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RESEARCH REPORTS

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Inflating and Economic Activity

I. Ineffective Attempts to Manage the Economy

Readers of these reports presumably understand that disciples of the British economist, Lord Keynes, believe that by manipulating the Government's fiscal (spending and taxing) policies, central planners can effectively regulate important aspects of the economy. The monetarists share the Keynesians' confidence that the economy can be regulated effectively, but they believe that manipulating the Nation's "money supply" is a more useful tool than fiscal actions for controlling the rate of economic activity.

During the 3 years that he has been in office, President Nixon has provided both the Keynesian economists and the so-called monetarist group with opportunities to use the Nation's economy as an experimental laboratory in which to test their respective "theories." Repeatedly he has expressed his faith that the economy would respond to fiscal and monetary policy changes initiated in Washington, and he has employed both tactics with seemingly equal vigor, although there are signs that during the recent past he has placed more emphasis on fiscal than on monetary policy in an effort to stimulate general business activity. That the Keynesian and monetarist notions are not as dissimilar as they may seem is a matter that we shall discuss later in this article. But first, let us review some of the plans made for the economy by the Administration during the past 3 years.

The President's Economic Plans

On March 26, 1969, in a special message to Congress, the President stated that "Only a combined policy of a strong budget surplus and monetary restraint can now be effective in cooling inflation. . . ." Thus, the President served notice that the advice of both Keynesian and monetarist economists would be followed in an effort to restrict increases in prices. This statement also revealed that fighting "inflation" was the principal objective of economic policy early in 1969. As do most economists and other observers, Mr. Nixon used the word *inflation* to refer to rising prices. Repeatedly in these reports we have pointed out that *inflation* (meaning rising prices) is one of the usual results of *inflating*, which is the process by which the banking system creates purchasing media in excess of those needed for representing gold and other things being offered in the Nation's markets.

The following year, in his Economic Report to Congress submitted in February 1970, Mr. Nixon declared: "A prudent fiscal policy, avoiding the risks of returning to budget deficits, and a prudent monetary policy, avoiding the risks of overly long and overly severe restraint, offer the best promise of relieving strains and distortions in financial markets, bringing interest rates down, and encouraging a sustainable and orderly forward movement of the economy."

The foregoing statement reflected a shifting of policy from fiscal and monetary restraint to a relatively neutral position, in spite of the fact that curbing the rate of increase in prices, which was the principal objective set a year earlier, had not been achieved. Instead, the Consumer Price Index increased more during 1969 than it had during any year since 1951.

The President's next Economic Report, in February 1971, included the following observation: ". . .existing and foreseeable expansionary forces in the economy are not strong enough to assure that output will rise as much as is desired and feasible. These forces must, therefore, be supplemented by expansive fiscal and monetary policies."

This further shift from the relatively neutral fiscal and monetary policies planned a year earlier to active expansionary efforts presumably reflected the President's disappointment with economic developments during his first 2 years in office. Prices rose even more rapidly during 1970 than they had during 1969, but business activity diminished and the unemployment rate rose markedly. Obviously, the economic advice that had been accepted and applied by the President had failed dismally to accomplish the desired objectives. Nevertheless, among the President's advisers, none apparently offered alternatives to the Keynesian and monetary dogma. Therefore, Mr. Nixon presumably decided, in effect, that although the remedies prescribed by these advisers had not cured the Nation's economic ills during the preceding 2 years, he would "double the dose" and hope for better results in the future. The budget for fiscal 1971 originally had been estimated to involve a small surplus of $1.3 billion. However, increased expenditures and reduced revenues resulted in a deficit of $23 billion. In addition, expansion of the "money supply" accelerated during the first half of 1971 to an annual rate of 10½ percent, which was nearly double the rate of increase during 1970 and was greater than the rate of growth in any prior 6-month period since World War II.

Conspicuous Failure

The counterproductive results of that greatly increased "dose" of fiscal and monetary stimuli were well-publicized when President Nixon made his report to the Nation last August 15. In that report the President announced his decision to impose wage and price controls, a gold embargo, and other restrictive devices in an effort to suppress some of the more obvious adverse consequences of these expansionary policies. Nevertheless, Mr. Nixon evidently still continued to accept and apply the advice of his Keynesian and monetarist advisers. In their annual report, which the President incorporated in

his Economic Report for 1972, the Council of Economic Advisers summarized the situation as follows: "The actual path of the economy in 1971 and the forecast for 1972 would result in a budget deficit around $38.8 billion in fiscal 1972 (ending June 30, 1972) and $25.5 billion in 1973. . . . .The role of monetary policy in the expansion ahead will be to provide for the increase of liquidity required to support increases in activity and income."

Clearly, the political and monetary authorities have not lost faith in the notion that Federal deficits and "easy" monetary policies represent a panacea that will stimulate business expansion, reduce unemployment, and generally enhance the economic welfare of the country.

A provocative and pertinent question is, What accounts for the conspicuous failure of such policies to produce these utopian results? The advocates of such policies have not provided a convincing explanation. Consider, for example, the response of Dr. Arthur Burns, Chairman of the Federal Reserve Board, when he was asked such a question during his testimony before the Joint Economic Committee of Congress in the summer of 1971. His reported reply was simply that: "The rules of economics are not working in quite the way they used to." Dr. Paul McCracken, while he still was Chairman of the Council of Economic Advisers, offered a similar non-answer, phrased in somewhat more sophisticated terms by stating, ". . .there may be some. . .fundamental and pervasive and deeper phenomenon of social dynamics at work here, the nature of which we may not fully understand."

The Answer to the Question

As a result of our research on money-credit problems that has now continued for nearly 4 decades, we are convinced not only that there is an answer to the foregoing question but also that the answer is not obscure except to those who persist in wearing blinders that block their vision.

One type of blinder that seems to be in wide popular use prevents the wearer from seeing the difference between the process of inflating, which we described earlier in this discussion, and the rise in prices and wages that usually results, which those with blocked vision have chosen to call "inflation." Members of this group, apparently including President Nixon, focus attention only on the symptoms and not the cause of the problem. For example, they are misled into assuming that the current difficulties are of recent origin, having begun as recently as 1965 or 1966 when the rise in prices began to accelerate. As we shall demonstrate later, the existing problems had their origin in the inflating that began during World War II and that has continued almost without interruption since then.

Another vision blocker is the notion that purchasing media (the total of demand deposits or checking accounts and currency, popularly called the "money supply") are all of one variety. Long ago our research revealed that there is a marked difference in the results to be expected from the creation of inflationary and noninflationary purchasing media. Noninflationary purchasing media are those that represent gold and other things being offered in the markets. Inflationary purchasing media are those that are created by the banking system and loaned to the Government or to private borrowers who do not offer consumable things for sale in the markets. Failure to distinguish between these two types of purchasing media seems to be the single most important flaw in the hypotheses developed by the so-called monetarist economists. They concern themselves only with the rate of increase in the total "money supply" and give no consideration to its composition.

For example, during the allegedly "tight money" year of 1969, the total supply of purchasing media increased $6.8 billion, which was substantially less than the increase of $13.4 billion during the "easy money" year of 1968. Thus, the monetarists then claimed that this marked reduction in the growth rate of the "money supply," after allowance for a reasonable lag, could be expected to retard the rate of increase in prices. Later, they acknowledged that they were puzzled by the fact that prices continued to rise at an accelerating rate throughout the following year and on into 1971. Obviously, they failed to take into account the changes in the types of purchasing media that were created during the years involved. Had they done so, they would have had no reason to be puzzled by the continued rise in prices. The increase of $13.4 billion in total purchasing media during 1968 included an increase of about $6.1 billion of noninflationary and $7.3 billion of inflationary purchasing media. During 1969, the smaller total increase of $6.8 billion included a decrease of nearly $1.6 billion of noninflationary and an increase of nearly $8.4 billion of inflationary purchasing media. Thus, inflating was greater during 1969 than it had been during 1968, in spite of the reduced rate of growth in the total "money supply" during the later year.

Note: The concluding part of this discussion will be presented in a subsequent issue.

STATISTICAL INDICATORS

Inverted average weekly initial claims for unemployment insurance increased for the sixth consecutive month during March. This development increased the probability that this series is expanding cyclically. The index of new private housing units authorized by local building permits was revised downward for February, reflecting a decrease instead of the increase that was reported earlier. During March that series decreased a third consecutive month, which raised some doubt that it was still expanding cyclically then. The percentage of primary leading indicators apparently expanding cyclically was unchanged at 75.

Increases during March in industrial production and in personal income and an increase during the first quarter in constant-dollar gross national product tended to confirm the cyclically expanding statuses of these series. Six of the seven primary roughly coincident indicators, or 86 percent, appear to be expanding cyclically.

No new data were received for the lagging indicators, and 67 percent of those series apparently are expanding cyclically.

Cyclical expansion of three-fourths of the primary leading indicators seems to justify optimism about the near-future trend of general business activity.

SUPPLY

INDUSTRIAL PRODUCTION

The Federal Reserve Board estimated that the seasonally adjusted index of industrial production for March was 109.6 (1967=100), which would be 0.6 percent more than the downward-revised index of 108.9 for February. The March increase was the seventh consecutive monthly increase and the fifth consecutive increase of 0.6 percent. March production was 3.9 percent more than that a year earlier but 2.0 percent less than the record volume during September 1969.

Revised data revealed that mining output decreased during February rather than increased as was indicated by the initial estimate by the Board.

INDUSTRIAL PRODUCTION
FEDERAL RESERVE BOARD INDEXES
(Seasonally adjusted, 1967=100)

Industry	1971 Mar.	1972 Feb. p	1972 Mar. e
Industrial Production—Total	105.5	108.9	109.6
Manufactures—Total	103.2	107.4	108.0
Durable	*98.3*	*100.5*	*101.2*
Nondurable	*110.4*	*117.4*	*118.1*
Mining and Utilities	120.2	120.5	121.9

p Preliminary. e Estimated.

The preliminary estimates for March indicate that production increased in all major industry groups. Production of durable goods, which accounts for about one-half of total industrial production, increased 0.7 percent to a volume 3 percent more than that a year earlier. Such production has increased during each of the past 4 months. Recent large increases probably reflect a cyclical expansion of durable goods production. Production of iron and steel increased 2.4 percent during March following a small decrease in such production during February. Production of transportation equipment, which is a component of the durable goods group, decreased 0.6 percent, primarily as a result of a 1.5-percent decrease in production of motor vehicles and parts. Production of furniture and miscellaneous manufactures increased 0.3 percent to a volume nearly 9 percent more than that a year earlier.

Nondurable goods production, which accounts for about one-third of total industrial output, increased 0.6 percent during March to a volume 7 percent more than that a year earlier. All four major categories of nondurables manufactures increased during March. Production of chemicals, petroleum, and rubber increased 1.2 percent and was 9.2 percent more than that a year earlier. Mining output increased 1.2 percent but was 3.3 percent less than that during March 1971. Coal production increased a marked 11 percent but was 4.8 percent less than the year-earlier volume of such production. Utilities output increased 1.1 percent and was 6.2 percent more than such output a year earlier.

Among the market groups, increases in output during March occurred among all major categories. Production of consumer goods increased 0.2 percent to a volume 6 percent more than that a year earlier. Production of durable consumer goods increased 0.2 percent to a volume 6.1 percent more than that during March 1971, despite a 1.7-percent decrease in automobile production. Production of durable home goods increased 0.7 percent to a volume 10.3 percent more than that a year earlier. Production of nondurable home goods during March was 0.1 percent more and 6.0 percent more, respectively, than that a month and a year earlier. March production of business equipment (excluding that for defense and space) increased for the third consecutive month. The volume of such production during March was 3.6 percent more than that a year earlier but 10.7 percent less than the record volume during September 1969. Materials production increased 1.1 percent during March to a volume 3.3 percent more than that a year earlier.

The Federal Reserve Board noted that, for the second consecutive quarter, increased industrial production had little effect on plant capacity utilization by manufacturers. Factories were operated at an average of 74.5 percent of capacity during the first quarter of 1972, compared with a utilization rate of 73.8 during the fourth quarter of 1971.

During the 15 months following the tentatively identified business-cycle trough month of November 1970, industrial production increased at the compounded annual rate of about 3.5 percent. This rate of expansion measured from the trough month has been less rapid than that during previous recoveries. However, during the past 7 months industrial production increased at a compounded annual rate of more than 7 percent. The larger increases in industrial production during the past 7 months provide a clearer indication that industrial production is expanding cyclically.

Further increases in industrial production seem probable during the next few months.

Latest Weekly Data: Selected Items

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:

	1929	1932	1957	1961	1971	1972
Steel						
Ingots - million tons						
1 week: April 15	1.32	0.35	2.31	1.75	2.90	2.72
4 weeks: April 15	5.29	1.37	9.39	6.69	11.66	10.82
Automobiles						
Vehicles - thousands						
1 week: April 15	113	28	125	114	150	191p
4 weeks: April 15	439	124	527	397	670	721p
Electric Power						
Kilowatt-hours - billions						
1 week: April 15	1.7	1.5	11.7	14.4	28.1	31.7
4 weeks: April 15	6.7	6.0	46.8	57.1	116.2	125.7
Percent change from 4 weeks a year earlier: + 8.2						
Lumber						
Board feet - billions						
1 week: April 8	0.71	0.22	0.69	0.62	0.78	0.85
4 weeks: April 8	2.84	0.83	2.70	2.43	2.94	3.01

p Preliminary.

DEMAND

PURCHASING MEDIA

Total purchasing media increased from the amount late in February by $3.6 billion to $229.9 billion late in March. This total was 5.6 percent more than that a year earlier. Subtraction of an estimated $2.8 billion of inactive purchasing media indicates that purchasing media in use late in March totaled $227.1 billion.*

Noninflationary purchasing media increased $1.3 billion during March to $72.2 billion, which was $1.9 billion more than the amount a year earlier. Purchasing media derived from monetary gold and reflected in the Federal Reserve gold certificate account remained unchanged during March at $9.5 billion, which was $1.0 billion less than that a year earlier. Purchasing media derived from short-term commercial, industrial, and agricultural loans increased $1.3 billion during March to $62.7 billion, which amount was $2.9 billion (4.8 percent) more than that late in March 1971.

Inflationary purchasing media increased $2.3 billion during March to $157.7 billion, which was nearly 7 percent more than the amount a year earlier. Purchasing media created by the commercial banks for making term loans of more than a year's duration are inflationary because they were used for buying things such as plant and equipment that the borrowers did not offer in the

*Although inactive purchasing media include both hoarded currency and idle checking accounts, most of them currently are in the form of hoarded silver coins. 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 for buying things in the markets, it is subtracted from the total.

markets. Such purchasing media increased $0.7 billion during March to $41.1 billion, which was 0.5 percent more than that a year earlier. Purchasing media created by these banks for making speculative inventory loans were used by borrowers for buying stocks of materials and other things that they did not offer in the markets; such purchasing media also are inflationary. The amount of such purchasing media decreased $0.4 billion during March to $19.5 billion, which was 4.3 percent more than the amount a year earlier.

The relatively stable amount of inflationary purchasing media derived from U.S. debt monetized as Treasury currency and coin remained at $5.8 billion during March, compared with $5.5 billion a year earlier. Purchasing media created by the commercial and Federal Reserve banks for purchasing securities issued by the Federal Government were used by the Government and other sellers of the securities for buying things that they did not offer in the markets. Such monetized Federal Government debt accounts for the largest portion of inflationary purchasing media. This portion increased $2.0 billion during March to $91.3 billion, which was 11 percent more than that a year earlier.

The gold stock of the U.S. Treasury was $9.6 billion at the end of March, which was $1.1 billion less than that a year earlier. Gross foreign short-term claims against the Treasury gold stock (including dollar claims held by the International Monetary Fund) estimated at $71.3 billion at the end of January were partly offset by short-term dollar claims against foreigners at that time of $12.4 billion. If these totals were unchanged during February and March, net foreign short-term claims would exceed the Treasury gold stock by $49.4 billion. This contrasts with $29.6 billion a year earlier.

The "money stock" or total of purchasing media, after seasonal adjustment by the Federal Reserve Board, increased $1.2 billion from late February to late March. This change suggests that the increase in the unadjusted total of purchasing media during March reported at the beginning of this article was larger than the usual increase during that month.

After changing little during the final 4 months of 1971, the seasonally adjusted total of purchasing media increased substantially during each of the first 3 months of this year. The Federal Reserve Bank of St. Louis reported that this total increased at an average annual rate of 9.4 percent then. This rapid rate is about 1½ times as large as the average annual rate of increase in total purchasing media of about 6 percent between the fourth quarters of 1966 and 1971.

In view of the problems of estimating and adjusting data on total purchasing media, changes in this total during a period of one or even a few months may be of little significance. However, if the total continues to increase rapidly during the next few months, this would suggest that inflating had resumed.

RETAIL SALES

Estimates of retail sales for the most recent week and 4 weeks compare with such sales during the corresponding periods a year earlier as follows:

Period	*Percent change*
Week ended April 15	+ 5
Four weeks ended April 15	+ 5

PRICES

COMMODITY PRICES

Index	*1971* *Apr. 10*	*1972* *Apr. 3*	*1972* *Apr. 10*
Spot-market, 22 commodities*	287	300	300
Commodity-futures	298	316	320
Steel-scrap	$34.17	$35.17	$35.17

*For the preceding Tuesday.

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.