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The Nation's Economic Problems

Output of the United States economy is at a volume never before attained in spite of the fact that various maladjustments restrict or inhibit output to some extent. Moreover, some aspects of the economy are so seriously distorted that, unless these distortions soon are removed, the inevitable result will be widespread economic distress.

This article is the first of a series that will describe the economic problems confronting the Nation, the unsound economic policies that account for these problems, and the steps necessary for their solution. No useful purpose would be served in attempting to fix the blame on individuals. In the discussions that follow, we shall not imply that those responsible for decisions that have resulted in economic maladjustments were motivated by evil intent or hope of personal gain.

The Balance-of-Payments Problem

The most urgent economic problem confronting the United States today is the continuing imbalance in its international payments. Since the beginning of 1950 U.S. citizens, individually and through their government, have spent, loaned, and given away $29.3 billion more abroad than has been received from foreigners. As a result, during this period foreigners have withdrawn $9 billion of gold from the U.S. Treasury and their net short-term claims on the U.S. gold stock have increased by nearly $15 billion to an amount that now exceeds the Nation's entire gold stock by $6 billion.* Consequently, the foundation of the Nation's monetary system today is in jeopardy, and in a relatively short period the once-strong international financial position of the United States has deteriorated to such an extent that the Nation's solvency now depends upon the forbearance of its foreign creditors.

The imbalance of the Nation's international payments is not a temporary difficulty that will resolve itself in due course; rather, it is a symptom of economic maladjustments. These maladjustments have resulted from decades of unsound fiscal, monetary, and other policies and of unsound banking practices. The question arises, How has it happened that the Nation chose to follow such policies and practices? A general answer seems to be that they were chosen on the basis of inadequate economic knowledge. Some useful knowledge about the economic functions of gold and management of commercial banking that had been developed earlier apparently was forgotten. Ignorance apparently has been largely responsible for the maladjustments currently present in the U.S. economy. An understanding of how a sound money-credit system functions is essential to choosing sound policies; therefore, we shall attempt to describe these functions before considering the imbalance-of-payments problem in detail.

The Function of Gold

Gold has been used as a medium of exchange since the history of mankind first was recorded, and it probably was so used long before then. For centuries gold has been universally acceptable for making exchanges, and it is the only material that has never become unacceptable for such use. Although credits are granted in connection with the trading of things across national boundaries, this is done with the promise of repayment in gold or other things of equal exchange value, and gold is the only medium with which international obligations not otherwise settled ultimately are discharged.

The acceptability and usefulness of gold have been demonstrated repeatedly by its use during wartime for purchasing strategic materials indirectly from enemy nations and for paying espionage agents. More recently gold was used by Communist nations to obtain wheat from their ideological adversaries in order to alleviate food shortages. Despite the deprecatory references of some allegedly sophisticated economists, the acceptability of gold as a universal purchasing medium is a long-established fact of life.

The function of gold as a foundation of a monetary system is of profound importance, but it has been overlooked by many nations for several decades. Its influence is most effective when the monetary unit is a fixed amount of gold and no restrictions are placed on the import, export, minting, and use of gold or on the redemption of currency with it.

Many beneficial effects resulted from such an arrangement, which constitutes a full gold standard. Increases in the amount of purchasing media derived from the money commodity are relatively uniform, because changes in the rate of increase of gold production occur only gradually; thus, a gold standard tends to facilitate a steady rate of increase in the total amount of purchasing media. A gold standard provides an automatic warning when the banking system creates purchasing media in excess of the amount needed for the exchange of current production; when this occurs, the resulting outflow of gold from banks forces bankers to discontinue this unsound practice. A gold standard provides the citizens of a nation with a means to prevent prolonged continuation of unsound fiscal policy by their government. If a government's expenditures continue to exceed the total of receipts and savings borrowed by it, citizens can express

* The difference between the amount of gold withdrawn from the Treasury plus the increase in net short-term claims of foreigners and the total imbalance of U.S. payments since 1950 reflects payments that cannot be ascertained. These payments presumably include unreported transfers of gold and untraceable transfers of currency and other things as well as statistical errors in pricing, etc.

their disapproval and force termination of such a policy by demanding redemption of their currency with gold. They can thus better preserve their freedom by preventing the increasing governmental control of economic activity that unsound fiscal policy inevitably seems to require. By restricting the issuing of excess purchasing media, a gold standard tends to limit some of the economic delusions that accompany inflation and thereby minimizes fluctuations in business activity. By tending to prevent depreciation of the currency, a gold standard encourages saving and investment and preserves the integrity of long-term contracts such as life insurance, annuities, and pensions.

In the early 1930's U.S. Government authorities lost sight of whatever understanding they may have had of the beneficial functioning of a full gold standard and took steps that hampered its functioning. Acting on the mistaken notion that raising prices would alleviate the Great Depression (which was the aftermath of a speculative mania that not even the gold standard could prevent), the Government rescinded the right of citizens to redeem currency in gold in 1933, devalued the dollar in 1934, and began deliberately to incur budget deficits. The banking system was virtually forced to create excess purchasing media with which to finance such deficits. Never before had the U.S. Government attempted to correct the aftermath of the issue of excess purchasing media by augmenting such an excess. The experiment was a costly failure; average unemployment remained above 14 percent for the unprecedented period of 6 years, and production remained below its long-term trend for that unusually long period. Had the gold standard been permitted to operate, the distortions that had been introduced into the economy by the speculative excesses of the twenties probably would have been removed and recovery could have proceeded much more quickly. Such, at least, had been the Nation's experience in the past.

The attempt to raise prices by Government authorities indicated that they did not understand the triangular relation that has long existed among gold production, purchasing media, and commodity prices. To describe this relation briefly, the quantity of gold produced varies inversely with the cost of producing it. Rising prices of commodities other than gold including wages and equipment used for gold production reduce such production, relatively if not absolutely. Inasmuch as gold not used in industry nor hoarded becomes purchasing media, the total amount of purchasing media in use or its rate of increase is reduced when gold production is reduced or curtailed by rising prices. Thus, the attempt to raise prices during the mid-1930's had the undesirable effect of relatively reducing gold production and the amount of purchasing media derived from it. The low level to which commodity prices had fallen early in 1933 had stimulated gold production, which was increasing the amount of purchasing media in use and which tended to raise commodity prices, albeit slowly. Attempting to raise prices rapidly by inflating or creating excess purchasing media tended to discourage gold production, especially when the rise in prices became great during the 1940's. In short, the notions for alleviating the depression that were tried were unsound, because they did not take into account the function of gold in a monetary system.

The Function of Commercial Banking

The other useful economic knowledge that appears to have been forgotten or perhaps never fully learned in the United States is the basic principle of sound commercial banking. The Bank of England practiced such banking for nearly a century prior to World War I. Banking in the United States, however, was characterized during that period by repeated issues of excess purchasing media that culminated in financial crises and resulted in a long series of booms and recessions, each of which involved hundreds and in some instances thousands of bank failures. After a particularly disastrous boom and bust in the early 1900's that resulted from unsound commercial banking, a monetary commission was formed to study the problem. In the course of a 5-year investigation this commission acquired an understanding of the principles of commercial banking that had been practiced in England for nearly a century. These principles were incorporated in the Federal Reserve System established in 1914 and were applied in the following 3 years. With the advent of World War I the law was changed to permit monetization of Government debt for financing the war. Subsequently, although the monetary authorities forced retirement of excess purchasing media in 1920-21, they permitted creation by the banking system of a large amount of such purchasing media during the 1920's, largely by monetizing private noncommercial debt. Thus, for the nearly half century since World War I, the principles of sound commercial banking have been overlooked or ignored by American bankers.†

The performance of American commercial bankers indicates that most of them do not understand their proper function in the economic system. Ordinarily, the services of a professional man are sought only if he is competent in his field. The services of a commercial banker, however, apparently because they include the creation and provision of purchasing media that everyone wants, are readily accepted merely if he demonstrates ability to remain solvent for a decade or two. Avoiding bankruptcy is a necessary but not a sufficient characteristic of sound commercial banking. In order to perform his function competently, a commercial banker should carefully judge the gold exchange value of things that a processor (manufacturer, wholesaler, transporter, merchant, etc.) intends soon to offer on the market, and then create and provide only that amount of purchasing media for the period of time during which the things ordinarily are offered in the Nation's markets. If a processor has nothing soon to offer on the market, or if a prospective borrower does not intend to use the purchasing media in connection with processing activity but instead intends to purchase something already on the market, the commercial banker should *create no purchasing media* but should provide only purchasing media that are available from savings deposits or capital accounts.

A commercial banker that used sound judgment in applying the principles just described would have no difficulty in maintaining solvency. Moreover, if the commercial banking system as a whole adhered to these principles, a balance between gold and the value of things offered on the market and total purchasing media in use would be maintained. The exchange value of such purchasing media would necessarily always be equivalent to that of gold and things in or soon to be placed on the market.

† These principles are described in a nontechnical discussion in the Institute's Economic Education Bulletin No. 1, *The Gold Crisis and the Evolution of Commercial Banking* (5 for $1.00).

When the Nation's currency was redeemable with gold, a commercial banker who created and loaned purchasing media for purposes other than processing activity that involved soon placing things on the market inevitably found his solvency threatened as these purchasing media were presented for gold. Elimination of currency redeemability inactivated this mechanism that had automatically restrained such unsound banking.

Under the banking laws and monetary policies of the past three decades insufficient restraint has been placed on the creation of excess purchasing media by the Nation's commercial banking system. The result has been the monetizing of Government debt and of private debt in the form of consumer, real estate, and security loans and for banks' investments. This long-continued abuse of the money-credit system and the policies that permitted and fostered it are the result of ignorance of the economic function of gold and of commercial banking on the part of bankers, Government and monetary authorities, and the American people as a whole.

The Nation's imbalance of payments is a symptom of this basic economic maladjustment and others that have resulted from it. Until this basic difficulty is remedied, many others will continue to plague the economy of the United States. In subsequent articles we shall describe these associated maladjustments and their effects on the balance-of-payments problem and consider the alternative means by which the maladjustments in the U.S. economy can be removed.

What the Indicators Say

Among the leading indicators, the accession rate and the inverted layoff rate both decreased in July, but the average workweek increased in August.

Among the roughly coincident indicators, payroll employment in nonagricultural establishments and retail sales increased in August.

The indicators continue to forecast further expansion of business activity.

PRICES

Commodity Prices

Index	*1963* *Sept. 14*	*1964* *Sept. 8*	*1964* *Sept. 14*
Spot-market, 22 commodities	246	264	265
Commodity-futures	306	288	289
Steel-scrap	$26.83	$36.17	$36.17

Note: The indexes are, respectively, those of the U.S. Bureau of Labor Statistics, Dow-Jones, and *Iron Age*. The spot-market and futures indexes are converted so that their August 1939 daily averages equal 100. The steel-scrap index is a composite price for No. 1 heavy melting scrap.

DEMAND

Department-Store Sales

The seasonally adjusted monthly index of sales of department stores reporting to the Bureau of the Census is estimated at 201 for August (1947-49=100), compared with 194 for July and with 186 for August 1963. Unadjusted weekly sales totaled $395 million in the week ended September 5, or 33 percent more than those in the corresponding week last year; sales in the 4 weeks ended September 5 totaled $1,459 million, or 15 percent more than those last year. These spectacular increases reflected the fact that the 1963 week included the Labor Day holiday whereas the 1964 week did not. Nonetheless, sales in August and early September exceeded considerably the long-term growth rate of department-store sales. Some observers attribute the recent large volume of sales partly to an increased proportion of the additional income resulting from the tax cut being directed into consumer purchasing channels; they expect this stimulating influence to continue through the Christmas season.

Prices of department-store goods decreased slightly from June to July, as average apparel prices and those of housefurnishing items both decreased fractionally. Our index of such prices was 117.0 in July, compared with 117.2 in June and with 116.5 in July 1963.

Our index of the physical volume of goods sold in department stores, derived by dividing the dollar-sales index by the price index, increased nearly 4 percent in August and was 7½ percent greater than the index a year earlier. Factors other than the tax cut that influenced recent department-store sales were the favorable shopping weather during August and unusual increases in the back-to-school segment of the population.

Continued gains in department-store sales appear to be probable during the remainder of 1964.

Latest Weekly Data

Sales of department stores reporting to the Bureau of the Census compare with those of corresponding periods a year earlier as follows:

Period	*Percent Change*
Week ended September 12	− 5
Four weeks ended September 12	+11

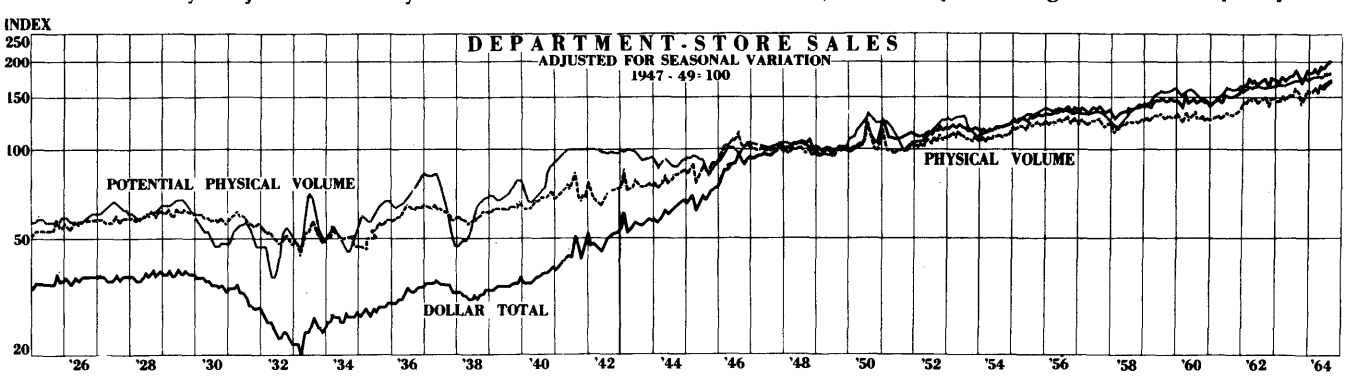
SUPPLY

Residential Construction

Our seasonally adjusted index of the dollar amount of residential construction increased 4.5 percent in June but decreased 7 percent in July. The indexes for these months were 1.5 and 3 percent higher, respectively, than those for the corresponding months a year earlier.

The *Engineering News-Record* index of construction costs continued to reach new highs in June and July. In both months the index was 4 percent higher than it was in the corresponding months a year earlier.

Our index of the physical volume of residential construction (derived by dividing the seasonally adjusted



amount of contract awards by the index of construction costs) for June was 2 percent lower than the index for the corresponding month a year earlier. For July the index was the same as that for July 1963. The index for June was 4 percent more than that for May, but the index for July was 7½ percent less than that for June.

Private nonfarm dwelling units started in June and July were estimated at seasonally adjusted annual rates of 1.57 million and 1.50 million, respectively. This rate in June was 4 percent more than that in May and 1 percent more than that in June 1963. The rate in July was 5 percent less than both that in June and that in July 1963.

New nonfarm units privately financed without Government aid were at the seasonally adjusted annual rate of 1,358,000 in June, which was 4 percent greater than that in June 1963, and at the seasonally adjusted annual rate of 1,294,000 in July, which was 3 percent less than that in July 1963. New nonfarm units privately financed under Government-insured loans were at the seasonally adjusted annual rates of 212,000 in June and 201,000 in July, 16 and 15 percent less, respectively, than the rates for the corresponding months a year earlier.

Applications for FHA commitments for new home construction were 173,000 in May and 177,000 in June but decreased to 162,000 in July. Requests for VA appraisals increased from 99,000 in May to 103,000 in June and to 109,000 in July. Total applications and requests were 12 and 11 percent less, respectively, in June and July than those in the corresponding months a year earlier.

Residential construction increased in June but remained well below the volume early in 1964. In July such construction decreased to a new low for the year. The downward trend of residential construction since the peak in March suggests that a cyclical contraction of this activity has begun.

The President signed the 1964 Housing Act on September 2. This $1.5 billion legislation provides funds for construction of urban renewal projects ($725 million plus an additional $50 million revolving fund to provide 3-percent loans for 20 years to help businessmen and home owners rehabilitate properties in urban renewal areas). It provides $75 million more for housing for the elderly, $150 million more for loans to rural residents by the Farmer's Home Administration (with $10 million additional for low-rent housing for domestic farm labor), and additional grants to aid local community planning and to help cities buy and preserve undeveloped land. Other provisions widen the lending power of Federal savings-and-loan associations and permit these associations and the FHA to be more lenient in dealing with homeowners who are in default on federally-insured mortgages. The FHA now is authorized to guarantee up to a $30,000 mortgage on a single family house, compared with an earlier ceiling of $25,000; the limits on 2-, 3-, and 4-family dwellings have been increased similarly. In the hope that new money markets will be found, the Federal National Mortgage Association now is authorized to sell participations in a pool of mortgages.

The provisions of the new housing act probably will augment demand to some extent and thereby retard the present apparent downtrend in residential construction. However, the current excess supply of housing probably will not be absorbed in the near future.

We continue to expect further decreases in the volume of residential construction.

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: September 12	1.19	0.24	2.10	2.03	1.80	2.46
4 weeks: September 12	4.87	0.93	8.37	8.02	7.10	9.70
Automobiles						
Vehicles—thousands*						
1 week: September 12	104	23	105	106	150	151*p*
4 weeks: September 12	449	96	509	340	356	516*p*
Electric Power						
Kilowatt-hours—billions						
1 week: September 12	1.8	1.4	12.0	15.8	18.1	18.9
4 weeks: September 12	7.0	5.8	47.8	63.2	71.6	77.4
Lumber						
New York Times Index						
1 week: September 5	135	35	101	97	107	100
4 weeks: September 5	132	35	101	96	100	103

* Cars and trucks in the United States and Canada.
p Preliminary.

PURCHASING MEDIA
(In millions of dollars as at month ends)

	1963	*1964*	
	Aug.	*July*	*Aug.*
Private noncommercial debt monetized as F.R. notes and checking accounts	50,549	59,926	60,417
U.S. debt monetized as F.R. notes and checking accounts	20,488	13,478	10,251
Silver and U.S. debt monetized as Treasury currency by U.S. fiat	3,888	3,888	3,888
Total inflationary purchasing media	*74,925*	*77,292*	*74,556*
Private commercial debt monetized as F.R. notes and checking accounts	56,557	61,233	61,631
Gold	15,582	15,462*	15,461*
Total noninflationary purchasing media	*72,139*	*76,695*	*77,092*
TOTAL PURCHASING MEDIA	147,064	153,987	151,648
Less inactive purchasing media	223	807	836
Total active purchasing media	*146,841*	*153,180*	*150,812*

*Net foreign short-term claims as of June (latest figure available) exceeded U.S. gold stock as at end of July and August by $6,118 million and $6,119 million, respectively.