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Reaping the Whirlwind

(Economic Aspects of the State of the Union)

Having sown the "winds" of inflation for three decades, much of the civilized world is beginning to "reap the whirlwind," the undesired "harvest" being the inevitable consequences of inflating the money and credit of the various nations concerned. Among the industrially more advanced countries, the consequences have become most apparent in Great Britain.

Only a few decades ago, Great Britain was the wealthiest nation in the world. The possessions of its individual citizens and corporations extended over an economic empire that included even more of the world than did the political elements of the British Empire. From the earnings of those possessions flowed a vast stream of things to the homeland: wool from Australia; gold, copper, platinum, and other metals from Africa, and hundreds of other things for the use and enjoyment of the people of Great Britain.

These material things were in part the dividends and interest on foreign investments. Of course, streams of money incomes paralleled the flow of other things, and much of the money incomes was taken in taxes by the British Government. Nevertheless, the net effect was that the people of Great Britain received much more in the form of usable things from the rest of the world than they had to give in return.

However, prolonged inflating of the money supply has had the usual effects. Union labor was encouraged to demand more and more; featherbedding practices became general; the easy windfall profits of inflation lessened the incentive for managerial efficiency and modernization of industry, and socialistic programs now constitute a welfare-state millstone around the necks of the British people.

As the situation became worse, the Government of Great Britain chose to inflate more rather than make politically painful corrections. The foreign stocks and bonds owned by citizens were seized, and citizens were given government bonds as compensation. Then the "geese that laid the golden eggs," the foreign assets, were gradually sold abroad in an effort to maintain convertibility into gold for a currency debilitated by prolonged inflating. Finally, even the best of the profitable foreign investments, the remainder of more than a billion dollars worth of American common stocks, were sold in the fall of last year.

Only the beginning of the "whirlwind" to be reaped has thus far been seen: the devaluation of the pound sterling last November. Few citizens of Great Britain seem to realize as yet that much of the capital accumulations of the past few centuries has been sold to finance socialistic experiments doomed to failure even in the relatively short run of recent decades. Lord Keynes wittily argued that "in the long run we are all dead." Of course, some of those responsible for England's present plight, including Lord Keynes himself, are dead; but their children and grandchildren are not. Theirs is the burden of attempting to remedy a situation that may deteriorate much further and result in the loss of hard-won advances achieved during recent centuries.

The United States has followed policies similar to those adopted in Great Britain. Thus far, the "gold rush" in the closing months of 1967 has been the most striking consequence, with nearly $1 billion of gold lost in December alone. This was only the beginning of the economic "whirlwind" that is to be our "harvest." Now, for the first time in the Nation's history, strict controls of capital exports by U.S. corporations have been ordered, and restrictions on the freedom of U.S. citizens to travel abroad have been proposed. Capital exports in the form of purchases of foreign securities previously had been penalized by the so-called "interest equalization" tax.

Few U.S. citizens apparently realize the seriousness of the imbalance-of-payments problem; and even fewer probably know about the extent to which "slick tricks" have been used to conceal aspects of the problem and to postpone the remedial action necessary. In its daily statement, the U.S. Treasury continues to report the total of gold held with no indication that substantial amounts have been pledged to preferred creditors. This is comparable with an insolvent business reporting cash on hand that already has been assigned to a preferred creditor. Such are the ingredients of a fraudulent bankruptcy for which businessmen are sent to prison.

Special U.S. bonds have been issued of longer ostensible maturity than one year but with a 48 hour or shorter "escape" clause whereby foreign central bank holders may obtain repayment virtually on demand. The amount of these bonds as issued is counted as an export in the balance-of-payments calculations, and is excluded from officially reported foreign short-term claims on U.S. gold.

In addition, the Treasury reports, as part of its reserves among convertible currencies, large holdings of pounds sterling taken in the futile attempt to prevent devaluation of the pound. Borrowings from the International Monetary Fund (which must be repaid in a gold equivalent) and currency "swaps" arranged with other countries also have helped the United States to postpone solving its problems while making them worse.

Oh, What a Tangled Web

"Oh, what a tangled web we weave, when first we practice to deceive," might well be the motto of the U.S.

Treasury. Since the United States first adopted the policy in 1934 of continuing to circulate a currency with the pledge, "The United States of America will Pay to the Bearer on Demand X Dollars" (a dollar by statute is one thirty-fifth of an ounce of gold) while continually dishonoring that pledge, the monetary web has become tangled almost beyond the wit of man to untangle.*

Other leading nations of Western civilization have aided the U.S. Treasury in weaving the tangled web by participating in some of the arrangements mentioned above. However, they are not responsible for what the U.S. Treasury has published in its accounts.

In an effort to continue holding down the "price" of gold (or to support the 40-cent dollar so that it would seem "as good as gold," such alternative descriptions of the process being dependent on the point of view), the United States sent Under Secretary of the Treasury Deming to Basel, Switzerland, early in December. He proposed to the nations still participating in the London gold pool that they make available large quantities of their gold (for supporting the gold-exchange value of dollar claims on gold) and accept in exchange for their bullion gold certificates, which would be reported to the public as part of their gold reserves. In effect, the proposal was that members of the gold pool double count their gold so that the public would not be aware of the drain on their gold reserves used to support dollar claims.

That such a proposal was seriously made by the United States sufficiently reveals the standards of integrity, or lack of any, on the part of the U.S. officials concerned and their advisers. Perhaps it also reveals arrogant complacency that "the King can do no wrong" as well as contempt for the economic sophistication of the general public. Also revealing is the fact that not one of the European central bankers present at the Basel meeting would consider the proposal for a moment.† (Standards of integrity on their part are indicated that might well be emulated.)

Credit is Suspicion Asleep

Not only was the U.S. proposal immediately rejected, but also it aroused serious doubts. Suspicion became general among the European bankers present that the situation, already known to be bad, might, if the truth were known, be worse. Their attitude should surprise no one. If you were urged by some improvident debtor to assist him in deceiving his creditors, would not you wonder whether the debtor had revealed to you the full extent of his obligations?

Chairman Martin of the Federal Reserve Board and others have asserted that the dollar would be supported at $35 per ounce of gold even if it required the last bar of gold at Fort Knox to do so. We have reason to believe that such assertions no longer are being taken seriously by any central banker or other well-informed individual abroad. Moreover, some are so skeptical as to emphasize that the further repetition of such assertions will only increase their doubts about the redeemability of dollar claims. They are well aware that no world power such as the United States could afford to risk not having a reserve of gold, the only universally accepted means of payment. Even if American politicians and some bankers might acquiesce in dissipating all U.S. gold, foreign observers do not believe that United States military authorities would agree to that course of action, nor do we believe that the Nation's military leaders would do so.

As for the possibility that the measures announced by President Johnson on January 1 will remedy the situation, we do not see how anything more than temporary postponement of some developments, possibly until after next November, could result; and even that "breathing spell" is by no means assured. As we pointed out in *Research Reports* for January 8, the imbalance-of-payments problem will not be remedied by such superficial concern with present symptoms.

In a modern industrial economy with its relatively great need for continual additions to capital equipment, the full consequences of prolonged inflating become apparent only after years have elapsed.

For example, major public utilities in the United States recently have awarded contracts for generating and other equipment to one Swiss and two British companies whose bids were much lower than those of the leading American producers. (One of the three successful bidders was a foreign subsidiary of a parent United States bidder.)

The divergence of relative costs must develop and continue for years in such a highly specialized field before foreign manufacturers are even invited to bid. Design and planning of major electrical generating stations also requires years; and more years elapse before equipment ordered is scheduled for delivery. In this aspect of competition with foreign manufacturers, the effects of many years of inflating and rapidly rising wages sponsored by monopoly unions are only beginning to be seen.

Similarly with automobiles, a foreign manufacturer must gain acceptance on a small scale here, develop a dealer organization, plan and construct spare parts depots, and train personnel. Several years have elapsed since the manufacturers of Mercedes automobiles first began to compete effectively in the American market, and only now are they beginning to sell cars here on a scale that promises keen competition within the United States for American producers. The latter lost most of their foreign market for American cars several years ago, and have little prospect of regaining such markets.

Thus the excess of American exports over imports of goods and services, which had prevailed for many years, is decreasing and soon the favorable balance may be reversed. Results for the last quarter of 1967 were striking. They suggest that Mr. Johnson's plan to remedy the balance-of-payments deficits is little more than a "pipe dream." As a "grandstand play," it apparently has temporarily restored some hopes that the dollar will not follow the course of the British pound, but no one should assume that it has won the "ball game."

If Mr. Johnson is determined to postpone revaluing gold (raising its dollar "price," or devaluing the dollar) until after next November, and if drastic deflation is not contemplated in order to save the dollar, he will find that the controls proposed January 1 were only the beginning. Control over the export of capital funds by corporations and banks will not prevent individuals from in-

*This promise to pay apparently became a source of so much embarrassment that the Treasury began eliminating it from the currency, first, a few years ago, from the dollar bills ("bill" is one name for a promise to pay), and later from other paper currency. It remains on some currency not recently printed.

†We are aware that press reports of the December meeting in Basel gave the public a quite different impression. The gold pool nations were reported to be supporting the United States by continuing the pool's operations with their combined holdings, some $26 billion of gold. This was nonsense. Although we may not be in a position to reveal our source of information for a few years, we are confident that our report of what occurred is correct.

vesting more abroad. The interest equalization tax is a partial barrier to such investments, but ways already have been developed for legally avoiding that tax. Experience has shown that exchange controls breed more exchange controls in a never-ending procession of scope and complexity. Many people are not stupid. The expectation of such further controls will induce thousands to shift funds abroad in order that they may retain freedom of action and travel in an economically disordered world.

Failure to go to the root of the imbalance-of-payments problem, failure to substitute deflating for inflating, failure to lessen the power of monopoly unions, failure to remove the prohibition against having a job unless some employer will pay a high minimum wage, failure to recognize that inflating drives a horizontal wedge into society raising to greater affluence those who have much and robbing those who have little, failure to correct the underlying situation (inflation-augmented special privileges) that accounts for decaying cities and metropolitan ghettos, to name some of the aspects of the problems to be solved; all these failures to act wisely, coupled with continuation of economic follies, make the situation in the United States more precarious; invite those who have even moderate funds to shift them abroad; and even force those who would otherwise prefer to remain here to prepare for life abroad when and if the riots in American cities escalate further to the status of mob uprisings where no man is safe, especially if he appears to have or is known to have somewhat more than many of his fellowmen.

For those who "sow the winds" of inflation and related economic evils, there is no escape. That the United States will continue to "reap the whirlwind" of economic and social tribulations is as highly probable as it is improbable that those in the seats of economic and political power will see the error of their ways and reverse the course of the American ship of state.

Lest our conclusions be misunderstood, we should emphasize that we do not know of any way to predict the precise timing of the unpleasant events ahead. That the process of inflating and thus "embezzling" the savings and life iusurance of the American people can continue for years seems obvious. Only recently has the annual loss in buying power of such assets approximated the annual savings of the public. Much previously accumulated remains to be "embezzled," and there is no apparent reason why the United States could not continue the process as long as France did. (That country sowed inflation for nearly half a century, until the French franc finally became worth less than four-tenths of 1 percent of its original value.) However, the imbalance-of-payments problem, the riots in U.S. cities, and other troubles seem to be escalating rapidly. We find no reason to hope that subsequent phases of the whirlwind will be long postponed.

Statistical Indicators of Cyclical Trends

Among the leading indicators, the net change in manufacturing and trade inventories increased markedly during November.

Among the roughly coincident indicators, the gross national product in terms of 1958 constant dollars increased moderately during the fourth quarter, and manufacturing and trade sales increased substantially during November.

Among the lagging indicators, manufacturing and trade inventories increased substantially during November.

These increases were consistent with the apparently expanding cyclical statuses of the series.

Cyclical expansion of three-quarters of the leading indicators leads us to expect further business expansion during the next few months.

SUPPLY

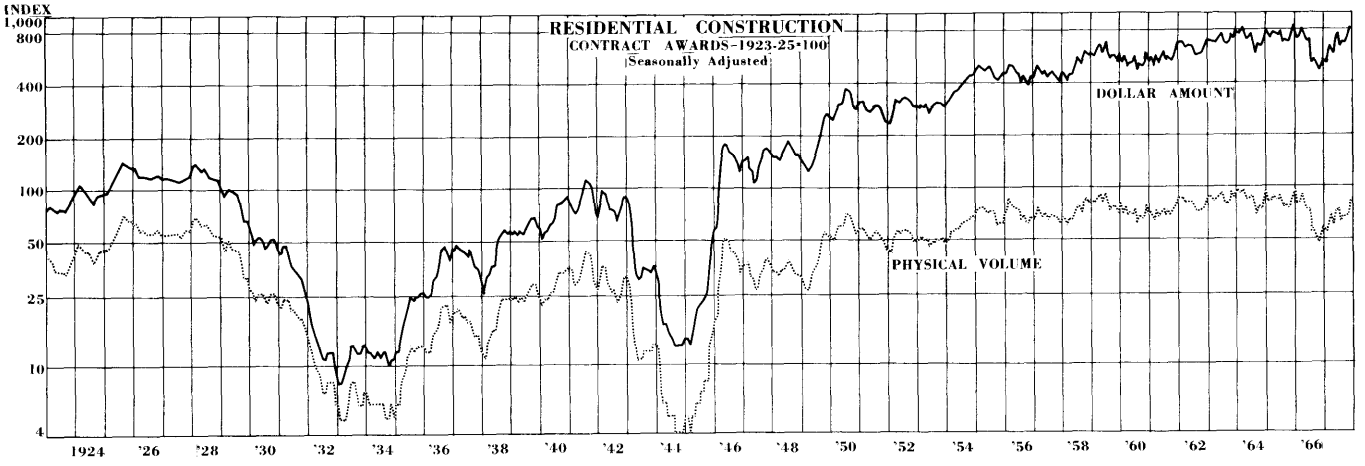
Residential Construction

Our seasonally adjusted index of the dollar amount of contract awards for residential construction increased 15 percent to a record during November following a 6 percent increase during October. The index previously had decreased slightly during September. The index for November was 60 percent more than that for November 1966, which had been the smallest for that month in many years.

The *Engineering News-Record* index of construction costs increased 0.7 percent during December after increasing 0.1 percent during both October and November. In December the index was 6.5 percent more than that in the corresponding month a year earlier. Materials costs in December were 3.5 percent more than those of a year earlier, and costs of skilled labor and common labor were 6.9 percent and 7.6 percent more, respectively.

Our index of the physical volume of residential construction is computed by dividing the index of the dollar amount of such construction by an index of costs, and the apparent increases in residential construction that result from cost increases thus are excluded. After decreasing about 1 percent during September, this index increased more than 5 percent in October and increased nearly 15 percent in November.

Private nonfarm dwelling units started were at seasonally adjusted annual rates of 1,468,000 in October and



1,533,000 in November, 78 percent and 60 percent more, respectively, than such rates a year earlier. Such dwelling units started without Government insurance or guaranty in October and November were at annual rates of 1,259,000 and 1,325,000, respectively. The annual rates of such units started with Government-sponsored loans were 209,000 in October and 208,000 in November, compared with rates of 132,000 and 147,000 in the corresponding months a year earlier.

The Federal Home Loan Bank Board reported national averages of effective interest rates of 6.49 and 6.54 percent in November on conventional first-mortgage loans on newly-constructed and on existing one-family homes, respectively. Such rates pertained to loans averaging 73.7 percent of prices of newly-constructed homes averaging $27,900 for an average duration of 24.2 years, and averaging 72.7 percent of prices averaging $23,500 for existing homes for an average duration of 21.5 years. These averages included effective interest rates on home loans as high as 7.45 percent in the South and 7.34 percent on the West Coast.

George A. Christie, chief economist for the F. W. Dodge Co., viewed the marked November increase in contract awards for new housing units as proof that people will borrow at very high rates to finance housing construction in times of great need. However, the continuing drain of funds from the mortgage market to other fields of investment, as a result of recent increases in competing interest rates, together with ever-increasing construction costs, probably soon will restrain or terminate the recent expansion of housing construction.

Protracted continuance of the recent increases in residential construction appears improbable in view of prospective cost increases and reductions in the supply of mortgage funds.

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*	*1967*	*1968*
Ingots, etc.—million tons						
1 week: January 13	1.16	0.40	2.52	1.48	2.45	2.64
4 weeks: January 13	3.58	1.24	10.05	5.28	9.43	10.66
Automobiles						
Vehicles—thousands						
1 week: January 13	78	26	154	98	166	194*p*
4 weeks: January 13	220	85	497	377	592	695*p*
Electric Power						
Kilowatt-hours—billions						
1 week: January 13	1.7	1.6	12.3	14.7	23.4	26.4
4 weeks: January 13	7.7	7.1	47.4	58.0	91.2	99.8
Lumber						
Board feet—billions						
1 week: January 6	0.59	0.21	0.52	0.46	0.46	0.37
4 weeks: January 6	2.52	1.05	2.28	1.93	2.21	2.03

p Preliminary.

DEMAND

Retail Sales

The Department of Commerce estimated that the dollar amount of retail sales (after adjustment for seasonal variation and trading day differences) decreased 0.5 percent from November to December to $26.3 billion. This was nearly 4 percent more than the reported total of adjusted retail sales in December 1966. However, the estimate of unadjusted retail sales for December was only 1.7 percent more than the unadjusted total a year earlier. The seasonal adjustment thus resulted in substantial overstatement of the year-to-year increase in retail sales. Department of Commerce officials did not explain the discrepancy.

The purpose of seasonal adjustment is to eliminate or minimize fluctuations in data that recur during specific periods of each year. Comparison of unadjusted retail sales data for December with those of any other month, for example, is not useful because such sales increase markedly as a result of Christmas shopping. On the other hand, comparisons between unadjusted retail sales during Decembers of different years are useful, because such sales are subject to similar seasonal influences. Therefore, both adjusted and unadjusted data should indicate a similar percentage change from a month in one year to that in another.

The most reliable year-to-year comparisons are those of unadjusted data, which do not include an element of arbitrary judgment as do seasonally adjusted data. The Institute currently is exploring a method involving the use of unadjusted data for analyzing month-to-month and long-range developments in the statistical indicators of business-cycle changes. If this method proves to be useful, its future adoption would eliminate the misleading influences of inappropriate seasonal adjustments. This method indicates that retail sales increased during 1967 and accelerated substantially during the second half of the year. In contrast, seasonally adjusted retail sales data do not indicate an increasing trend during recent months; such data decreased during 2 of the last 3 months.

Adjusted retail sales of non-durable goods, which account for about two-thirds of the total, decreased 1 percent from November to December but were nearly 5 percent more than those in December 1966. Adjusted retail sales of durable goods, which account for most of the cyclical variation in total retail sales, increased about 2 percent during December and reportedly were about 2 percent more than such sales during the corresponding month a year earlier.

Latest reported data indicate that the unadjusted sales of the major groups of retail establishments during December compared with those during December 1966 as follows: general merchandise, 4.7 percent more; food, 1.2 percent more; but automotive, 1.6 percent less. These three groups account for slightly more than half of total retail sales.

If the increase in the dollar amount of retail sales during 1967 was nearly 2 percent, it was accounted for entirely by increased prices of retail commodities. If the increase was nearly 4 percent, more than half of the increase was attributable to increased prices.

The dollar amount of retail sales apparently increased at about the same rate as did prices of retail commodities during 1967. Consequently, physical volume of retail sales last year changed little from the volume during 1966.

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 13	0
Four weeks ended January 13	+7

PRICES

Commodity Prices

	1967	*1968*	
Index	*Jan. 15*	*Jan. 8*	*Jan. 15*
Spot-market, 22 commodities	273	256	255
Commodity-futures	382	300	297
Steel-scrap	$27.83	$31.50	$31.50