

THE BUSINESS SITUATION

An Address Before the Sphex Club
Lynchburg, Va., December 3rd, 1920

By A. F. Thomas

The substitution of credit exchange for barter was a long step forward. As an instrument for promoting civilization it perhaps has no equal. Although it has been in existence a long time its machinery is as yet only partially developed and it has not been sufficiently strengthened and perfected to withstand the strain and shock to which exceptional circumstance more or less periodically subjects it. Its fundamental requisite is confidence and its degree of effectiveness is measured by the amount of faith existing in the soundness of its instruments.

Credit primarily is a demand upon the **existing stock** of products available for exchange. The sum of legitimate credits can no more exceed the amount of products existing for exchange than can the barterer trade his products for others that are non-existent. There is, then, if the standard of value is to remain stable, a fixed relation between products and credit instruments. Any augmentation or diminution of the one or the other destroys the equilibrium of the standard of value and throws the machinery of exchange out of adjustment. If the disturbance is progressive and continues to a sufficient extent, it will necessarily impair in destructive measure the confidence upon which the system depends and precipitate a collapse. When this condition arises we call it **Panic**. Whether the undermining of confidence results from more or less recondite violations of sound principle proceeding slowly and practically unobserved or is caused by a sudden catastrophe such as rapidly developed revolution, a wide spread drouth, or destructive earthquake, the result with varying degrees of intensity is the same.

Historically, the more or less regular times of recurrence of panic phenomena give the impression that they move in cycles, and that we, in overcoming the effects of one panic, plant the seeds of the next. Beginning at the zero point when industrial activity is at its lowest ebb, prices lowest, and labor poorest and most idle, people hesitatingly and falteringly begin to pull themselves together to begin another ascent. Progress is at first slow and painful, but with time and the happy faculty of forgetting the unpleasant lessons of the past, possessed in a marked degree by most men, they gather courage and impelled by various motives of ambition, greed or desire to serve in a larger way they speed up, but neglecting to keep their courses well within sound principles, when the climax is again reached, the house of cards falls and the vicious circle is begun again.

Psychology of Progression and Regression

The psychology of the progression and regression is interesting. As already noted, the period of expansion is invariably accompanied by over extension of credit with its rising prices which sets the wheels of business in motion at an ever accelerating speed requiring more labor and drawing it from primary production. This in turn raises the price of products and

lessens the actual returns of labor, hence it begins to clamor for higher wages. The higher products go, the more intense the struggle becomes between Capital and Labor, until the bubble bursts and Capital loses the opportunity to do business and make a profit and Labor loses its job.

In the ascending period the standard of value is continually lessening in real value, hence debts, fixed charges and incomes, salaries and wages while nominally remaining the same continually diminish in purchasing power, while products rise, inspiring a feeling of prosperity that grows with the rising tide until it superinduces waste and inefficiency. Debts are easily paid and quite as easily made. When the tide turns the reverse happens: the standard of value rises in purchasing power, prices of products fall, salaries and wages buy more, but labor generally loses its job, debts are more difficult to pay, fixed charges and incomes of all kinds measured in products are worth more. The debtor was the beneficiary in the ascent but the creditor comes in on the descent for the advantage.

It may be thought that the gain of the debtor going up is balanced by his loss in coming down but such is not the fact. The creditor has all the best of it: e.g., if A buys 100 bushels of wheat in 1913 at \$1.00 per bushel, giving his note payable in 1920, he sells 50 bushels of wheat at \$2.00 per bushel, pays the debt, leaving a gain of 50 bushels of wheat. While B sells C 100 bushels of wheat in 1920 for \$2.00 and wheat falls to \$1.00 per bushel, C must sell the hundred bushels of wheat and then still get another hundred bushels from another source before he can liquidate the debt. Hence B gains 100 bushels of wheat or double the amount that A gained. Thus it will be seen that in any period of rise and fall of prices the creditor class must of necessity gain while the debtor class must lose since the latter's gain is a percentage of the lower price while the creditor's gain is a percentage of the higher figure. In view of this fact, the creditor class especially that part of it holding liquid credits only, and that having fixed incomes can look with more or less complacency not to say resignation upon panics, however disastrous they may be. They can at least console themselves with the thought that matters might be worse.

During the life of the American Republic panics with more or less regularity have occurred. They have invariably been introduced with high prices and followed by the reverse. In 1809 land in Pennsylvania sold for \$38.00 per acre. In 1815 it rose to \$150.00 but receded in 1819 to \$35.00. In 1820 wheat sold in Kentucky at 20 cents per bushel, flour in Pittsburg at \$1.00 per barrel. The price average from 1865-9 was 178.8 but following the panic of 1873 it fell by 1889 to 93. The culmination of inflation after practically all wars is found in trade booms, notably those of the Crimean War in 1857, the Civil War in 1866 and the Franco-Prussian in 1870. After the panic of 1893 a period of decline lasted until 1898. With the beginning of the Spanish-American War, an upward movement of prices occurred which with a slight interruption in 1903 and a severe but rather spasmodic bankers' panic in 1907 continued to rise until 1912, when Bradstreet's index commodity prices showed that the advance had been from 5.70 to 8.65—that is to say 67 per cent. This general advance in prices was generally ascribed to the increased production of gold.

World Inflation Began in 1914

In July, 1914 the most of the so-called civilized world went mad. Practically all of Europe engaged in the most gigantic war that had ever

been fought. The credit exchanges of all countries were utterly inadequate to stand the shock and promptly collapsed. Governments, out of sheer necessity had to improvise credit machinery to take their places. These powers spent what legitimate credits they possessed. then as is usual in war, proceeded by inflation to create arbitrary credits which as already explained, served to cause prices to amount still higher than abnormal demand had carried them. Under the press of foreign necessity America bought back at low prices the seven or eight billions of her securities held in Europe, paying for them in products at inflated prices. This process continued greatly to the enrichment of America, until the spring of 1917 when she realized that her own security demanded that the Central Powers should be defeated.

Declaring war upon Germany and Austria, America launched the most gigantic undertaking that has ever been tried. History furnishes no parallel. Force without stint and cost without question were the slogans. To crush Germany was the purpose. This accomplished and the cost could be counted afterward. The result was worth all that it cost. The war furnish the occasion and the Federal Reserve system the instrument for inflating the currency and bank credits of the country between 13 and 14 billion dollars. Some idea of the immensity of this sum may be had when we recall that it is more than double the total deposits in all the National Banks in 1914, which only amounted to \$6,268,692,430.

As an indication of the extent to which bank credits were inflated under the operation of the Federal Reserve system, attention is called to the fact that total deposits in the National Banks in 1914 were as above stated, \$6,268,692,430, while they had increased at the close of 1919 to \$15,924,865,000—an increase of \$9,656,172,570—something over 150 per cent. The enormity of the increase may be more clearly grasped when we recall that the increase of deposits in National Banks from 1866 to 1914, a period of forty eight years, had only been \$5,735,354,256. In other words, the increase in National Bank deposits for five years under the Federal Reserve system had been nearly double the increase of these banks for the forty eight years preceding. The above figures cover the period closing with the year 1919, those for 1920 not being available. It is stated that 25 per cent of the currency and bank credit inflation of this country has occurred since the signing of the armistice Nov. 11, 1918. Secretary Houston a few weeks ago stated that bank loans and investments, between the armistice and Oct. 1, 1920 had increased more than seven billion and Federal Reserve notes more than seven hundred and forty millions and in the period from Jan. 23, 1920 to the end of September, the loans and investments of all the banks of the country increased approximately one billion and Federal Reserve note circulation increased 460 millions. Such enormous creations of credit instruments as have now become general are without precedent. Even Colonel Mulberry Sellers with his pet obsession that "there are millions in it," would be compelled to admit that his imaginative faculty was hopelessly inadequate to grasp the magnitude of the operations of our present financial machine engaged in the business of making something out of nothing, on a scale that neither John Law nor any visionary advocate of fiat money outside of the lunatic asylum would have conceived possible.

Under the operation of the law of relativity between product and credit instruments, this opening of the flood gates of inflation necessarily caused the standard of value—i.e. the dollar—to become of less and less

value as the volume of credits increased. This cheapening of the standard of values was reflected in a constant rise in prices. It is of course understood that the highest essential of a standard of value is stability. It is of the same importance in credit transactions as is the maintenance of a given measure, content or weight in the exchange of products. In the days of Moses, we were told "Thou shalt not have in thy bag divers weights, a great and a small; thou shalt not have in thy house divers measures, a great and a small, but thou shalt have a perfect and a just weight, a perfect and a just measure shalt thou have for all that do such things are an abomination unto the Lord thy God." Again we are told in Proverbs, that divers weights and divers measures both of them alike are abomination to the Lord, and for emphasis it is repeated that divers weights are an abomination unto the Lord and a false balance is not good and still again we are taught that a false balance is an abomination to the Lord but a just weight is his delight.

I am emphasizing this point because it is the crux of the entire matter. Inflation changes the measure of value and necessarily repays in a smaller measure than that used when the credit was made, and conversely deflation collects in a larger measure than that used when the credit was granted, the one process robbing the creditor and the other robbing the debtor. Inflation and deflation both violate this moral law and herein lies not only the inexpediency and stark unwisdom of such policies, but a moral sin the punishments for which are self inflicting. Individuals through ignorance may escape moral responsibility for these sins, but society whether it knows or doesn't know must atone in suffering and loss for the infraction of this moral law.

In an address made June 10, 1918, before the Ways and Means Committee of the House on the Income Tax bill, I said, "While assessment both of material and liquid values would show that the United States is richer today than ever before, this increase is largely imaginary. It partakes of the nature of the limitless wealth of some crazy Monte Cristo who in his padded cell vainly imagines himself the owner of the universe. The psychology of such periods is always interesting and even ludicrous when the seriousness of the final effects is not considered. Whether this inflation of values comes as the result of rag doll paper money inflation or the general expansion of credit for destructive purposes, the results are the same, a rise in nominal values and a decrease in actual wealth. In such periods General Waste assumes command and disruption of relative values follows necessitating incessant readjustments in the attempt to reestablish the proper ratios! The debtor robs the creditor, wages, salaries and fixed incomes decrease in purchasng power and general exhilaration on account of a supposed increase of wealth supervenes.

The disorganization that results necessarily increases risks and the percentage of profit increases to cover them. Once begun, the fever to get as much as possible seizes the public mind and an era of profiteering is ushered in affecting everybody from the bootblack to the financial magnate. It is as useless as it is unjust to undertake to select a particular class as the horrid example of the conscientless and unpatriotic profiteer. The humble laborer who does his bit in getting his wage raised from \$1.00 per day to \$7.00, the small corner grocer who keeps busy marking up his goods to the limit, the wayside innkeeper who patriotically follows the advice of Mr.

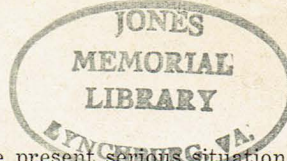
Hoover to conserve food by reducing by half the portions and at the same time doubles the price, the poor farmer upon whose shoulders the burdens of civilization have weighed so heavily in the past imbibes that hope that springs eternal and who proceeds to get all he can for his products, that quintessence of patriotic fervor, the dollar-a-year industrial magnate who offers his valuable services upon the altar of his country, with apparently no objections to a few large contracts to be sent to his former associates merely as tokens of remembrance, are all doing what they can to avail themselves of the present opportunity, if for no other reason, to provide a surplus against the evil day that even a novice knows must come, when the inevitable reaction takes place.

The fault is not primarily personal. It is the result of a defective economic system that cannot function normally under the severe strain that such conditions produce. When we consider that our money in circulation has increased two billions—about 60 per cent—in four years, Federal Reserve notes from 187 millions to one billion five hundred million, our circulation from \$24 to \$56 per capita, national debts of the world from 43 billions to 161 billions, money in the principal countries from two billions, eight hundred millions, to 19 billions 500 millions, and compare with the production of actual wealth expressed in bushels, pounds, etc.—corn from 2 billion, 400 million bushels to 3 billion, one hundred million bushels—an increase of about 30 per cent—wheat 763 million bushels to 650 million bushels—a decrease of about 14 per cent—coal from 508 thousand tons to 580 thousand tons—an increase of 14 per cent—copper 546 thousand tons to 843 thousand tons—an increase of 35 per cent—iron ore from 59 million tons to 75 million tons—an increase of 25 per cent—and petroleum about 40 per cent increase in gallons, and when we further consider that the real wealth produced is being largely devoted to the destructive purposes and therefore, being consumed more wastefully and more rapidly than in normal times, we must conclude that the increase in the nominal amount of credit instruments has been out of reasonable proportion to the amount of increase of actual wealth, and therefore, the nations have embarked upon a sea of inflation which is uncharted and as the price index shows, the commerce of the world is being done by guess. Present profits, invested as they must be in inventories at inflated prices, when the bubble bursts, as in time it must do, will shrink to an alarming extent. Measured by the purchasing power of real wealth today these nominal profits would be reduced half. Final judgment, if it is to be just, cannot be rendered until the cycle is completed and all the evidence is in. The ascending period is now in process, the descending is yet to follow. It might be well to remember that to be punitive the pains of sin must exceed its pleasures. The reasonable supposition is that during the orgy of inflation with its fool's paradise of apparent prosperity in which the world is now indulging itself, wealth will be dissipated to a large extent and when the tide turns we will find a maximum debt with its additional burden of interest both to be paid out of a reduced amount of wealth that will be constantly declining in nominal value. In view of these possible contingencies it might be well to defer final judgment upon even the most conscienceless profiteer. If conviction is to be had on motive it is to be feared that there are not enough innocents to incarcerate the guilty, while if actual accomplishment of the purpose is to be the test, justice demands that the game be concluded first."

The Present Panic

The ascent finished, the climax reached, seized with vertigo we go over the precipice and down its jagged sides we fall at an ever increasing rate of speed, bound for unexplored depths the profundity of which only the future can measure. In other words, panic, the worst in the history of this country, has seized us, agriculture, industry and commerce are paralyzed. Labor is idle and the foundations of credit and solvency are tremendously shaken. Lest luxuriance of examples of tragic effects should obscure the cause, let us revert to the principle already stated that **inflation inevitably changes the standard of value by cheapening it and deflation changes it by making it dearer.** These changes introduce the use of divers measures which has been denounced of old as an abomination unto the Lord. It is abomination because it perpetrates robbery between creditor and debtor robbing the former in the period of ascending prices and the latter in the period of declining prices. Viewed in its economic effects, the change in the value of the standard violates the Commandment "Thou shalt not steal," and the emphatic prohibition put upon the use of divers weights and measures is but another statement of that law. We have already seen that the most of the evils producing unrest, profiteering and other antisocial practices were due to the uncertainty of values incident to changing the standard of value and the present condition is due entirely to the same thing. The existing debts both public and private were in large measure contracted in the cheap measure, that is to say, when prices were high, and now at one fell swoop the measure is doubled in value and these debts doubled accordingly. Expressed differently, half and in many cases more than half of the debt paying power of products has been destroyed, necessitating the delivery by the debtor of twice as much of his product to cancel his debt as would have paid the debt when it was contracted. In other words, if the prices of products had remained stationary and all debts had been arbitrarily doubled the economic effect upon the debtor would have been the same as that produced by the present deflation.

The debtor contracted the debt when corn was \$2.00 per bushel, he must pay it when corn brings 80 cents per bushel, therefore, must give $2\frac{1}{2}$ times as much corn to satisfy the debt as it was worth when he contracted it. He borrowed when tobacco was worth 20 cents per pound and pays when it is worth 6 cents per pound, requiring over three times the quantity of product to pay the debt, that the amount borrowed would have brought when he received it. The cotton farmer borrowing \$200 when cotton was 40 cents per pound had the equivalent of one bale but with cotton at 16 cents per pound he must give $2\frac{1}{2}$ bales to discharge the debt. The solvent merchant having \$100,000 inventory and owing \$50,000 before the change, finds that his inventory has shrunk to \$50,000, thus leaving him after his debts are paid penniless. The farmer purchasing a \$10,000 farm and paying half cash, finds that it will take the entire farm to pay the debt. Special attention is invited to the fact that uniform deflation of the price of products does not alter the ratio of their exchange value, e.g., if oats and wheat at the high level bring \$1.00 and \$2.00 per bushel respectively and the prices are deflated to 50 cents and \$1.00 per bushel, they continue to exchange at the low values at a ratio of 1 to 2 just as they did when the prices were high. Manifestly then the vital change effected by inflation and deflation relate primarily to credits and debts. It the business of the



country was done by barter the present serious situation could not possibly have arisen. With the great war behind us and the rest of the civilized world badly in need of our products, with our warehouses and granaries filled with all kinds of desirable productions, yet the economic machinery fails to function causing untold suffering and loss because our system of exchange is so operated that it necessarily wrecks one class for the benefit of another. Truly the price that must be paid for the use of divers measures is terrific.

This great shrinkage in the market value of products has raised the question of the solvency of the debtor class and destroyed the confidence that is absolutely essential to the normal functioning of the credit machinery of the country. Before a resumption of business activity on a normal scale can be had there must be revaluations and liquidations to ascertain to what extent each debtor has been injured, whether he is bankrupt or solvent, and if solvent, the amount still left him as margin to form the basis for future credit. He is indeed an optimist who thinks that recovery from such a catastrophe will be rapid. It is entirely probable that thousands will never recover but will go down under the increased burden of debt put upon them by an economic process contrary alike to sound public policy and that most fundamental of moral laws that forbids that one shall unjustly take the goods of another.

2
1/3
The stark unwisdom of it is most striking when it is apparent that it could have been avoided. The fact that inflation had taken place furnishes no excuse for deflation. If the creditor class had been wronged in the ascent, which is admitted, it recouped itself largely by profits and the greater part of the present indebtedness having been contracted in the higher standard, it is therefore manifest that doing a greater wrong in deflating would not be a wise remedy for the first evil that is now largely irremediable. The more just and scientific course would have been to stop further inflation, but keeping what we had so as to stabilize the standard of values, thus enabling debtors to have liquidated their obligations in the same measure in which they were contracted. So much was I impressed with the advisability of adopting this course, in the early months of 1919 I called the attention of Mr. Caldwell Hardy, Governor of this Federal Reserve District, to the matter pointing out the necessity of the Board adopting a policy of stabilization to avoid the condition we have today, but nothing more than an interesting correspondence came of it. He requested that I put the letters away for a couple of years and then compare the different positions. Scarcely eighteen months have elapsed but I am now ready for the comparison.

The more I study people, the more I am impressed that if the Lord was vindictive, really desiring to be cruel to his creatures he would only have to answer their prayers to satiate his desire for vengeance. Like blind Sampson they generally pull down the temple upon their own heads. They knew there was something wrong and jumped to the conclusion that high prices were the source of the trouble, hence public clamor demanded that the cost of living be reduced. **Instability of the standard due to continual inflation was the cause but they did not discover it.**

The Federal Reserve Board set about granting their request. It first undertook to restrict credit in what it might decide to be non-essential industry, such as automobiles etc., then raised the discount rate which, by

the way, enabled the banks to exact a return that would not otherwise have been possible, and if the statement of Comptroller Williams is correct the banks of New York did not fail to take advantage of this opportunity. The high rates prevailing there induced the country banks to divert large sums to that center for the purchase of commercial paper carrying 8 per cent and better, doubtless to the deprivation of their local customers, whom they could not charge more than the state statutes allowed.

The effect of the higher discount rates did not, however, accomplish the purpose, and a more effective method had to be found. The farmer disorganized, with no marketing organization worthy of the name had to sell his crops, and gradually the impression got abroad, no one seems to know exactly how, that he was to have no assistance that would enable him to hold his crops. He could get just enough to get them to the market where he must take whatever was offered for his products. This restriction of credit at the source touched the vulnerable spot and pulled the foundation stones from under the entire exchange structure, and it started down with a crash and is still going. The irony of the situation is that the farmer was implored through all the press, by every appeal known to the propagandist art to produce. A wrecked world was looking to him to rehabilitate it by generous production. He heard the call, went forth to achieve, accomplished the desired result, but to his utter discomfiture, he now finds that in doing so he damned himself, and disrupted the industrial and commercial organizations of the country. If half his productions were sunk in the ocean the remaining half would pay more debts than the whole. While the public allows such things to be true, it raises the question if the practice related in Poe's remarkable story of the lunatics overpowering and incarcerating the sane members of the community, has not continued until now. The public's prayer for lowered costs of living is being answered and I miss my guess if it does not find its latter state worse than its first. I have tried to make plain that the scientific and more just solution of the matter would have been found not in deflation and lower prices but in stabilization and steady prices, for had the indefensible inflation been arrested we would have continued the cheaper stabilized standard and escaped the terrible effects of deflation the overcoming of which will likely be a matter not of months but of years. The deluge is now upon us and the slogan at Waterloo "Sauve qui peut" would seem to be apropos. There is a constructive side to the subject which I will not deal with now, further than to say that with the currency and credit of the country in the hands of private monopoly, under an incentive to abuse its power, we can feel reasonably sure that the end of our troubles is not yet in sight.

