FALLING PRICES AND BORROWING COUNTRIES

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FROM the year 1896 to the year 1925, the world was passing through a period of steadily rising prices and steadily declining value of gold money. Eliminating the artificial peak of the price index between 1916 and 1920 caused by wartime credit inflation, and substituting for it on the chart a line joining the 1914 normal point to the 1922 normal point, we get an almost consistent curve of just under thirty years, the slightly more rapid rate of rise after 1914 being due partly to the fact that the base itself was much higher than in 1896 (so that the same percentage increase looks much larger on the chart), and partly to the increased volume of credit based on each gold unit as a result of improved efficiency in monetary machinery. The end of this long rise was reached in 1925. All the business thinking of the present generation of business men, economists, and statesmen, is conditioned by this rising-price phenomenon, which has prevailed throughout the whole period of which they have any personal experience.

It is true that a general upward tendency has been characteristic of prices ever since they began to be put on record centuries ago. But this general tendency has not prevented the occurrence of frequent and considerable periods of movement in the opposite direction. One of those periods lasted from 1872 to 1896, covering roughly the first half of the history of this Dominion. It is at least a tenable theory that we are now in the early stages of a similar long downward swing, which in that case will be due like the last one to two political events of the first magnitude, namely an important extension of the area in which gold is the measure of currency, and an important increase in the volume of international debts. The behaviour of the price index in the last six years has been almost identical with its behaviour in the eight years following the Franco-German War and subsequent indemnity, and the establishment of Germany on the gold basis. In those eight years the wholesale index in Canada, which follows fairly closely that of the world at large, declined more than 25 per cent., before it showed even a modest and temporary recovery; this time it has done the same thing in six years.

The purpose of this article is to suggest that some slight revision of the mentality developed during the three decades of rising prices is highly desirable, and that that revision must be very largely concerned with the relation between debtor and creditor—the only financial relation which is of such a long-term character that it is seriously affected by even a slow change in the value of money.

The Canadian public has been pretty generally familiarized in recent months with a pair of charts prepared by the Research Department of a large advertising agency, and dealing with the growth and periodic fluctuations of Canadian business and the movement of the price level since 1867. But concerning the most striking coincidence in these charts not a word has been said. That coincidence lies in the fact that so long as the price level was moving downward, the growth of Canadian industry was almost negligible; and that the instant the price level began to move upward, Canadian industry embarked on the meteoric flight which came to an end only in 1928-9, after three years of sagging commodity prices had sapped the foundations of its final boom. Now a great many reasons have been advanced for the remarkable progress shown by Canada between 1896 and 1928, from the advent to power of Sir Wilfrid Laurier to the discovery of new kinds of wheat and the cessation of free land offers in the United States. All of these things, and many others doubtless, had something to do with it; but one is strongly tempted to conjecture that the immense improvement in the position of debtors which inevitably results from a decline in the value of money was more important than all the other factors put together. For Canada is not a country of creditors, in the long-term sense, and she is a country of debtors. We are debtors on individual account, on municipal account, on provincial account, on Dominion account, and for enormous sums. Our income is the produce of the sweat of our brow, and that produce has been getting more valuable, in terms of money, for thirty years; our outgo is what we pay to outsiders for the use of the capital which we have borrowed, and the burden of those payments has been growing lighter, in terms of commodities, for thirty years. In 1925 that thirty-year process suddenly came to an end. Since that date our income has become steadily lighter and our interest burden heavier. In 1929 we began to realize the situation. By 1933 we may be thinking of doing something about it.

One of the natural consequences of thirty years of rising prices is a tendency to think lightly of fixed indebtedness. Our ancestors of the 'eighties had a horror of debt. We have none; we rather like it. The reason is simple; owing to the constant slow rise of prices,

it has required no special effort and no special brains to make enough to pay the interest. A factory is worth what it would cost to replace, unless there has ceased to be a demand for its products at prices that would justify replacement. This means that almost every factory in Canada during the years from 1896 to 1925 showed its owners an unearned increment averaging 2 per cent. a year. As a rule the owners provide little more than half of the value of the plant, the remainder being provided by the bondholders, who do not share in the appreciation; on this basis the unearned increment to the owners is more like 4 per cent. To reverse the process, and to provide that every factory could be replaced for 2 per cent. *less* than what it was worth last year, means that the 2 per cent. must be provided, in addition to ordinary depreciation, out of the earnings for the year, and if there is a bond issue for half the value, then the 2 per cent. must be provided by the ownership equity, on which it will amount to 4 per cent. But there have in recent years in Canada been financial reorganizations on an enormous scale, in which the fixed-charge equity, far from being confined to half the value of the permanent plant, has by means of successive mortgages been raised to the full value and even expanded to cover part of the working capital; there is no ownership equity left to absorb the depreciation resulting from falling prices, and bankruptcy and reorganization are the natural consequence.

A price change which operates to diminish the proportion of a given block of capital represented by the mortgage, and to increase the proportion represented by the ownership equity, is obviously highly favourable to the expansion of enterprise. As regards international payments, it is (if the bonds are largely held abroad) also highly favourable to the interests of the country which contains the property. When we reverse the process, we put a severe handicap on the expansion of enterprise, and we also favour the country which lent the money (in the case of bonds held abroad) at the expense of the country where the property is situated. In the case of "private" borrowings—those, that is to say, which are secured solely on the property of a specific enterprise, and not on the general credit of a community—there is a limit to the extent to which the lending country can benefit by the increase in value of the money due to it; for it can never get more than the value of the mortgaged property. The original ownership equity can be wiped out, but the creditor can go no further, and if the proceeds do not equal the amount of the debt, the creditor has to share the loss resulting from depreciated value. But in the case of "public"

borrowings, those contracted on the general credit of a community, there is no limit to the possible loss to the borrower and gain to the lender. The community must stand the loss, and pay the lender in appreciated money, so long as the taxpayers can stand the strain; for the alternative is public default, and ruin to the community's credit.

Throughout the thirty years of rising prices, Canadians incurred with a light heart and a hopeful disposition an enormous and constantly mounting mass of public obligations. Their experience was that such debts gradually wrote themselves off, so to speak, by the constantly increasing value of the permanent assets acquired with their proceeds. This was true for the period 1896-1925; it is extremely doubtful whether it will be true for the period 1926-55. And if this thirty years in which we are now launched is to be a thirty years of declining prices, the weakness of the policy of incurring public (and therefore inescapable) indebtedness for the acquisition of capital assets will be demonstrated in unmistakable terms.

The amount of money sent abroad from Canada in payment to foreign holders of Canadian securities in 1929 is placed by the Dominion Bureau of Statistics at 309 million dollars. This, however, includes dividends, which need not be paid if not earned, and interest on private bond issues, which can be defaulted if necessary. But the larger part of these remittances—overwhelmingly the larger part in the case of British recipients—is made up of bond interest on Government, municipal and public-ownership issues. The Dominion Government has about 500 millions of bonds actually payable in London or New York, and a considerable portion of the 1,825 millions payable in Canada is actually held abroad. In addition there are over 700 millions of Dominion-guaranteed railway bonds in the hands of the public, chiefly outside of Canada. The Provincial debts are about 800 millions, and the municipal debts about 1,100 millions, and a large but unknown proportion of these is held by American and other institutions. These classes of public securities total over 4,200 millions of dollars, and probably more than half of them is held abroad, involving an annual export of over 100 million dollars of money for interest. Against this there are Canadian investments abroad producing an annual income of 91 millions, but the great bulk of these are in common stocks, and will on the average yield less as prices diminish, while hardly any of them are gilt-edged bonds. Adding to the undefaultable public debts the absolutely secure first mortgage bond issues on private enterprises, we may assume that Canada has an inescapable

annual charge of about 200 millions of dollars due to outsiders, and a variable annual charge of about 100 millions which will vary in about the same degree as, and will approximately offset, the 91 millions due by outsiders to Canadians on account of similar investments.

Now Canada has to pay this inescapable 200 millions in the form of her exportable commodities, all of them basic commodities (newsprint, while classified as a manufactured product, is really little more than pulpwood and water-power mixed in the proper proportions) and all of them subject to the maximum amount of price movement in either direction, down or up. Wheat in 1926 was worth over $1.50, at which rate it took only 133 million bushels to pay the debt charge; wheat to-day is worth 60 cents in gold, at which rate it will take 333 million bushels, or precisely two-and-a-half times as much.

If Canada had continued to finance all of her productive enterprises by the issue of stock, as she mainly did in the good old days before 1896, she would be able to adjust her external payments to her economic situation. Let us for a moment compare the financial situation of the Canadian Pacific Railway, and its effect on the community, with that of the Canadian National Railways and its effect. The Canadian Pacific was financed in accordance with nineteenth-century policies, by stock issues. Out of total net earnings last year amounting to 58 millions, only 19 millions were absorbed by "fixed charges," and even these are by no means so "fixed" as the interest charge on a Government-guaranteed bond, since if they were not paid, nothing would happen except that the bondholders would take over the road. Five million was paid in dividends on preference stock, and 33 millions on common stock. During the past year the distribution to the common shareholders has been reduced, and if the present rate is maintained, they will get only 16½ millions in future instead of 33. If that cut were insufficient, and the revenues of the road would not provide the 16½ millions, the common dividend could be cut out altogether, and after that even the preferred dividend could be sacrificed; and still the railway would go on operating, and nobody would lose except the shareholders, who would be out 16½ millions, or 33 millions, or 38 millions as the case might be. And, as already suggested, yet another 19 millions could be cut off the distribution with no other result than the transfer of the road to the bondholders.

Compare this situation with that of the Canadian National Railways. In its best year this road came within 20 million dollars of paying its annual interest charges (public and Government);

but they have to be paid whether the earnings fall short by 20 millions or by 120 millions. There is no question here of asking the investor to bear a share of the loss, or even to allow his income to be scaled down as the price of commodities goes down. The investor did not invest in the Canadian National Railways, he invested in the credit of the Dominion of Canada, and to maintain that credit he must be paid in full. It has never been possible to pay him in full out of the proceeds of the operation of the system; and if commodity prices continue to fall, the hope of doing so will become more and more remote. For wheat at 60 cents cannot bear the same freight rate as wheat at $1.50, and we are to-day admitting that fact indirectly by paying out of the taxpayer's pocket five cents towards the freight charge on every bushel of wheat moved to seaboard. In other words, low commodity prices mean less freight moving on the railways, or lower rates, or a little of both, and all these things mean lower earnings, but none of these things make any difference to the annual price that Canada must pay for the capital value of the Canadian National Railways.

The same thing may be true of electric current. If everything that electric current is used to produce is worth less than it was in 1925, how can electric current itself continue to be worth the same amount? And if current is worth less, the earnings of power plants must be lower. The privately owned power plants can adjust themselves to the new order by reducing their dividends, if necessary; but the whole capital value of the public-ownership plants is represented by bond issues on the public credit. Nothing can be done to adjust the interest charge on these bonds. It must continue to be paid; and it must be paid either by the communities which endorsed the bonds or by overcharging the consumers of current—who in that event will gradually move away to places where they can get current at the price justified by the new order of things.

In a single sentence, the capitalists who invest in a private enterprise take a chance on the possibility of a change in the dollar value of that enterprise. Even if they are divided into shareholders and bondholders, they are still collectively taking a chance; what extra security the bondholders have is obtained merely by the shareholders taking more of a chance than if the whole capital were obtained by sale of shares. So far as the community is concerned, the relation between the bondholders and shareholders is a private matter; if as the result of the compact between them the shareholders lose control of the enterprise and the bondholders

take it over, the community is not affected. But the capitalists who invest in a publicly owned enterprise do not take any chance at all. The enterprise may crumble away before their eyes, and they are not affected; it is the community that loses. In a period of rising prices the community never loses, and the bondholder does not realize that he is losing, because he views his capital and income simply in terms of their money value. But in a period of falling prices the bondholder profits immensely, and altogether at the expense of the borrowing community.

And if the world is in for an era of declining prices, it is a fairly safe bet that by the end of it the enthusiasm for public ownership in Canada—if accompanied by the "bourgeois" concomitant of public indebtedness for the full amount of the cost—will be very greatly diminished. Public ownership in the Russian sense, originally established by confiscation and maintained by enforced savings on the part of the whole community, and with no interest charges attached to it, is another matter, and might conceivably become very popular. There is really nothing more calculated to evoke a general admiration for communism than a pronounced change either way in the value of money. The whole structure of capitalism rests upon long-term debts. A fall in the value of money helps some borrowers to become millionaires (it is significant that there were very few millionaires before 1896, and those there were had become so by slow and laborious degrees); and a rise in the value of money ruins many borrowers and makes all creditors hateful. Friends of the capitalist system should pray, and work, for a stable currency unit.