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FINANCIAL SITUATION IN THE UNITED STATES

1. Present Position.

The level of economic activity has remained more or less steady since the date of my last report (November 16th). The Federal Reserve Board Index of Industrial Production (adjusted) was 103 for November and 104 for December, and is expected to be 101 for January. This slight decline is in the main due to seasonal adjustment, as a rise in activity is usually expected in January. Of more up-to-date statistics, the New York Times Weekly Business Index, which varied between 75 and 80 in the spring and early summer of 1938, was at 93 at the end of November and for the latest available date (January 28th) stood at 92.3. The extremely rapid upturn of business, in fact, which proceeded from the early summer of 1938 up to November, then flattened out, and there was a very slight set-back in January.

There has been no very outstanding feature to which I need refer as regards particular trades: the motor industry has remained pretty good, and private residential construction has continued to increase, with the help of the Federal Housing Administration's mortgage insurance scheme.

Bank deposits have risen a little farther during the past three months, though the rate of increase has been very much slower than during the spring and summer of 1938. The figures of adjusted demand deposits of reporting member banks are as

follows/

follows (in millions of dollars):-

March 30th, 1938	14,268
June 15th,	15,565
October 26th,	15,995
February 8th, 1939	16,077

Bank reserves have also risen a little farther, excess reserves of member banks being estimated on February 8th at $3,460,000,000. During the same period bank investments in Government and in other securities have also risen, though only slightly, while the level of loans and advances shows a slight fall. Figures for reporting member banks have been (in millions of dollars):-

	Investments	Loans
April, 1938	12,215	8,604
July,	12,317	8,213
October,	13,041	8,282
February 8th, 1939	13,280	8,179

The reason why the big inflow of foreign money and gold into the country in the past three months has not resulted in a greater rise in bank deposits and reserves is to be found partly in a certain expansion of the currency, but mainly in the treatment of Treasury balances. These have been built up and kept in the Federal Reserve Banks, thus offsetting and practically sterilising an equivalent amount of gold. This is only a matter of convenience and there is no policy of more permanent gold sterilisation: as the Treasury balances run off the credit base will expand. Thus a further large increase in the excess reserves is to be expected.

Money has remained exceedingly easy, with Government and other high grade bonds at new high levels. Treasury bills have been sold at almost no cost to the

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Government, and on two occasions, owing largely to the existence of a local Illinois tax on cash balances, have actually been sold at a negative rate of interest, so as to yield the Government a profit. The effect of the continuing fall in the yield on short dated Government obligations has been to drive the banks into increased purchases of longer dated securities, and conditions have been very favourable for Treasury financing. The stock exchange on the other hand has tended on the whole to weakness since November and fell in January to the lowest level since September last, but has since risen somewhat, though the level is still slightly below that of November.

The very low rates of interest led to a fairly substantial volume of refunding issues in the second half of 1938, but the flow of new corporate capital market issues has been rather slow and fell off almost entirely in January. Figures for the first 6 months, and for the two succeeding quarters of 1938 and for the month of January, 1939, are (in millions of dollars):-

	New issues	Refunding
January to June	358	311
July to September	316	321
October to December	180	589
January, 1939	5	10

These figures do not include private placings. The outlook for any substantial improvement in the capital market in the early future is at the moment regarded rather pessimistically.

Commodity prices, both of raw materials and of finished goods have shown very little change in the past three months, tending perhaps slightly to weakness. The

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price of grains and of cotton remains severely depressed.

There are some 9 million persons, or so, still unemployed, and about one sixth of the total population is in receipt of some form of public relief.

2. Causes of levelling off.

The principal explanation of the very mild set back which has taken place is no doubt that during the short recession in the later months of 1937 and the early months of 1938, production fell substantially behind consumption: in the summer of 1938 the rate of production rose very rapidly, but levelled off when it caught up with the rate of consumption. Manufacturers and traders who were caught in 1937 are still very cautious of building up stocks of goods in hand. There are no satisfactory statistics on this, but that these stocks of goods have not been seriously increased is shown by the fact that commercial loans by banks have not shown any upward tendency, but are in fact a little lower than they were in October. If this explanation is correct it is obvious that a resumption of the upturn may be expected when the rate of current consumption increases or alternatively when manufacturers and traders once more begin to build up stocks of goods in hand.

A quite subsidiary factor, but one which is, I think, worth mentioning, is the weakness which has shewn itself on the Stock Exchange. The fall has not been severe, but a rising seems to have been replaced by a sinking tendency. The effect of this on current consumption is of course impossible to measure, but that it has some effect is generally admitted.

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The weakness in the Stock Exchange appears to have been in part due to disappointment with company profit statements, in part to nervousness about the European situation, in part to the sterling position. In particular the sharp fall in stocks which took place in January is said to have been started by foreign selling, and this is believed to have been due partly to the instructions given to banks in London in connexion with the embargo on loans against gold etc., which led to the sale of American securities because of the reduction of facilities for loans against them, and partly to sales on account of fear of war. Belief in the imminence of hostilities in Europe would have seemed more likely to lead to purchases than to sales of American securities, but apparently the opposite is the case, due perhaps to the desire to hide the proceeds, since securities would presumably be taken over and liquidated. (There is a certain amount of foreign hoarding of large denomination dollar notes.) But while these external factors are stressed by market commentators, I think the truth is probably that they merely touched off a movement which was fundmentally caused by American disappointment with the progress of recovery. The fall has not in any case been severe, and in this connexion it must of course be borne in m ind that, owing to the activities of the Securities and Exchange Commission, the Stock Exchange is at present a very thin market and quite a small volume of buying or selling is liable to produce what appears at first sight a disproportionate rise or fall in values.

The levelling off in the rate of production of consumption goods has not been compensated by any

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rapid increase in the rate of production of capital goods. The reasons for the continued idleness of capital are discussed below; for the moment it is enough to record the fact.

3. Budgetary policy.

It is owing to the continued comparative failure of private capital to move into work that the "pump priming" theory has been openly adopted by the Administration. While the theory had played its part in the framing of earlier budgets since 1932, it was not frankly adopted as a basis of budgetary policy until the present year. The theory in briefest outline as applied to this country is more or less as follows.

While an expansion of spending on consumption goods, if it goes far enough, must lead to expansion in the production of capital goods, a flat level of spending on consumption goods, even if that level is a high one, leads to a contraction in the production of capital goods - because plant is already available sufficient to meet the demand - and hence starts a downward economic spiral. Moreover capital goods are produced not to meet current needs but to meet a demand which is expected in the future. While America was growing there was a continuous growth of consumption, but with the end of territorial expansion and large scale immigration, the rate of consumption has become more or less level, and there is no big increase in demand to be expected to meet which private capital will, without Government stimulation, be set to work. Consequently Government investment is required to fill the gap caused by the contraction of private investment. Far from Government spending discouraging private investment,

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it is precisely Government spending which led to the higher rate of consumption and hence to the moderate increase in private investment which took place from 1933 to 1937, and it was the temporary balancing of the Federal budget which caused the set-back in 1937. The increase in the public debt must therefore continue, but this need not give rise to any worry, because the national income, as shown by what happened in 1933-1937, will rise sufficiently fast that the increase in tax revenue, without any alteration in tax rates, will be greater than the increase in the interest on the debt. Thus the national debt can safely be allowed to grow. The real waste lies in allowing savings to remain idle.

The theory if carried out to its ultimate logical conclusion would, I suppose, lead to State socialism. Its main immediate weakness, apart from the uneasiness it causes with regard to the budgetary situation, seems to me to lie in the assumption that private investment would not, if allowed, absorb the volume of savings becoming available. What actually to a considerable degree has happened is that the Government has obstructed private investment, and then, because private investment has not expanded sufficiently, claims that Government investment must take its place.

But whatever the merit, or lack of merit, of the theory, it has been accepted by the Administration that a continuing high rate of Government expenditure is essential if a new depression is to be avoided, and that the best method of attaining budgetary balance is by expanding the national income.

That the theory is neither understood nor accepted by the Congress is probably not important. The

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pressure against any specific large items of economy is very strong, and I should expect Congressional protests against Government extravagence to be in the main verbal and in general terms. Even the much publicized cut in the President's requested appropriation for relief is comparatively small, and was made in terms which amounted to a suggestion that the President should request a further supplementary appropriation before the end of the fiscal year if it was found that the amount provided was really insufficient. Such a request has already been made by Mr. Roosevelt with what result remains to be seen.

I see no reason therefore to expect that the appropriations suggested in the President's budget message will be drastically reduced by the Congress and this policy of high deficitary spending may, unless circumstances change considerably, be expected to continue for some time to come.

The net deficit for the current fiscal year up to the beginning of February (after deduction of debt retirements and payments to trust funds etc.) is about $1,700 millions.

4. <u>Capital Investment and General Prospects</u>.

If pump priming is to be successful it must lead to a substantial increase in the investment of private capital and in the national income. The figures of new capital issues given above are not encouraging, and while I have set out in previous reports what seem to me to be the main obstacles to the revival of capital investment, it is worth discussing these again, even at the cost of some repetition, since the whole theory to a large extent stands or falls on this.

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It must of course be borne in mind that the figures of new market issues only tell part of the story. Private placings, mainly with insurance companies, of which there is no complete public record, are said now to amount to some 30% of the total issues. Figures of capital expenditure out of funds already in the hands of companies (depreciation reserves, etc.) are also unavailable. But despite the lack of figures, it seems clear that the general position is that the upturn which took place last summer led to a certain resumption of capital activity, after the almost complete paralysis of the winter and early spring, but that this activity is not very vigorous and shews at the moment no signs of expansion. The main factors obstructing such expansion seem to me to be:-

(a) Insofar as speculative ventures are originally financed by wealthy men who are willing to take substantial risks in the hopes of possible large profits, the tax system in force, and in particular the capital gains tax, although this has been somewhat improved, is a severe deterrent. The large reservoir of tax exempt bonds provides a safe and reasonably profitable refuge.

(b) Insofar as capital expenditure is incurred to meet expected future demands or in the expectation of future profits, the high and inflexible level of costs, particularly labour costs, is a deterrent. It is maintained in some quarters, and perhaps with truth, that output per man hour has risen in recent years almost, if not quite

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as rapidly as hourly wages+, but whether or not this is the case,,the level of profits in general is not at present very high, and the absence of any clear Government policy with regard to labour, other than that of keeping up the nation's purchasing power by a high level of wages creates a feeling of insecurity. So far as I know there are no important labour disputes at present in prospect, but further wage cost increases are threatened in two respects: a further increase in minimum wages from 25 to 30 cents an hour, and a reduction in maximum hours of labour from 44 to 42 hours a week, are due in October next under the Wages and Hours Act, and a further increase of ½ of 1 per cent in the pay roll taxes levied on both employers and employees under the Social Security Act come into force at the end of the year. Further cost increases under both Acts are due in later years.

Moreover at the present level of industrial activity, which is still well below what it was in late 1936 and the first half of 1937, there is clearly, by and large, a considerable amount of excess productive capacity in existing plants, so that in most directions there is neither any immediate need for new capital expenditure on a large scale nor does there seem any early prospect of an inflationary rise in prices such as would raise profit margins to any very attractive height. Apart from excess productive capacity, there is steady

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+ Note. The National Industrial Conference Board calculate that labour cost per unit of output was 30% higher at the end of 1937 than in 1929, but is now less than 10% higher than in 1929, a reduction in labour costs through increased efficiency of some 20% in 1938.

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pressure to keep prices of finished goods down through the Anti-Trust laws, and the monopoly investigation. A good deal of re-equipment and reorganisation was carried out in 1937, and the reluctance of business managements to sink their money in new or improved plant at the present time is increased by their general doubts about Government policy and in particular by the fear that even the present level of activity may fall away when the peak of Government spending is passed. Some capital investment is no doubt to be expected, and the longer business runs on at its present level or higher the more replacement and improvement expenditure may be looked for, but it does not seem as if any very striking increase of capital expenditure by industry generally were to be expected in the near future.

(c) The railways are in a long term period of slow decline. About one third of them are in the hands of receivers. In periods of comparative economic prosperity the remainder can keep their heads above water, some of them with difficulty: but with each recession a few more come nearer bankruptcy. They have been refused on the one hand a cut in wages and on the other hand freedom to fix their charges. There has been a succession of committees and reports on their position, but nothing of any real value to them has been done. The problem is again in the lap of Congress, and most observers seem to be sceptical of anything very useful being accomplished. In the meantime the economic improvement which has taken place and the movement of a very large harvest have greatly improved their position from what it was a year ago, and they will no doubt place some orders for rails etc., but nothing spectacular can be expected in this quarter.

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(d) The position of the utilities, particularly the electric power companies, seems at last rather more hopeful. The legal position as regards both the Tennessee Valley Authority and the "death sentence" has been largely cleared up, the Securities and Exchange Commission seem to have established quite good relations with the companies affected by the Public Utility Act of 1935, and finally the Tennessee Valley Authority has at last reached agreement with the largest private electric company in the Tennessee area for the purchase of its properties. This agreement should help to dispel the fear that the Government would not pay reasonable compensation for the property of private companies taken over. There are still certain matters on which the private utility companies need reassurance, in particular the method of computation of the "yard-stick" (if it is ever in fact used) and the possible use of public funds to build municipal power plants, but at least a considerable advance has been made; and with electric power consumption moving upwards, some increase of capital expenditures in the utility field seems a reasonable expectation. This may not be very large, at any rate at first. I understand that the Chairman of the Securities and Exchange Commission is not expecting any very great volume of capital investment in the utilities, but even a beginning would be encouraging.

(e) Finally the prospects of a further increase in the pace of residential building seem to be good. The maximum of residential mortgages that the Federal Housing Authority may insure has been increased from $2000 to $3000 millions, and there has been a definite reduction, Government aided, in mortgage rates and also some

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reduction in direct construction costs in the course of the last year or two. The greatest danger here is that owing to drastic reduction in the number of apprentices taken on during the slump, and also to the volume of public construction which is proceeding, there may be a shortage of skilled labour sufficient to prevent a private building boom from developing. There is also another danger in connexion with the mortgage situation. A high proportion of residential building is financed at present by mortgages partly insured by the Federal Housing Authority. If a real private building boom is to develop, either the Federal insurance system will have to be enormously further expanded, or else a system of cheap mortgage borrowing without Federal insurance will have to get going. Of the latter there is no great sign as yet.

The general picture then is of a not very high level of business activity which is at the moment running very steadily without any particular either improvement or deterioriation: this level is largely dependent on current consumer buying, which is in turn largely dependent on heavy deficitary Government expenditure. Since this expenditure is likely to increase rather than decrease over the next few months, the rate of consumption may be expected to rise further during the same period, and this seems likely to lead to some, but not to any very striking, expansion of private capital investment, and seems quite unlikely to be accompanied by any early substantial rise in the price of finished goods. Building remains rather the key to the situation, and the prospects of a building boom are still quite doubtful.

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This forecast, for what it is worth, is of course for the next few months only and, equally of course, ignores such possibilities as war. One of the experts of the Federal Reserve Board told me he expected the Index of Industrial Production to average about 105 over the whole of 1939, as against about 100 at the present time. To return to the level of activity of 1929 would, with the increase since then in the population, require an Index of about 130. I understand that even that figure would leave a substantial number of unemployed, and I doubt whether even 130 would be regarded as "normal" by the authorities here. At any rate a rise to a national income of $80,000 millions, at which figure the President suggests the budget can be balanced, although it obviously may be reached later on, does not seem to be yet in sight.

5. Balance of trade.

The net excess of merchandise exports over imports (silver being excluded as well as gold) amounted to $1,134 millions for the year 1938, the largest export balance in any year since 1921 and comparing with $255 millions for 1937. The 1937 and 1938 figures are (in millions of dollars):-

	1937	1938
Imports	3,084	1,960
Exports	3,349	3,094
Excess of exports	255	1,134

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It will be seen that the cause of the large excess of exports is the abrupt contraction of imports, mainly due of course to the industrial recession.

Merchandise exports in 1938 were only slightly below their 1937 value. There was a reduction of some $275 millions in non-agricultural products in general, and a reduction of $140 millions in cotton exports, but these falls were to some extent counterbalanced by heavy increases in the exports of other agricultural commodities, especially wheat and corn (exports of grains rose from 94 to 223 million dollars) the United States having had large crops when harvests were poor in other important exporting countries.

As regards imports the figures are much lower in 1938 than in 1937 for practically all leading commodities, but the percentage fall was heaviest in agricultural raw materials (rubber, wool, etc.), feeding stuffs for animals and certain semi-manufactures (such as tin bars, etc.).

Current anticipation in this country is of a substantial fall in the export balance in 1939: an expert in the Federal Reserve Board puts it at from 25 to 50 percent: Colonel Ayres - without supporting his enthusiasm by argument - has committed himself to the prophecy that it will disappear altogether.

The uncertainties are obviously very great, but the essential point is that if United States recovery proceeds while conditions elsewhere are deteriorating or, if improving, doing so more slowly than is the case in this country, United States imports are bound to rise, while United States exports are likely to decline. The fall in sterling and its associated currencies,

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comparatively slight though it has been, should help in this direction.

The most doubtful individual item on the export side is cotton. So far no attempt has been made to force cotton exports, and the Administration, some of whom are themselves concerned about the size of the American export surplus, would oppose subsidies for this purpose, but the position is very difficult with 11 million bales of cotton held by the Government for which no market can be found, and the possibility cannot be ignored that the Southern Senators will be able to drive some scheme through under which more cotton will be forced into world markets. No doubt also armament purchases from America will continue on a large scale. On the import side, increased purchases, if and as recovery proceeds, seem a certainty. There has been no building up of stocks as yet, and increased imports both for stock and for current consumption are certainly to be expected. The position would alter very rapidly indeed if there were a rise in raw material prices. I have not the data on which to judge whether this is to be expected. The most doubtful individual item is silver, of which $230 millions worth was imported in 1938 (not included in the general figures given above). I cannot yet venture any prediction at what rate or price foreign silver purchases, if continued at all, will be continued through 1939: the attitude of the silver bloc in the Senate is still obscure.

I cannot see that one can well draw any more definite conclusion than that, even if the United States has large harvests again this year, in the absence of a new severe economic set-back, the excess of exports should be materially less in 1939 than in 1938; that the

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export surplus would be rapidly reduced if the harvests here should fail, or if prices of raw materials purchased by this country should rise; but that the prospects are made additionally obscure by the doubt as to the policy which will be followed here as regards, in particular, silver and cotton.

6. Capital Inflow.

Apart from the gold required to settle the export surplus, there has been a further large capital inflow into the United States in 1938, net imports of gold during the year amounting to $1,974 millions. The position has once more been taken under consideration by the Federal Reserve authorities, and there is an interesting analysis of the capital inflow in the February issue of the Federal Reserve Bulletin. In round figures the total inflow of gold since the end of January, 1934, when the dollar was stabilised, amounts to $7,000 millions, of which $2,100 millions corresponds to the surplus in the country's merchandise trade, and $4,200 millions represents capital movements: of the latter figure, $1,500 millions represents repatriation of American funds abroad, $1,200 millions represents net purchases of dollar securities by foreigners, and $1,500 millions represents the growth of balances held by foreigners in this country. It also appears that foreign investment in American securities has in the main been made at times of stock market boom and that the money was not, on balance, withdrawn in times of stock market weakness. The foreign money invested in United States securities is in fact pretty stable, and only some part of the liquid balances - the excess

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over working balances - can really be regarded as volatile or "hot" money.

No conclusions are drawn in the Federal Reserve Bulletin, but two comments seem to be justified:-

(i) The liquidation and repatriation of American assets abroad has been on a very substantial scale, and I am told - I do not know with what degree of truth - that the volume of such assets abroad which can still easily and rapidly be repatriated is now not very large. This particular capital drain from the rest of the world may thus dry up.

(ii) The Federal Reserve authorities are really less concerned about the "hot" money - since its amount is, according to this analysis, not so very great, and they would in any case be glad to see some of the gold flow away - than about the influx of capital generally. The excess reserves are already at a height at which the Board cannot control them (i.e. they are already higher than the amount that would be absorbed if the reserve requirements were raised to the maximum and the whole portfolio of Government bonds in the Reserve Banks were sold) and are likely to rise much further. There is no real danger in this at present, since there is no sign of an inflation "taking", but sooner or later this vast reserve of credit may begin to be used, and the Board have already suggested (in their Annual Report for 1938) that their powers of credit control should be enlarged. The question has once again been brought before the Board whether some restriction of the continuous inflow of foreign capital may not be desirable if it does not dry up of itself. The matter has been raised before on more than one occasion, but has always eventually been dropped owing to the various difficulties which are

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involved. I think the probability is that nothing will in fact be done this year, either in the direction of giving the Board enlarged powers or in the direction of trying to control the inflow of capital, and that the matter will be postponed until there is some sign of credit expansion really getting under way. There is however just the possibility that the question of controlling the inflow of capital may become active. In this event I should hope and expect that the attempt would be made to act in cooperation with the other signatories of the Tripartite Declarations.

(iii) A further point which I should mention in this connexion is the possibility of a renewal of foreign lending. There does not seem any prospect at all of the resumption of market loans abroad on any scale, and as regards direct investments, participations, etc., in foreign enterprises, the prospects are not encouraging. If foreign lending is to be resumed it would seem that the most hopeful channel would be the Export-Import Bank. I think there will probably be some expansion of the Bank's operations in South and Central America, but not on any very large scale. The Administration would, I think, like to extend its operations. Some form of credit for Brazil, for instance, through the Bank, is very much on the cards at present. But the Senate, under the impulsion of Senator Johnson, has called for an enquiry into existing Latin-American defaults before new loans are made; and the Banking Committee of the House of Representatives has recommended that Export-Import Bank loans outstanding at any one time should be limited to a maximum of $100 millions. (The Bank's loans now outstanding are between $25 and $50 millions and commitments amounting to some $55 millions.)

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7. Miscellaneous.

There are certain matters which I should mention as they may lead to discussion in Congress.

(a) Stabilisation Fund and Currency Control.

The President has asked for an extension of his powers to alter the gold content of the dollar within certain limits, and of the life of the stabilisation fund. There is little, if any, opposition to the latter proposal. As regards the former, there is some movement in Congress to allow the President's power to alter the gold content of the dollar to expire, thus vesting the power over the currency once more solely in the Congress. While this would be a move in the direction of rather greater stability of the dollar in terms of gold (since the "24 hour basis" would be removed), the movement, such as it is, seems to be due more to general suspicion of the President, and desire to clip his wings, than to any policy of permanent stabilisation. In any case it is impossible to gauge the strength of the movement as yet: I suppose the probability is that in the end the President will get the extension he desires.

Since the recent transfer of gold to the Exchange Equalisation Account in London and the strengthening of sterling, the little talk there had been previously of further dollar depreciation seems to have died down almost entirely.

(b) Banking questions.

There are certain matters in connexion with banking on which legislation may be introduced during the present session of Congress. The position with regard to bank examinations is very unsatisfactory,

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since four or five separate authorities have power to conduct these examinations, all of which authorities do not see eye to eye on questions of policy. In particular the Federal Reserve authorities, with their eye on the general economic situation, are at present anxious to encourage free bank lending and would probably take a more lenient view in their examinations than would the Federal Deposit Insurance Corporation, which is solely interested in preventing bank failures (55 banks, all of them very small, were closed last year).

Two other banking matters on which legislation may be sought are the increase in the maximum of individual deposits insured by the Federal Deposit Insurance Corporation from $5,000 to $10,000, and prohibition of bank holding companies. The latter piece of legislation is earnestly desired by Senator Glass, but opposed by Mr. Eccles, who was himself president of a holding company which controlled a number of banks in the West.

The prospects of legislation on any of these matters are still very doubtful.

(c) Federal debt limit.

The existing statutory debt limit for issues after and including the Liberty Bond issue is $45,000 millions. As the total debt is expected to be $44,500 millions by June, 1940 the question of raising the statutory limit has been brought up. The position could however be eased by getting the Reconstruction Finance Corporation and other semi-autonomous bodies not

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covered by the debt limit to repay their debt to the Treasury and finance themselves by a market issue. In any case the matter is not urgent, and will, I expect, probably not be dealt with till next year.

(SGD) T. K. BEWLEY

February 14th, 1939.