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The State of the Union Message

President Johnson's State of the Union address brings back memories of similarly optimistic viewpoints expressed in earlier periods. Other presidents also have been complacently confident that flourishing business activity could be maintained indefinitely by following the Keynesian economic notions. That the application of those notions invariably has resulted in costly failure seems to have been forgotten.

In November 1928, Governor Brewster of Maine, at the request of President-elect Hoover, offered before a Conference of Governors a plan for the creation of a $3 billion reserve fund for the promotion of construction work as a remedy for economic recession. Governor Brewster said:

"It is the considered recommendation of the one who has received the overwhelming mandate of the American people to guide and guard their progress in the next four years that a construction reserve may prudently be accumulated in time of plenty against the lean year that is to come.

"Picture the approach of an economic crisis with unemployment threatening on every hand. The release of $3,000,000,000 in construction contracts by public and quasi-public authorities would remedy the situation in a twinkling of an eye. . . ."

This proposal preceded the widespread acceptance of the Keynesian notions, but it was essentially Keynesian in nature. A program of new construction was tried early in 1930. The descent to the depths of depression during the following 2 years attested to the failure of that program to remedy the situation.*

Beginning in 1934 President Roosevelt implemented a program for recovery that had been proposed to him by the then influential English economist, John Maynard Keynes. The program included artificially low interest rates and large expenditures for public works financed with deficits incurred by the Federal Government. In the following 2 years business activity increased rapidly, and President Roosevelt triumphantly announced that "we planned it that way." In October 1936, the President asserted that "within a year or two, with income increasing and expenditures declining, we shall be able to balance the budget and start paying down on the debt." Less than a year later the artificially-forced "prosperity"† ended abruptly and one of the most precipitous contractions of business activity in the Nation's history began.

President Johnson's statement that "we will continue along the path toward a balanced budget" is reminiscent of the unwarranted assertion made by President Roosevelt nearly 30 years earlier. A balanced budget *never was* attained under the economic policies of the New Deal. To assume that it can be attained by continuation of such policies is to ignore the facts of history.

Ominous similarities exist between the economic nostrums that were tried with such disastrous results during the 1930's and the economic policies propounded in President Johnson's plan for a growing economy. His plan includes proposals for Congress to (1) make available "special funds for job-creating public programs . . . for immediate use if recession threatens," (2) permit rapid action on temporary income tax cuts, and (3) make a substantial reduction in excise taxes. The President's economic advisers presumably believe that the loss of revenue that would result from a reduction of excise taxes would be replaced by an increase in other revenue as economic activity is stimulated by the reduction.

On the other hand, implementation of the proposals to reduce income taxes and spend funds for public works if recession threatens obviously would involve increased deficit spending by the Federal Government. Thus, such action would constitute yet another attempt artificially to force an extension of prosperity by application of the Keynesian notions. These notions, which have been tried repeatedly without success, invariably have resulted in inflating, with seriously detrimental consequences for the economy of every country that has tried them.

The state of the economy was described in our recent series of articles on the Nation's economic problems. The assertions by the President that the soundness of the dollar is unquestioned and the economy is essentially sound revealed that he and his economic advisers either fail to recognize or choose to ignore the actual situation. Consideration of one fact alone might help to dispel their euphoria, namely, that U.S. automobile producers have failed for the ninth consecutive year to exceed the number of automobiles produced in 1955. In the absence of the economic distortions that have resulted from the long-continued experiment with the Keynesian notions, this important industry presumably would have competed more successfully in satisfying the increasing worldwide demand for automobiles during that period.‡

In addition to advocating continuation of the Keynesian nostrums, the President urged some other actions that clearly would be uneconomic and inconsistent with

*A brief discussion of "The New Construction Panacea" is presented in an article so entitled in the Institute's *Economic News* for April-May 1962. Copies will be sent upon request.

†An average of 14.3 percent of the civilian labor force still was unemployed during the year 1937.

‡In 1955, 7,920,000 domestically-made cars were produced, or .084 per person older than 24 years in the United States; in 1964, 7,739,000 cars were produced, or .074 per person older than 24. Domestic per capita automobile production decreased during that period, in spite of the fact that this should be a growing industry inasmuch as its market is highly elastic.

his proposal that "we make an all-out campaign against waste and inefficiency." Extension of the minimum wage to another 2 million persons probably would increase, not reduce, unemployment. Increased subsidizing of small farmers would perpetuate the operation of those farms that are inefficient. Apparently the President's most difficult task is not to know what is right, as he asserted, but to do what is economically sound albeit politically inexpedient.

We confine our comments to the *economic* implications of the annual State of the Union message. A final observation seems pertinent. President Johnson referred to the land where he was born as a place "where a free man could build for himself." Yet, paradoxically, his proposals constitute a renunciation of the principle that individual freedom is greatest in a society in which the individual provides for himself. Implicit throughout the address is the conviction that a great society can be achieved only through increased direction of individual activity by the central government.

The implications of this centralist view are of profound significance for the future of the Nation. If this view prevails, future historians may regard the State of the Union message of 1965 as the formal announcement of the demise, after a prolonged illness of many decades, of the United States Constitution, which originally had closely restricted the power of the Republic's central government as an additional safeguard for individual freedom.

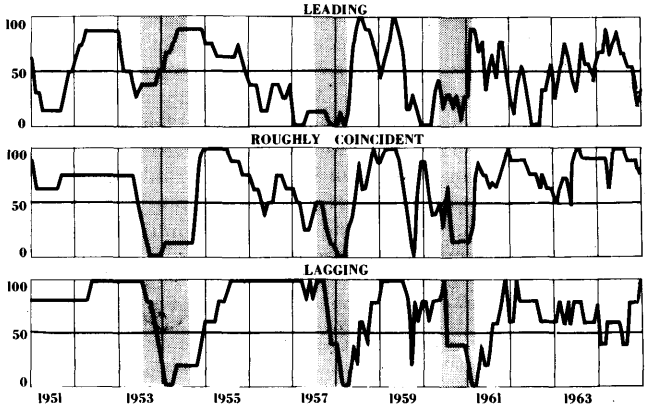
What the Indicators Say

Percentages of the three groups of indicators apparently expanding cyclically are plotted on the accompanying chart, with periods of cyclical contractions as determined by the National Bureau of Economic Research indicated by shaded areas.

Among the leading indicators, November resumption of full-scale automobile production was reflected in a marked improvement in the average of hours worked weekly in manufacturing, and the accession rate improved in October. However, recent data for most other primary monthly leaders for November and December were unfavorable, and the group percentage expanding, at 44, remained in the recession-forecasting zone. Of particular significance were the continued cyclical contraction in the number of houses started and the continued decrease in new orders for durable goods. A decrease in the latest moving average of common stock prices raises a question as to whether or not the prolonged cyclical expansion of this series may have ended.

Among the roughly coincident indicators, retail sales decreased in November for the third consecutive month and the inverted unemployment rate continued to be indeterminate. All other coincident series, or 75 percent, increased strongly in November and continued to expand cyclically, thus indicating that general business activity continued to expand through that month.

PERCENTAGE OF INDICATORS EXPANDING



The average of bank rates on business loans increased slightly in December, and this series therefore was reappraised as expanding cyclically. The increase of the group of lagging indicators to 100 percent expanding suggests that the current cyclical expansion of business activity has reached the stage of late maturity. The unanimous expansion of the lagging indicators also reduces the probability that some of the leading indicators will continue to expand. This is so because the lagging series represent business costs, and increases in such costs tend to affect adversely the trend of some leading indicators.

The leading indicators continue to give an unfavorable forecast for future business activity. However, inasmuch as the adverse effects of the automobile strikes last fall have not yet been overcome, this forecast still is subject to question.

SUPPLY
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*	*1964*	*1965*
Ingots—million tons						
1 week: January 2	0.86	0.33	2.49	1.10	2.04	2.62
4 weeks: January 2	3.22	1.05	10.15	5.24	7.88	10.46
Automobiles						
Vehicles—thousands*						
1 week: January 2	66	19	109	109	158	155*p*
4 weeks: January 2	242	124	613	578	793	842*p*
Electric Power						
Kilowatt-hours—billions						
1 week: January 2	1.5	1.5	11.7	14.0	18.2	18.8
4 weeks: January 2	7.9	7.8	47.3	58.7	74.9	77.9
Lumber						
New York Times Index					*1963*	*1964*
1 week: December 26	115	39	76	115	91	100
4 weeks: December 26	123	35	107	117	113	116

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

DEMAND
Purchasing Media

Total purchasing media increased from the revised amount for November by $7.5 billion to $166.7 billion late in December. This was 6 percent more than that at the end of December 1963. Subtraction of an estimated $1.0 billion of inactive purchasing media§ indicates that purchasing media actively in use at the end of December totaled $165.7 billion, about 6 percent more than the total of a year earlier.

Inflationary purchasing media increased $5.8 billion in Decembed to $84.0 billion, about 3 percent more than the total at the end of December 1963. 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 govern-

§Inactive purchasing media comprise hoarded currency and coin 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.

Increases in Loans Contributing to December Increases in Purchasing Media
(Billions of dollars)

December	Commercial, Industrial, and Agricultural Loans	Consumption Loans	Security Loans
1961	1.3	1.4	1.1
1962	0.9	1.4	2.0
1963	0.4	1.7	0.6
1964	1.7	2.6	0.1

ments) increased $4.9 billion during the month to $64.3 billion, 14 percent more than that at the end of December last year. The next largest component of inflationary purchasing media, that derived from monetization of the Federal debt by the commercial banking system, increased $0.9 billion in December to $15.5 billion but was 27 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 in the form of Treasury currency, was practically unchanged in December at $4.2 billion but was 1 percent more than that at the end of December last year.

Noninflationary purchasing media, derived from gold and from commercial, industrial, and agricultural loans, increased $1.7 billion in December to $82.7 billion, 9 percent more than the total at the end of December 1963. The amount derived from commercial, industrial, and agricultural loans increased $1.7 billion during the month to $67.3 billion, 11 percent more than that at the end of December last year.

The gold stock of the United States was $15,388 million at the end of December, compared with $15,386 million at the end of November and with $15,513 million at the end of December 1963. Gross foreign short-term claims against the U.S. gold stock were last reported at $29,616 million at the end of October, partly offset at that time by short-term claims against foreigners of $6,266 million. If these totals were unchanged in November and December, net foreign short-term claims would exceed the U.S. gold stock by $8,002 million. This compares with $6,423 million a year earlier.

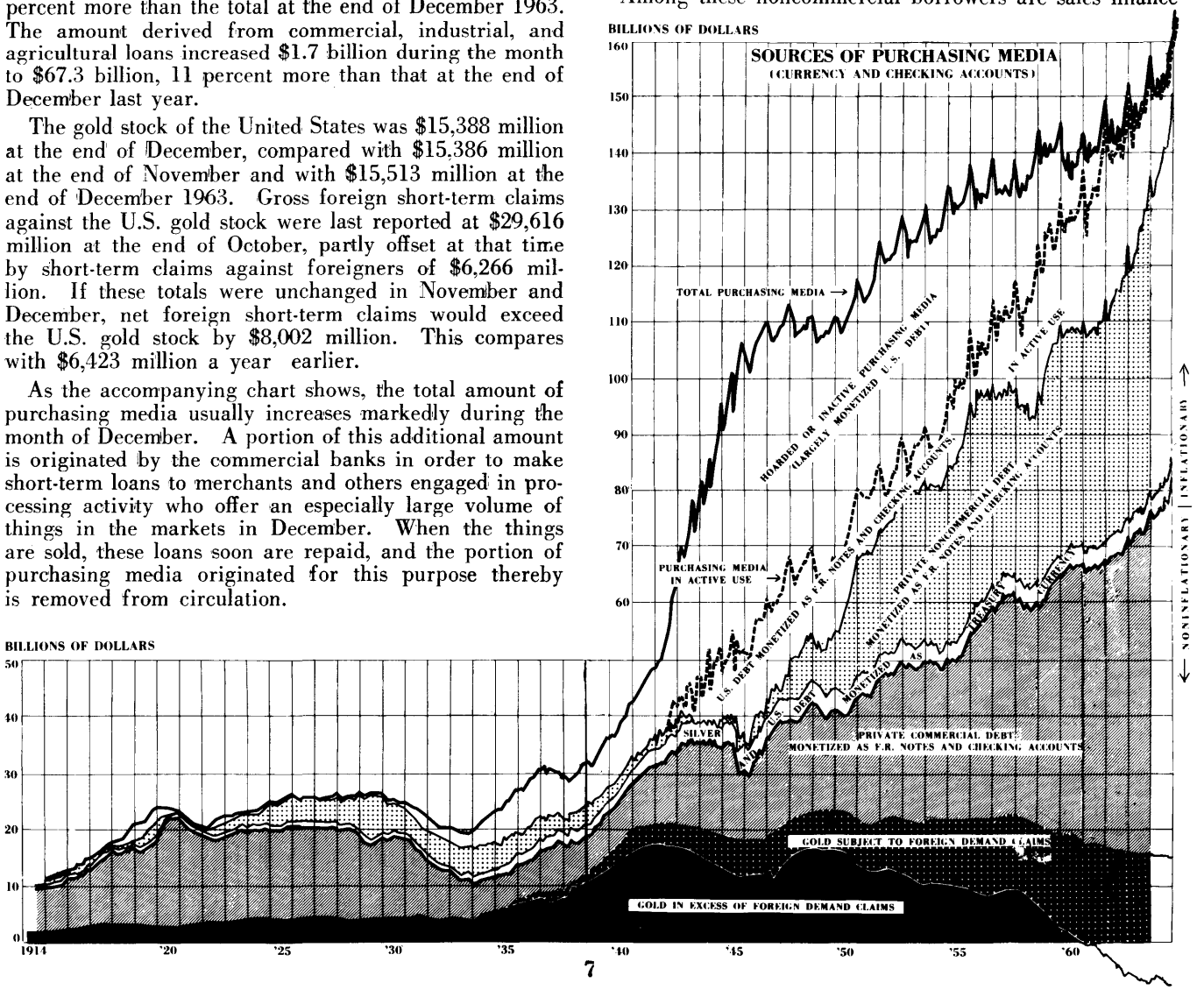
As the accompanying chart shows, the total amount of purchasing media usually increases markedly during the month of December. A portion of this additional amount is originated by the commercial banks in order to make short-term loans to merchants and others engaged in processing activity who offer an especially large volume of things in the markets in December. When the things are sold, these loans soon are repaid, and the portion of purchasing media originated for this purpose thereby is removed from circulation.

Purchasing Media
(In millions of dollars as at month ends)

	1963 Dec.	1964 Nov.	1964 Dec.
Private noncommercial debt monetized as F.R. notes and checking accounts	56,283	59,417	64,297
U.S. debt monetized as F.R. notes and checking accounts	21,197	14,605	15,527
Silver and U.S. debt monetized as Treasury currency by U.S. fiat	4,203	4,192	4,192
Total inflationary purchasing media	*81,683*	*78,214*	*84,016*
Private commercial debt monetized as F.R. notes and checking accounts	60,367	65,556	67,268
Gold	15,513	15,386*	15,388*
Total noninflationary purchasing media	*75,880*	*80,942*	*82,656*
Total Purchasing Media	157,563	159,156	166,672
Less inactive purchasing media	331	955	1,008
Total active purchasing media	*157,232*	*158,201*	*165,654*

*Net foreign short-term claims at the end of October (latest figure available) exceeded the U.S. gold stock at the ends of November and December by $7,928 million and $8,004 million, respectively.

In addition to performing the essential function just described, however, the commercial banking system also usually originates a large amount of additional purchasing media in December for lending to noncommercial borrowers. In that month such borrowers use these purchasing media largely for buying consumer goods. Among these noncommercial borrowers are sales finance



companies, which relend to individuals who purchase consumer goods.

Commercial banks also usually originate additional purchasing media in December for lending to brokers and dealers in securities. A portion of these additional purchasing media usually is reloaned to investors who purchase consumer goods. The amount of additional security loans made in December has varied in recent years, as the accompanying table shows. This variation is attributable to different trends in security markets and other factors. Security loans increased little last December, perhaps because of increased short selling of common stocks and sales of them made in order to take tax-reducing losses.

Other operations of the commercial banking system also contribute to the increase in purchasing media in December. These include purchases of Government securities by the Federal Reserve banks and purchases of these and other securities by the commercial banks.

In the first 2 months of the year the total of purchasing media usually decreases as the amount of both commercial and noncommercial loans decrease. If the commercial banking system confined the amount of purchasing media originated for noncommercial purposes in December to the amount of savings-type liabilities becoming available then, the total amount of purchasing media would increase only to the extent necessary for the greater processing activity during that month. Consequently, the magnitude of the variation in the total amount of purchasing media at the yearend would be smaller than that resulting from existing banking practices.

As a result of the continuing "easy money" policy of Federal Reserve authorities, total purchasing media probably will decrease somewhat less than it has in the corresponding months of recent years during January and February.

Department-Store Sales

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 January 2	+21
Four weeks ended January 2	+13

Note: Percentages for the week and 4 weeks ended December 26 were +43 and +9, respectively.

PRICES

Consumer Prices

The Consumer Price Index increased 0.2 percent between mid-October and mid-November to 223.1 on the 1935-39 base.¶ As of mid-November the index was 1.2 percent higher than it was a year earlier.

Among the major components of the index, five increased, one decreased, but two were unchanged. Prices of transportation increased 0.5 percent; prices of reading and recreation increased 0.3 percent; prices of apparel and upkeep increased 0.2 percent; prices of housing and medical care increased 0.1 percent; prices of food decreased 0.1 percent; but prices of personal care and other goods and services were unchanged.

Average weekly earnings after taxes for a factory worker with three dependents increased $1.43 in November to $93.61, compared with $88.58 a year earlier. The purchasing power of the consumer dollar in November was 44.8 percent of that in the 1935-39 period.

The November to December increase in the index was larger than the average monthly increases during the past year but about the same as the increase a year earlier. In commenting on this latest increase in the index, Robert J. Myers, Deputy Director of the Bureau of Labor Statistics, predicted that the index would continue its upward trend during 1965 at about the annual average rate of the past 6 years. This is about 1.5 percent, and compares with about 1.2 percent during the current expansion phase of the business cycle.

Because of the increase in the November price index, about 150,000 workers in the aerospace and meatpacking industries will receive wage increases of 1 cent and 2 cents an hour, respectively.

We find no evidence to indicate that the gradual upward trend of consumer prices will cease during the next few months.

Commodity Prices

	1964		*1965*
Index	*Jan. 4*	*Dec. 28*	*Jan. 4*
Spot-market, 22 commodities	253	273	272
Commodity-futures	323	287	287
Steel-scrap	$28.83	$39.00	$38.17

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.

¶The Consumer Price Index, compiled by the Bureau of Labor Statistics, is a statistical measure of changes in prices of goods and services bought by urban wage earners and clerical workers, including now both families and single persons. The index is often called the "cost-of-living index," but its official name is *Consumer Price Index for Urban Wage Earners and Clerical Workers*. It measures changes in prices that are the most important cause of changes in the cost of living, but it does not indicate how much people actually spend to defray their living expenses.