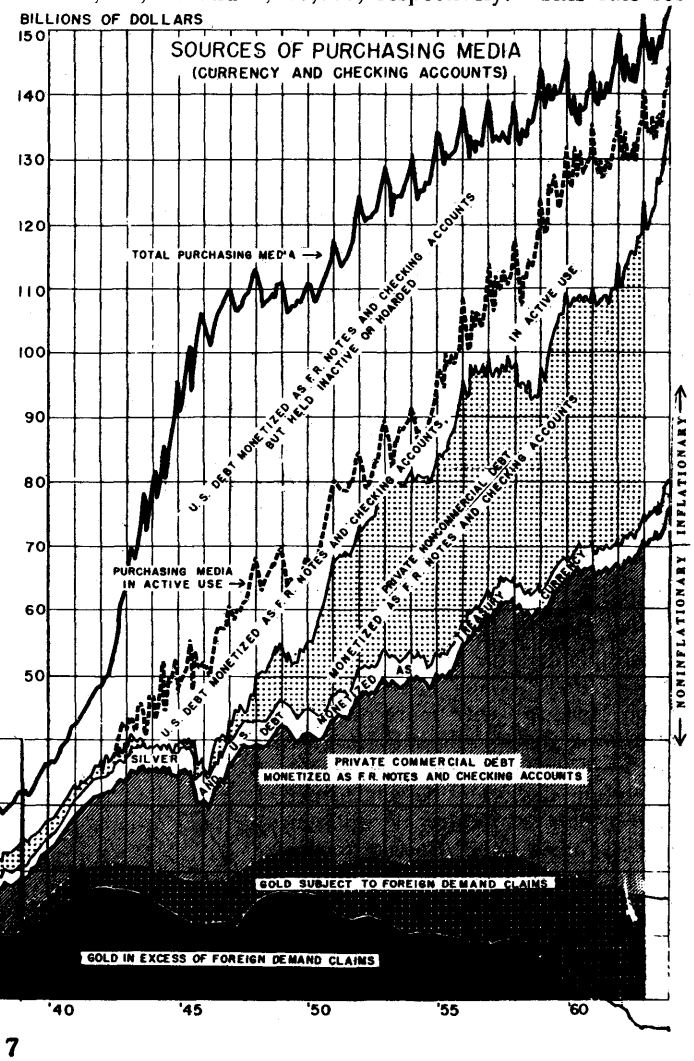
Residential Construction

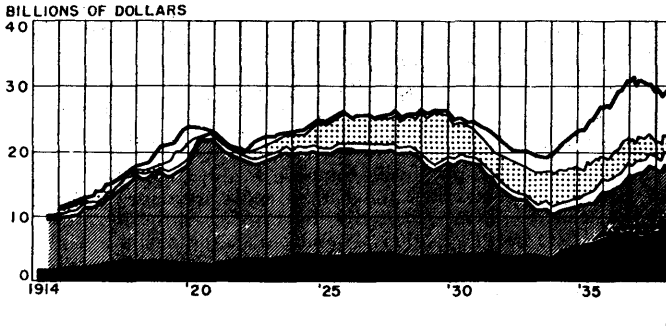
Our seasonally adjusted index of the dollar amount of residential construction increased 10 percent in October but decreased 6 percent in November. The indexes for these months were 26 and 12 percent higher, respectively, than those for the corresponding months a year earlier.

The *Engineering News-Record* index of construction costs in October and November was slightly below its September alltime high, but in both months it was 4 percent higher than in the corresponding months of 1962.

Our indexes of the physical volume of residential construction (derived by dividing the seasonally adjusted amount of contract awards by the index of construction costs) for October and November were 21 and 7 percent greater, respectively, than the indexes for the corresponding months a year earlier. The index for October was 11 percent greater than that for September, but the index for November was 6 percent less than that for October.

Private nonfarm units started in October and November were estimated at seasonally adjusted annual rates of 1,780,000 and 1,500,000, respectively. This rate for





October was 5 percent greater than that for September and 19 percent greater than that for October 1962. The rate in November was 16 percent less than that in October and 4 percent less than that in November 1962.

New nonfarm units privately financed without Government aid were at the seasonally adjusted rate of 1,559,000 in October, which rate was 25 percent greater than that in October 1962, and at the seasonally adjusted annual rate of 1,275,000 in November, which rate was 3 percent less than that in November 1962. New nonfarm units privately financed under Government-insured loans were at the seasonally adjusted annual rate of 220,000 in both October and November, nearly 10 and 14 percent lower, respectively, than the rates for the same months a year earlier.

Applications for FHA commitments for new home construction increased slightly from a seasonally adjusted annual rate of 173,000 in September to 176,000 in October and again increased to 190,000 in November. Requests for VA appraisals were at a rate of 140,000 in both September and October and at the rate of 145,000 in November. Total applications and requests were nearly 18 percent less in October and 8 percent less in November than those in the correspon ng months a year earlier.

Although the dollar amount and physical volume of new housing and the number of dwelling units started diminished in November, relatively high rates in September and October seem to indicate that in 1963 an increase occurred in all departments of housing activity over the record totals of 1959.

Boom psychology in any field usually continues far past the danger point, and the apartment building boom that is almost entirely responsible for present record levels of residential construction apparently will be no exception.

There seems to be less and less doubt that the danger point has been not only reached but passed. The Advance Mortgage Company of Detroit recently announced that their survey of ten large midwestern cities indicated that the number of apartments currently under construction in seven of them was "much greater than the market can comfortably absorb," despite which the boom is accelerating in most of the cities. Robert C. Weaver, administrator of the Housing and Home Financing Agency, has told the convention of the National Association of Home Builders in Chicago that "good business can result in bad business if sound judgments give way to excesses in market decisions and financing."

Later Mr. Weaver announced in Washington, with President Johnson's approval, an expansion of present Federal housing programs to provide 2 million new homes a year by 1970. Among other things, public housing is to be increased, private builders are to have new favorable terms of credit through the FHA to construct sewage and water systems in new developments, and Federal aid is to be given to provide relocation and modernization loans and to train personnel for the housing field.

A goal of 2 million new homes a year in 1970 perhaps is not unrealistic in view of the increased rate of formation of new households expected to occur in the last years of the present decade as the children of the war years reach marriageable age. However, intensified governmental aid to residential construction at this point not only may prolong the present boom to some extent but also may make more difficult the inevitable adjustment following an oversupply of new housing, particularly in apartments, that appears now to exist.

We continue to believe that decreases in housing activity are more probable than increases in 1964.

Industrial Production

Production of steel, automobiles, electric power, and lumber (1) in the 1- and 4-week periods ended on the indicated dates in the current year and (2) in the corresponding periods of earlier years was as follows:

Steel	*1929*	*1932*	*1957*	*1961*	*1963*	*1964*
Ingots—million tons						
1 week: January 4	0.86	0.33	2.49	1.36	1.88	2.04
4 weeks: January 4	3.22	1.05	10.15	5.20	7.30	7.88
Automobiles						
Vehicles—thousands*						
1 week: January 4	66	19	109	97	142	158*p*
4 weeks: January 4	242	124	613	509	706	792*p*
Electric Power						
Kilowatt-hours—billions						
1 week: January 4	1.5	1.5	11.7	14.2	16.9	18.2
4 weeks: January 4	7.9	7.8	47.3	58.3	68.9	74.9
Lumber						
New York Times Index	*1929*	*1932*	*1956*	*1960*	*1962*	*1963*
1 week: December 28	115	39	85	80	129	91
4 weeks: December 28	123	35	116	105	125	113

* Cars and trucks in the United States and Canada.
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PRICES

Commodity Prices

Index	*1963 Jan. 6*	*1963 Dec. 30*	*1964 Jan. 6*
Spot-market, 22 commodities	247	254	253
Commodity-futures	302	325	325
Steel-scrap	$26.50	$28.83	$28.83

BOOK REVIEW

World Economic Survey 1962, Department of Economic and Social Affairs, United Nations (2 volumes)
United Nations Sales Section, Room 1074, New York 17, New York ($2 and $1.50)

This fifteenth annual review of world economic conditions is in two volumes. The first volume reports the position of the developing countries in world trade. The second volume reviews recent events in the world economy.