As. Finances 207/13/39

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BRITISH EMBASSY,

WASHINGTON, D. C.,

May 8th, 1939

No. 498 E

My Lord,

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In continuation of my despatch No. 199E of February 16th I have the honour to transmit herewith copies of a memorandum by Mr. T. K. Bewley, Financial Adviser to this Embassy, on the financial position of the United States. I should like to draw the especial attention of Your Lordship's department to Section 5 of this report in which Mr. Bewley, while writing from the economic and financial point of view, depicts the extraordinary inefficiency of the American governmental machine, and its inability so far to adapt itself to new conditions.

2. I regret that this is the last of the periodic reports from Mr. Bewley that I shall have the pleasure of forwarding to Your Lordship, as he is due to leave in the course of a few days and return to duty in the Treasury. His reports have always been accurate, clear and penetrating, and all his work may be similarly characterised. To myself his advice has been invaluable, and I have often stood in grave need of it. By his technical competence combined with the integrity of his character he has commanded the implicit confidence of the United States Treasury and State Departments and I think it a high tribute to him to be

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The Right Honourable

The Viscount Halifax, K.G.,

etc., etc., etc.

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able to say that his departure will be regretted hardly less by Mr. Henry Morgenthau than by myself. I hope that what I now write may be borne in mind when in the future questions may arise as to the nature of Mr. Bewley's further employments.

3. Copies of the report are being sent direct to His Majesty's Treasury, the Department of Overseas Trade, the High Commissioner for the United Kingdom in Canada, and to Mr. P. K. Debenham, 2, Whitehall Gardens, London, S.W.1.

I have the honour to be,
with the highest respect,
My Lord,
Your Lordship's most obedient,
humble servant,

(SGD) R. C. LINDSAY

Enc. 6207/13/39

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FINANCIAL SITUATION IN THE UNITED STATES

1. Present Position.

There has not been any very great change in the general economic situation in the United States since the date of my last report (February 14th). The Federal Reserve Board Adjusted Index of Industrial Production, which was 101 in January, stood at 98 in February and March, and a further moderate fall is expected for April largely on account of the coal strike. The "New York Times" Weekly Business Index fell from 92.3 for the end of January to 86 for the middle of April. On the other hand neither of these indexes fully reflect the conditions in the building trade, which has continued to expand a little. Thus broadly speaking the general level of activity has remained fairly steady through the first quarter of the year.

F R Bulletin

Annalist

Owing to the continued influx of gold and silver and to the Government's borrowing from the banks, bank deposits have continued to grow, the figures of adjusted demand deposits of member banks being $16,619 millions for April 19th against $16,077 millions for February 8th. Reporting member bank loans shew a very slight fall at $8,124 millions for April 19th, against $8,179 on February 8th, while investments in Government and other securities continue to rise, being $13,684 millions on April 19th against $13,280 millions on February 8th. Bank reserves have, as expected, risen further, and excess reserves of member banks are estimated at $4,120,000,000 on April 26th. In these

Reporting M. Banks weekly

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circumstances money has of course remained exceedingly easy and Government bonds have risen to new high record levels.

The Stock Exchange on the other hand broke severely in March, partly under the influence of war fears, the Dow Jones Index falling to a lower figure in the first week of April than any reached since the upturn in June last. There has since been a partial recovery.

? Comm & Fin Chr. as annalist

New corporate capital market issues, excluding refunding issues, in the first quarter of 1939, amounted to only $53 millions, compared with $180 millions in the fourth, and $316 millions in the third quarter of 1938. There was a fairly sharp upturn in April. Final figures for this month are not published at the moment of writing, but the figure is expected to be in the neighbourhood of $250 millions. Owing to the growing habit of placing small and moderate sized issues privately in order to avoid the formalities laid down by the Securities and Exchange Commission, the published figures are becoming less and less satisfactory as a measure of the real volume of capital issues; but it is clear at least that taking the first four months of the year as a whole, the volume of new corporate issues has been rather small.

C. & F Chr. 2nd number of month

Commodity prices have on the whole remained very steady, and wheat and cotton prices remain severely depressed. There have in the last few days been some signs of improvement in some raw material prices.

FR Bulletin or

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2. War fears and other obstacles to recovery.

There is widespread disappointment that there has been no upturn in the business situation since the new year, as some further improvement had been generally expected. In consequence, since no other new factor is apparent to explain the lack of resilence in the business situation, there is a tendency to place the blame upon the uncertainties of the European political situation.

That these have some direct effect upon the Stock Exchange seems impossible to deny, since security prices have been fluctuating in direct response to the news from Europe. That a fall in stock exchange prices has some effect in slowing down the whole economy, and probably more effect in this country than in any other, is also hard to deny. And it may be that some manufacturers or merchants have even refrained from placing long term orders owing to the uncertainties created by the fear of war, though I find it hard to believe that this can be a factor of any very great importance. But granted all this, I still do not think that the influence of war fears in holding back business can be as important as is sometimes maintained. A glance at the Federal Reserve Index of Production figures for the second half of 1938 will show that the upward trend was unaffected by the Munich crisis.

The direct cause of the Stock Exchange weakness has not been foreign but domestic selling. A member of the Treasury told me in March that foreign purchases of securities were running ahead of foreign sales, and the volume of foreign dealings is in any case comparatively small. There are a number of reasons

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why war fears might give rise to domestic selling of stocks. In the first place, it is widely anticipated that foreign Governments involved in war will confiscate their nationals' holdings, and endeavour to realise them on the market. This weight of possible sales overhanging the market certainly has a depressing effect, and reassuring but vague hints given out by the authorities that plans have been made to meet the situation, have probably not given very much confidence to the nervous investor. There is also the fear of the short term operator that the stock exchange might be closed for a quite lengthy period, as was done in 1914, and that he might be in difficulties if he could not get his money out. And in addition speculators - I know of at least one large investment trust which falls in this category - are counting on a panic at the outset of war in which they could pick up shares cheaply.

These are all short term motives, but the short term operator is still fairly dominant in the United States. For the longer term, a European war would seem as likely to lead to higher as to lower quotations on the American stock exchanges. There may be some investors who are afraid that if war broke out in Europe the United States might be drawn in, and that this would lead to drastically increased taxation on war profits and a wide extension of Government control. I cannot say how much weight to attach to this.

But when all this is said, it still remains hard to explain why, if war fears are the major influence, the fall in security prices during the last couple of months should, if I am not mistaken, have been more severe here than in London or Paris. I think one must

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conclude that the underlying weakness of the Stock Exchange is largely due to disappointment with the progress of domestic recovery and that the spark was merely touched off by recurring European alarms. Of course the two things react upon one another, and it is impossible to assign the exact importance of either by itself.

Apart from this internal unsettling factor and the resurgence of some labour unrest, especially the current coal strike, the situation remains much as it was at the turn of the year. I do not think that the analysis of the position in my February report and in particular of the causes of the sluggishness of private capital investment, needs any material revision. The failure of any improvement to make itself felt during the past quarter is disappointing, but not very unexpected, and the Federal Reserve authorities appear to be still expecting some moderate improvement during the rest of the year. The residential building situation still remains mildly favourable, but rather high costs and a certain shortage of skilled labour in certain districts work against any spectacular expansion.

3. Monetary position.

It is perhaps worth giving details of the remarkable monetary position that has now been reached in this country.

In the first place the gold stock is now well on its way to the $16,000 million dollar mark, and amounts to about 60 per cent of the total aggregate gold reserves of the world, and gold is still flowing in rapidly. In addition the Treasury holds some

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$2,300 million ounces of uncoined silver against which it issues silver certificates at $1.29 an ounce. As regards money, the amount of currency in circulation, excluding cash held by banks, is now about $5,700 millions, compared to about $3.600 millions in 1929.

F R B/M
Eccles

(The reasons for this expansion of the currency are not very clear. Various reasons have been given, in particular (i) the substantial reduction in the number of banks in the country, necessitating greater holdings of cash in places where no bank is now handy, (ii) relief payments, and (iii) hoarding of United States money by foreigners. $25 millions of United States currency is reported to have been shipped abroad from New York in March, and a much larger amount in April, in addition to which foreigners are said to be holding large denomination United States currency notes in safe deposit boxes, etc. in this country. But these developments do not seem quite sufficient to explain so large an expansion, and it may possibly be that there is in addition a certain amount of domestic hoarding, though it is hard to see why this should be so, if it is.)

Bank deposits are now higher than at any previous time in the country's history; the aggregate amount of bank deposits against which cheques can be drawn (all banks) being now about $26,000 millions, as compared with about $23,000 millions at the peak of the 1929 boom.

Eccles.

The bank reserve situation is even more striking. The excess reserves in the banking system now amount to some $4,120 millions, whereas prior to the slump which started in 1929 the system never had as much as $500 millions in excess reserves. Moreover the

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reserves are almost bound to rise very much higher even than their present level. Not all the gold imported to date has yet been added to the credit base (i.e. had gold certificates issued against it), while as regards continued imports, at the present rate an addition of from $1,000 to $2,000 millions a year seems quite a conservative estimate. In addition, if silver purchases continue and silver certificates are issued against them at $1.29 an ounce, this might increase the reserves by $500 millions a year or so. In addition the Treasury holds something like $1,000 millions as balances in the Federal Reserve Banks: as this amount is spent or transferred to the member banks, it will increase the reserves to a corresponding amount. There is also $1,800 millions of gold sterilized in the stabilisation fund which might some day be spent.

No doubt the practical effect on the country's economy of 6 or 8 thousand million dollars of excess reserves might not be very different from that of 4 thousand million dollars, since in either case it is plenty to provide an explosive inflation. The essential point is that there is now a supply of money of all sorts in the country in excess of the supply at any previous point in the nation's history, that the volume of excess reserves is already so large as to be well beyond the existing technical powers of the Federal Reserve authorities to control and is rising rapidly, that strenuous efforts to induce credit expansion are being made by the Administration including "pump priming" expenditure on the grand scale, and that despite all this there is no present sign of an inflation "taking" and the only visible result is that Government obligations

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are standing higher than they ever have before, 90-day bills are selling on practically a no-yield basis, and in general the return on money is lower than it has ever been.

In saying that the reserves are already beyond the technical powers of the Federal Reserve authorities to control, I do not of course mean to imply that the Administration necessarily could not control an inflation by other means, should one get started, but simply that control of credit through the reserves, the classical weapon of the Reserve authorities, is now out of their power. The Board has suggested that Congress should give them additional powers, but I think there is enough force behind the belief that the mildly restrictive action taken by the Board in the spring of 1937 was an important contributory cause to the slump of 1937-38, to make it unlikely that additional powers will in fact be given by Congress this session.

It may be of interest that I know that the Federal Reserve Board has actually considered open market selling operations in order to keep down the price of Government obligations, and that Mr. Morgenthau was in favour of this, apparently on the simple theory that he would rather have a steady price for Government bonds and that what goes up will one day come down again. The Board decided against such action on the ground that open market operations should be directed towards the general economic situation, which certainly does not call for selling operations now, and should not be determined by the price of Government bonds.

4. <u>Governmental action.</u>

Since expansion of the volume of money and of the credit base have not resulted in very full recovery it

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would be expected that the Government would take further steps. So far however very little has in fact been done either by the Administration or by the Congress except for the voting of large appropriations. The current budget is running about as expected, the net deficit for the ten months up to the end of April being $2,855 millions (or, after deduction of payments to trust funds, etc. $2,275 millions). There has been a much publicized fight about the appropriation for relief for the balance of the current fiscal year, and Congress eventually cut $50 millions off the amount requested by the President, but this was an easy and not unpopular gesture in the direction of economy, since it is generally believed that the administration of the Works Progress Administration is thoroughly wasteful, and in any case $50 millions is not much compared to the total relief appropriations actually voted for the year of over $2,160 millions. In other directions, apart from some speechifying, no serious signs of economy have been visible. Indeed the farm bloc have been pressing for, and may yet succeed in putting through, substantially increased subsidies for cotton and other farm products, social security benefits are likely to be raised, and other additional expenditures are not impossible.

A useful bill has been passed increasing the maximum up to which the Federal Housing Administration may guarantee mortgages from $3000 millions to $4000 millions. This should at least ensure that the incipient improvement in residential building will not be brought to an end for lack of reasonably cheap mortgage facilities, and I understand that the losses on these guarantees are not expected to be very heavy.

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There has been a lot of talk of cooperation with business, but nothing much of a practical nature has come of it as yet. The Secretary of the Treasury agreed to have a review made of the tax system with the object of amending it in such particulars as might be harmful to business, but no specific proposals have yet been made, and remarks dropped by the President at press conferences and also by the Democratic Senate leader on the floor have been very cool to the prospect of any major revision such as is really required. One specific recommendation which has been made is that the Social Security payroll taxes for old age benefits should be frozen at their present level instead of rising by 1% in 1940, and the States should similarly be encouraged to freeze their unemployment insurance taxes at the present level. The prospective rises in these taxes would of course increase labour costs, and the proposal to leave the taxes for the present at their existing level is naturally welcomed by industry. The proposal seems likely to go through, but it will of course be expensive, and the actuarial soundness of the whole Social Security scheme is open to question. A complete overhaul of Social Security finance is really needed, and while there is a new Social Security Bill promised, it is doubtful if this will really place the finances of it on a sound foundation.

The prospects of satisfactory railroad legislation are similarly still very obscure owing to the clash of the different interests - labour, capital, other forms of transport, and the users of the railraods. The same is true of any amendment of the National Labour Relations Act. Nor has any success so far attended the

attempts/

attempts to patch up the quarrel between the American Federation of Labor and the Congress of Industrial Organisations, and the labour situation, while apparently not particularly menacing, remains confused.

The negotiations between the Securities and Exchange Commission and the public utility companies under the Public Utility Act continue to drag along without, so far as I have discovered, any striking progress having recently been made, and the nomination of Mr. Leon Henderson, generally regarded as a long way to the left, as a member of the Commission, and the apparent likelihood of Mr. Jerome Frank being elected chairman, have caused some dismay.

Various proposals have been put forward both by the Administration and by interested Senators, for dealing with the very uncomfortable cotton situation, but no general agreement has been reached and no solution of the problem is in sight.

The Administration in fact, while seriously disturbed about the failure of any full recovery to manifest itself, has so far been prevented, either by political considerations or by the conflicting pull of various interests in Congress, from taking any effective action other than by the flow of deficit spending and the lowering of interest rates.

5. More general considerations.

The main financial and economic problems which strike the eye as confronting the American Government are the budgetary problem, the unemployment situation, and the plight of certain branches of agriculture, in particular cotton. Fundamentally all

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these are aspects of the single general problem of creating conditions under which the full productive capacity of the country will be put to work. If this could be done the budgetary and unemployment situations would clear up of themselves, and even the agricultural situation would be enormously improved by the enlarged market. This is the general angle from which the economic problems of the nation are mainly being studied in Washington, and the division of opinion naturally is between those who think that the productive capacity of the country will function satisfactorily if it is only left alone by Government, and those who think that a greater degree of Government assistance and control is required to make it function properly. This division of opinion cuts across the division between the political parties, but broadly speaking the Republicans are more the party of industry who want the minimum of Government interference (except of course for high tariffs), while the New Deal wing of the Democratic Party stands for increased Government direction and control of business. At present owing to the comparative failure of the New Deal to restore prosperity and to uneasiness at some of its policies the trend of popular feeling seems to be away from further extension of Government control, and this is behind the Administration statements that the period of reforms was over and that the emphasis was now to be on consolidation and recovery. At the same time the strength of the trend is not easy to decide, both because it cuts across the organised political alignments, and because of other complicating issues, in particular foreign affairs. In any case it is

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probably a temporary reaction: in the long run it would seem that because of the anarchy of private business or decentralised State control, the trend must be towards greater centralised control by the Federal Government. For the moment however it seems that the President would be prevented by the feeling in Congress from embarking at the present juncture upon new measures of control or reform, but that it is at the same time difficult for him, both perhaps from personal conviction and because of the attitude of his supporters in the Democratic Party and of his advisers in the Administration, materially to modify the reform measures already introduced (e.g. in the very important realms of taxes and labour). This seems to be the main reason why it has not been possible for the Government so far to take any effective action to stimulate recovery other than by the high rate of spending. Of course if recovery continues absent the pressure for new measures will become stronger, and it is possible for instance that Congress might push a tax revision bill through either against the wish or with the very half-hearted assent of the President.

Behind this comparative impotence to take effective economic measures lies the inefficiency of the system of Government itself. I do not mean inefficiency of the Civil Service, which can be very greatly exaggerated. I mean rather the division of powers between the Congress and the Executive, and the method of election of Congressmen and Senators, which makes of them little more than delegates appointed to represent the interest of their particular constituency, while the President, more or less alone, represents

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the country as a whole. (I need not mention the position of the Supreme Court which at the moment seems inclined to "go along".) The division of power made Mr. Hoover practically impotent in the early stages of the slump because Congress was politically opposed to him: but even under a Democratic President who has had a Democratic majority in both houses since his election, the inevitable lack of party discipline and the play of regional and sectional interests have resulted in striking divagations of policy. It has, for instance, been clear since 1933, if not before, that railroad legislation was needed, but after six years, owing to the conflict of interests, an Act has still to be written (something may be done this Session, but it is quite doubtful); the Silver Purchase Act had few genuine supporters in Congress and was opposed by the Treasury, but was pushed through by a handful of interested Senators; I presume that not more than a small minority of Congress really believed that the Veterans Bonus Act of 1936 was justifiable; regional log-rolling in Congress has greatly complicated the Administration's dealings with the agricultural problem; even in 1933, immediately after the banking crisis, the President was unable or unwilling to insist on the establishment of a unified banking system, because of the fear of opposition from the supporters in Congress of the State banks. I need not multiply instances: the only point I want to make is that the damaging incapacity to declare a definite policy on many important matters, and then to stick to it, arises in many cases out of the constitution of the Government iself. (Of course this is abundantly clear in the matter of the Neutrality legislation). This

absence/

absence of a clear policy on many points, and the uncertainty created thereby, are a serious factor in holding back business. The lack of an efficient system of Government was comparatively unimportant while the country was expanding rapidly and abundant supplies of cheap labour were coming in. It is a more serious matter in a country which has ceased to expand geographically, where large scale immigration has ceased, where labour is active and to a large extent organised, where unified central Government control of business has increased and probably must continue, in the long run, to increase, and which has acquired a substantial national debt.

Whether even moderately full utilisation of the country's productive resources can be obtained under the present system of Government, or whether alternatively the country will eventually be forced into some drastic constitutional change, are matters for the future. At the moment the prospects of a rise in commodity prices and in the rate of business activity sufficient to balance the budget seem rather slight, and since the authorities do not regard the budgetary position as particularly dangerous, the present situation of unbalanced budgets and a substantial number of persons on relief seems likely to run along.

Of course a credit inflation might get started, and it is for instance not impossible that the election or even the expectation of a Republican President in 1940 might touch off a stock exchange and capital issue boom on the theory that the Republicans would leave business alone. This would entirely alter the immediate economic picture, but not the more fundamental question suggested above, whether the

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existing form of Government is capable, without considerable change, of coping satisfactorily with the ever increasing complexity of the financial and economic problems of the country. From this point of view the question from having been whether the Government could lift the country out of a depression, would only change to whether it could control boom conditions without precipitating a slump.

In the event of war in Europe, I suppose that, assuming the United States not to join in, there would at first be considerable stimulation of economic activity, arising out of preparedness orders on the part of the United States Government and of war purchases by Great Britain and France. Should the resources of the latter countries run low, this war boom would probably be followed by a severe slump, and the pressure on this country to extend further help to the United Kingdom and France, whether by loan or otherwise, would then become very severe. It is fruitless to pursue the speculation further.

6. Various.

(i) The legislation to extend the life of the stabilisation fund and to prolong the President's powers to devalue, within limits, has passed the House of Representatives by 225 to 158 but has not yet reached the floor of the Senate. The division was on straight party lines in the House, whereas some Democratic Senators are opposed to the extension of the devaluation powers, but the chances seem on the whole to be that the Bill will pass.

(ii) The prospects of the continuation of

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purchases of foreign silver are still quite obscure. Mr. Eccles has come out strongly against the policy; but Mr. Morgenthau has rather half heartedly said that, while he is merely carrying out the mandate of Congress, it may be better to get silver than paper promises in return for American exports. The fight has not reached the floor of either House. A member of the Treasury told me he thought in the end very likely nothing would be done this year because the Republicans would like to keep the issue as a telling one at the 1940 elections.

(iii) Taxation by the States of Federal salaries and vice versa has now been legalised, but nothing has been done as yet about tax free bonds, and the prospects for legislation on this issue are still quite doubtful.

(SGD) T. K. BEWLEY

May 4th, 1939.