Published Weekly by
AMERICAN INSTITUTE
for ECONOMIC RESEARCH
Great Barrington, Massachusetts 01230

RESEARCH
REPORTS

February 5, 1973

Dr. Burns' Proposal - A Lesson Ignored

The study of economic history is, to some extent, a study of repeated errors. This is particularly true in connection with inflationary episodes. Recognition of this situation is reflected in this question by a long-time student of economics, Henry Hazlitt: "Must we, from this appalling and repeated record, draw once more the despairing conclusion that the only thing man learns from history is that man learns nothing from history?" Unfortunately, an affirmative answer to that question apparently is as warranted today as at any time in the past.

Ignorance of the lessons of history by persons who are not influential is unfortunate but not necessarily dangerous. However, when a highly respected and influential economist ignores the lessons of history, there is cause for concern, because his recommendations may be used as a basis for important policy. We are puzzled that the historical record has been ignored by one who for more than four decades has been associated with an organization that was founded for the purpose of examining and describing historical economic events.

An Unsound Proposal

The event that prompted this report was a recent recommendation by Dr. Arthur Burns, Chairman of the Board of Governors of the Federal Reserve System, who formerly was Chairman of the Board of Directors and President of the National Bureau of Economic Research, Incorporated. *Barron's* reported that in a December 7, 1972 statement before a subcommittee of the Joint Economic Committee of Congress, Dr. Burns suggested that Congress give the Federal Reserve banks authority to lend to member banks on the basis of sound *mortgage* collateral. This suggestion received very little attention in the news media, although other parts of Dr. Burns' testimony were reported in some detail. Yet, this remark perhaps was the most important.

What Dr. Burns meant by sound mortgage collateral, we do not know. Nonetheless, however such collateral might be characterized, the practice itself would be unsound and deleterious, because it would tend to be inflationary.

Readers presumably know that inflating is the creation of purchasing media in excess of the gold-exchange value of tangible things offered in the markets. If the Federal Reserve banks were to make loans to member banks on the basis of mortgage collateral, the borrowings would provide the member banks with the opportunity to create more purchasing media that would not represent things offered in the markets. Most assuredly the member banks that so borrowed would create additional purchasing media for some purpose. Purchasing media are created whenever commercial banks in total increase their loans and investments (their earning assets) by more than the amount of saved purchasing media made available to them.

Member banks can borrow from the Federal Reserve banks on the basis of collateral arising from bona fide commercial transactions, which are loans associated with the offering of tangible things in the markets. Rediscounting of such loans by a central bank is consistent with the basic principle of sound commercial banking, and the original Federal Reserve Act provided that only such loans could be rediscounted. Amendments to the act subsequently permitted the use of Treasury securities as collateral for borrowing from Federal Reserve banks. This departure from the basic principle fostered great inflating, and the banking system already has created about $190 billion of inflationary purchasing media out of a $250 billion stock of total purchasing media. In this situation, what the Nation does not need is an arrangement that would facilitate further inflating.

One of the consequences of inflating is a general increase in prices. The prices of real property often increase substantially more than the prices of other things during inflationary periods, partly because the cyclical business "booms" that often result from inflating foster marked increases in the demand for land and structures. Thus, as the inflating related to the monetizing of mortgages fostered rising prices of real property, the greater apparent exchange value of the real property would seem to warrant increased mortgage loans. These mortgages then might be used as collateral for creating more inflationary purchasing media. The process thus could result in a kind of vicious circle. Inflating and the depreciation of currency could accelerate at the same time that monetary "collateral" remained allegedly sound.

That the use of mortgages as collateral for the issuance of purchasing media might have adverse effects is not simply conjecture. The monetizing of mortgages has been tried before. Some early experiments with this practice are described below.

Early Massachusetts Experience

At the beginning of the 18th century, the American colonies had persistent adverse payments imbalances with England. Large annual payments deficits reflected not only goods traded but also shipping, insurance, interest, and other charges for services provided by English nationals. Consequently, whatever specie (mainly silver) flowed into the colonies soon flowed out again to England. Also, because England herself faced a perennial drain on specie, the American colonists found it more difficult to attract specie than they otherwise might have. As a consequence of this situation, the development of commerce and manufactures in the American colonies was restricted due to an inadequate supply of specie for efficiently effecting exchanges.

Paper currency, therefore, came into use. Bills of

exchange drawn on deposits lodged with English agents and promissory notes of well-known and respected colonists were a popular early form of paper currency. Later, bills of credit issued by the provincial assemblies and carrying a pledge of designated tax revenues for their redemption came to be the major type of paper currency.

Such bills were first issued in Massachusetts in 1690. By 1710, the amount outstanding totaled nearly 90,000 pounds sterling. That this amount was not excessive is suggested by the maintenance of their stated value in terms of specie. However, the period during which future tax revenues were pledged for their redemption increased from less than 1 year for the earlier issues to nearly 5 years for the later issues.

Inasmuch as the future public tax revenues were pledged for so many years ahead, the Massachusetts Assembly in 1711 loaned 50,000 pounds sterling of bills in the form of secured loans to merchants, who pledged to redeem them in 2 years. The security for these loans was bills of exchange given to the merchants by British agents.

The next issue of bills based on private debt amounted to 50,000 pounds sterling and was in the form of loans to individuals who pledged their land as security for them. Prices soon began to rise rapidly, not only for things thought to be luxuries but also for the necessities of life. New issues of bills were clamored for both by those who already had received the attractive loans and by others who had not. The former urged further issues because they saw the advantage of paying back in depreciated bills. "Equity" and "justice" were mentioned as reasons for making similar loans to individuals who had not participated in the initial issue. Moreover, as prices increased, there seemed to be a need for more purchasing media to conduct everyday transactions.

Accordingly, in 1716 the Assembly authorized another issue of bills for the purpose of making loans to individuals on the security of their land. This issue totaled 100,000 pounds sterling and increased the amount of bills outstanding at the end of 1716 to 202,500 pounds. The depreciation of the bills of credit continued, whether measured by sterling exchange, coin, or prices of commodities. Coin became extremely scarce; bills served as the exchange medium in nearly all transactions. From 1713 to 1717, bills of credit depreciated about 50 percent in terms of both silver and sterling exchange. In his *History of the Province of Massachusetts Bay*, Thomas Hutchinson, historian and Governor of Massachusetts, wrote:

". . .The depreciation was grievous to all creditors, but particularly distressing to the clergy and other salary men, to widows and orphans whose estates consisted of money at interest, perhaps just enough to support them, and being reduced to one-half the former value, they found themselves on a sudden in a state of poverty and want. Executors and administrators, and all who were possessed of the effects of others in trust, had a strong temptation to retain them. The influence a bad currency has upon the morals of the people is greater than is generally imagined. Numbers of schemes, for private and public emissions of bills, were proposed as remedies, the only effectual one, the utter abolition of the bills, was omitted. . . ."*

The currency situation in Massachusetts remained troubled for more than the next 3 decades. By 1750, original-issue bills of credit were worth only one-tenth of their original exchange value in terms of silver. Not all of the monetary mischief can be attributed to the use of private mortgages for security of public bills of credit. Bills based on anticipated tax revenues also were a portion of total bills outstanding and contributed to the problem.

Moreover, in 1740 a private land bank, organized by some 700 or 800 persons, began operations. According to Hutchinson, "This notable company were to give credit to 150,000£ lawful money, to be issued in bills, each person being to mortgage a real estate in proportion to the sums he subscribed and took out, or to give bond with two sureties, but personal security was not to be taken for more than 100£ from any one person. . . . The directors, it was said, by a vote of the company, became traders, and issued just what bills they thought proper without any fund or security for their being redeemed. They purchased every sort of commodity, ever so much a drug, for the sake of pushing off their bills, and by one means or other, a large sum, perhaps fifty or sixty thousand pounds, was abroad."** Depreciation of Massachusetts bills no doubt increased because of this "bank."

Other Colonial Experiences

Along with Massachusetts, Rhode Island and South Carolina also issued bills of credit secured by private mortgages. Rhode Island first emitted bills in 1710, and by mid-1711, the total outstanding was 13,000 pounds sterling. These early issues were not secured by private mortgages, but by anticipated tax revenues. Although some of these bills were redeemed as stipulated, many were not, the tax revenues being unavailable at the redemption date. In addition, many of the bills that were redeemed were returned to circulation instead of being cancelled.

In July and October 1715, the Rhode Island Assembly created an additional 40,000 pounds sterling bills of credit; however, these were secured by mortgages on private lands. This relatively huge emission of bills brought the total outstanding at the end of 1715 to about 51,000 pounds. The value of the bills depreciated rapidly. From 1713 to 1715 Rhode Island bills depreciated from 8 shillings per ounce of silver to 12 shillings per ounce, a depreciation of 50 percent. Trade and manufacturing activity slowed substantially, and the purchase of even necessities became difficult, as was the situation in Massachusetts at about the same time.

Events connected with bills of credit in South Carolina were similar to those in Massachusetts and Rhode Island. Early issues of bills there were secured by tax revenues. In some cases, special duties were enacted for the specific purpose of redeeming the bills. Again, however, the bills seldom were redeemed as called for, and even when they were redeemed, they generally were reissued. Between the initial issue of bills in South Carolina in 1703 and the end of 1711, a total of 16,000 pounds sterling of regular bills was issued. By July 1711, 8,000 of these bills were to have been cancelled, but none was.

The Assembly voted to create 52,000 pounds sterling of new bills in 1712. Of this amount, 32,000 pounds were lent to private parties on the security of their land, 4,000 pounds were unsecured, and 16,000 pounds were secured by duties on imports and exports. The proceeds of the latter emission were to be used to retire the previously-issued bills, whose redemption was delinquent. However, apparently only 8,000 pounds were so used, and in 1716 the total amount of bills outstanding that were issued before 1712 was 44,000 pounds. Mortgages on private lands secured most of these bills.

South Carolina emitted bills secured by property taxes

*Herman E. Krooss, ed., *Documentary History of Banking and Currency in the United States*, Vol. I, Chelsea House Publishers in association with McGraw-Hill Book Co., New York, 1969, p. 75.

**_Ibid._, pp. 77-78.

totaling 30,000 pounds sterling in 1715. At the end of that year, bills outstanding totaled about 74,000 pounds. Data on the depreciation of South Carolina bills are available for 1710 and 1715. At the earlier date, bills were exchanged for silver at the rate of 8 shillings per ounce. In 1715, 10 shillings, 2 pence of bills were required to obtain an ounce of silver. Thus, the South Carolina bills lost about 25 percent of their exchange value in terms of silver between 1710 and 1715, which was a smaller amount of depreciation than that experienced in Massachusetts and Rhode Island.

A Lesson To Be Learned?

The aforementioned experiments with monetizing private mortgages do not prove that the type of security for purchasing media determines the rate of depreciation of the purchasing media. Overissuance of purchasing media is the cause of such depreciation. In colonial Massachusetts, Rhode Island, and South Carolina there probably would have been excessive issues of bills and currency depreciation with its consequent problems even if private lands had not been used as security for some bills. Such depreciation occurred in other colonies that did not resort to monetizing private mortgages.

However, as Curtis P. Nettels observed: "The colonies whose paper had depreciated considerably by 1717 were the ones which had issued unusually large amounts—notably Massachusetts, Rhode Island, New York, and South Carolina. The quantities of the paper printed, rather than the security behind it, apparently caused the depreciation. It is true, however, that there was a close relation between the security and the quantities of paper issued. When taxes for redemption were not collected until several years after the bills were authorized, this habit of deferred redemption speedily resulted in an increase in the supply of bills. Similarly, the use of private lands as security allowed the issues to expand almost indefinitely. . . ."†

The situation would be similar nowadays. There are millions of potential borrowers on the security of private mortgages. This is a large group that might add greatly to the pressure on the Federal Reserve banks to inflate further.

The adverse consequences of inflating during the past few decades are becoming more apparent. History contains lessons about the relationship between inflating and the monetizing of private mortgages. Why ignore those lessons and invite more problems, Dr. Burns?

STATISTICAL INDICATORS

Among the primary leading indicators, new orders for durable goods decreased during December. In spite of this decrease, this series still is appraised as expanding cyclically. Contracts and orders for plant and equipment decreased during December, but re-evaluation of the cyclical status of this series cannot be made until data indicating the magnitude of the reported decrease are received. Price per unit of labor cost increased during December, and this series continued to expand cyclically then. The percentage of primary leaders thus expanding remains at 92.

No new data were received for any of the primary roughly coincident or lagging indicators, all of which appear to be expanding cyclically.

Apparent cyclical expansion of 92 percent of the primary leading indicators warrants the expectation that general business activity will continue to expand during the next few months.

†Curtis P. Nettels, *The Money Supply of the American Colonies Before 1720,* August M. Kelley, New York, 1964 Reprint, p. 268.

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:

	1929	*1932*	*1957*	*1961*	*1972*	*1973*
Steel						
Ingots - million tons						
1 week: January 27	1.16	0.41	2.50	1.47	2.36	2.85
4 weeks: January 27	4.32	1.61	9.98	5.81	9.04	11.09
Automobiles						
Vehicles - thousands						
1 week: January 27	88	23	146	97	163	206p
4 weeks: January 27	308	98	536	366	679	796p
Electric Power						
Kilowatt-hours - billions						
1 week: January 27	1.7	1.6	12.4	15.4	32.8	35.3
4 weeks: January 27	6.7	6.4	49.0	59.1	130.6	143.1
Percent change from 4 weeks a year earlier: + 9.6						
Lumber						
Board feet - billions						
1 week: January 20	0.71	0.21	0.62	0.55	0.70	0.76
4 weeks: January 20	2.57	0.88	2.28	1.99	2.76	2.53

p Preliminary.

DEMAND

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 January 27	+ 13
Four weeks ended January 27	+ 11

PRICES

CONSUMER PRICES

According to the Department of Labor, the Consumer Price Index during December increased 0.3 percent before seasonal adjustment and 0.2 percent after such adjustment. The unadjusted 3.6-percent annual rate of increase during that month was more than the 2.4-percent rate during November and equal to the rate during October. The unadjusted December index of 127.3 (1967=100) was 3.4 percent more than that a year earlier. The rate of increase during 1972 equaled that during 1971.

Among the principal components of the index, unadjusted prices of food, housing, and health and recreation increased during December, but those of transportation decreased. Unadjusted prices of apparel and upkeep were unchanged during December. The percent changes among these components of the unadjusted index from those a month and a year earlier are shown in the table below.

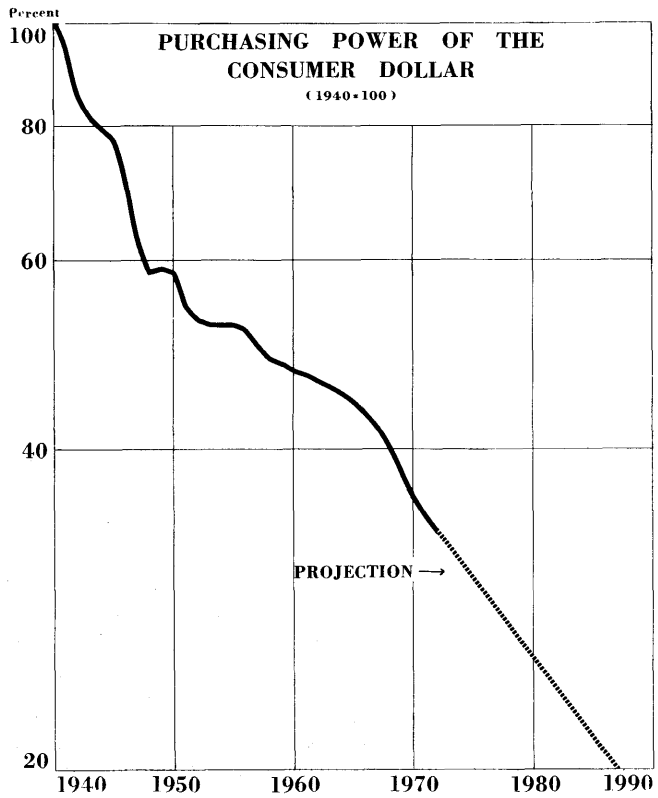
	Percent Change from	
Index	*Preceding Month*	*A Year Earlier*
Food	+0.5	+4.7
Housing	+0.3	+3.5
Apparel and Upkeep	0	+2.6
Transportation	−0.1	+2.3
Health and Recreation	+0.1	+2.9

The December increase in the food component of the index was the seventh consecutive monthly increase. This increase was the largest since the equal increase during July of last year. After seasonal adjustment, food prices were unchanged during December following an increase of 1.1 percent during November. The December increase in this component reflected increases in prices of dairy products and fresh vegetables. Unadjusted prices of meat, poultry, and fish decreased 0.2 percent during December.

Dr. Herbert Stein, Chairman of the Council of Economic Advisers, recently stated that "rising retail food prices are to be expected in the months ahead." Prices of meat, poultry, and dairy products are expected to increase as a result of both increasing costs of animal feeds and an increasing worldwide demand for meat, especially beef. During 1972, exports of beef from Australia, which is the largest beef exporter, were 20 percent more than those during 1971. According to the Australian Meat Board, this increase reflected "substantially increased shipments to established markets such as the U.S.A., Britain, Japan, Canada, Greece, and Sweden." However, shipments also increased to "significant new markets such as Romania, Peru, Egypt, and Chile."

During early January, costs of corn, soybean meal, and other protein-rich ingredients of animal feeds were about twice those a year earlier. During the week ended December 19, the Government's index of feed ingredients prices was 206.6 (1967=100), compared with 107.2 a year earlier. According to the *Wall Street Journal,* these increases in costs of feeds reflect a shortage of grains due to "unusually bad fall weather that has hampered completion of the corn and soybean harvests." That the sale of large quantities of wheat, soybeans, corn, and other grains to Russia has contributed to the reduction in supplies and resultant increase in prices in the domestic markets seems self-evident. However, this aspect of the situation has not been widely discussed by Administration spokesmen or the popular news media.

Dr. Earl Butz, the Secretary of Agriculture, stated that the shortage of such grains is a prime concern of the Administration. In an attempt to alleviate this shortage, the Administration recently announced that much of the grain held in storage by the Commodity Credit Corporation will be made available, leaving "small quantities of emergency reserves." Also, crop production and year-round grazing of cattle on 15 million acres of land originally "set aside" for conservation will be allowed. Dr. George P. Shultz, Chairman of the new Council on Economic Policy, stated that "further adjustments" in the Government's crop programs during 1973 will be made, if necessary, "to encourage production of grains and soybeans."



Among the remaining components of the Consumer Price Index, housing prices increased during December for the twenty-first consecutive month. The December increase equaled that during November but was more than that during October. This increase was attributable, in part, to a 0.2-percent increase in prices of fuel and utilities.

During December, prices of apparel and upkeep were unchanged, following increases during the preceding 3 months. The December decrease in the transportation component of the index followed 10 consecutive monthly increases. This decrease reflected a 0.8-percent decrease in prices of used cars.

The services component of the index increased 0.4 percent during December on an unadjusted basis. This increase was more than the 0.2-percent increase during November but equal to the increase during October. According to the Department of Labor, property taxes, insurance premiums, rent, and home-repair prices increased.

During December, the purchasing power of the consumer dollar was only 32.9 percent of that during the 1935-39 period. The accompanying chart, based on annual averages of the monthly Consumer Price Index, shows the deterioration in the purchasing power of the consumer dollar since 1940. The average annual rate of such deterioration since then has been nearly 3.5 percent. The chart shows that the average rate of loss of purchasing power diminished to about 1.3 percent annually from 1958 through 1965. After 1965, the annual rate of loss increased to 2.9 percent during 1966 but then decreased slightly to 2.7 percent during 1967. The rate of loss increased further to 4.0 percent during 1968, to 5.2 percent during 1969, and to 5.5 percent during 1970. During 1971, the rate of loss decreased to 4.2 percent, and during 1972 this rate decreased to 3.2 percent. The 1972 rate of loss was the smallest since that during 1967. However, continued losses at the 1972 rate would halve the purchasing power of the consumer dollar in approximately 23 years, or by 1996; continued losses at the average rate during the period 1940-1972 would halve such purchasing power in approximately 20 years, or by 1993.

Further increases in the Consumer Price Index and particularly in food prices seem probable during the next few months.

COMMODITIES PRICES

	1972	*1973*	
Index	*Jan. 22*	*Jan. 15*	*Jan. 22*
Spot-market, 22 commodities*	290	348	352
Commodity-futures	310	386	391
Steel-scrap	$34.17	$47.50	$48.50

*For the preceding Tuesday.

PRICE OF GOLD

	1972	*1973*	
	Feb. 3	*Jan. 25*	*Feb. 3*
Final fixing in London	$48.00	$65.60	$66.60