

BRITISH EMBASSY,  
WASHINGTON D.C.

No.972 B.

August 29th 1939.

My Lord,

I transmit to Your Lordship herewith  
a copy of a memorandum by the Financial Adviser  
to this Embassy regarding the financial situation  
in the United States.

I have the honour to be,

with the highest respect,

My Lord,

Your Lordship's most obedient,

humble servant,

(FOR THE AMBASSADOR)

(SGD) V.A.L.MALLET.

The Right Honourable

The Viscount Halifax, K.G.,

etc., etc., etc.

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FINANCIAL SITUATION IN THE UNITED STATES,  
AUGUST 1939.

General Economic Position

1. The situation has improved to a moderate degree since April. The Federal Reserve Board adjusted index of Industrial Production, after dropping from 98 in February and March to 92 in April and May, rose again to 97 in June and 102 in July. The "New York Times" Weekly Business Index, which stood at a low point of 86 in the middle of April, rose again to over 91 on the 12th August. Thus the main part of the losses since the beginning of the year appears to have been recovered. But the indices are difficult to interpret with precision, because of the effect of the Appalachian coal strike in April and subsequent strikes in automobile works, the fact that automobile producers have advanced the change-over to 1940 models by a month, and other disturbances.

2. As regards particular branches, automobile production has gone well ahead of 1938, sales in the first six months averaging 9,200 a day against 5,200, and prospects for the new 1940 models being regarded as good. This has contributed to the improvement in the steel industry, where capacity operated has risen to over 60%. Electric power production has been running about 10% above last year's level. Freight car loadings in July were nearly 12% above last year though they have not risen in the last month or two. Copper deliveries have maintained a better rate, and the June level is higher than that of any of the last eighteen months excluding only September and October 1938. Though copper stocks have risen somewhat, they are still lower than a year ago and are regarded as moderate/

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moderate in view of the anticipated demand.

3. Building construction is not altogether so satisfactory. After falling from \$389 million in December to \$252 million in January contracts recovered to \$330 million in April, but sagged again to \$288 million in June. Public works and residential building were chiefly responsible. There are however two new favourable factors (i) a decision by the Federal Housing Administration and the Home Owners' Loan Corporation to reduce interest rates from 5% to 4½% as from August 1st, and (ii) a comprehensive agreement between employers and men covering wages and working conditions, and in particular the training of apprentices of which the industry is short. On the other hand the industry is threatened with a "trust-busting" campaign by the Federal Department of Justice.

4. Inventories in general are estimated to be moderate. This fact, and the accumulation of plant maintenance requirements, are perhaps the main reasons why moderate optimism is felt on all sides, and a slow but steady improvement is anticipated for the rest of the year. It was noted with special, if somewhat cynical, interest that the improvement showed itself before Congress rose.

5. Agriculture remains the weak side of the whole system. The United States Government are being unwillingly forced to adopt subsidy systems for its staple exports, although it has attacked similar practices elsewhere, because such subsidies are the only alternative to major structural changes which the Government are unable to contemplate. In spite of



Government assistance cash farm income has dropped since 1937 about 10% more than the national income, and shows at present no sign of recovery.

6. Prices of farm products and foods have weakened since the beginning of the year, while those of other wholesale commodities have hardly changed on the average. The Bureau of Labour wholesale index for all commodities fell in consequence from 76.9 in January and February to 74.8 at the end of July. This is the lowest point reached in the past 5 years.

Money and Capital Markets

7. The inflow of gold has continued to show its sensitivity to political events abroad. In the 2 months September - October 1938, and again in March - April 1939, the increase in the gold stock was over \$900 million. It has since fallen rapidly and the preliminary figure for July 1st - 26th is only \$117 million.

Gold held by Federal Reserve Banks under earmark for foreign account rose from \$386 million in June, 1938, to \$627 million in December and to \$1,121 million in June, 1939.

8. The continued increase in the gold stock from \$15,791 million at the end of April to \$16,227 million at the end of July, together with Government deficit expenditure (covered during the last 3 months more by reduction of Treasury balances than by new borrowing) have had their usual effect on the position of the Banks. Adjusted demand deposits of Member Banks rose from \$16,619 million on April 19th to \$17,641 million on August 16th. Their loans are practically unchanged at \$8,186 million, while their investments have risen

from/

from \$13,684 million to \$14,151 million in the same period. Excess reserves have risen from \$4,120 million on April 26th to \$4,590 million on August 16th.

9. Money has naturally remained extremely cheap and the discount on Treasury bills has at times fallen almost to vanishing point. For some weeks past, however, the Federal Reserve Banks themselves have refrained from tendering for new Treasury Bills to replace maturities in full, in view of the absence of yield. This action does not, according to the Federal Reserve Board, represent any change in general credit policy, but it has probably been partly responsible for a recovery in the discount on Treasury Bills from practically nothing to about  $\frac{1}{2}\%$ .

10. Capital issues for new money in the first seven months of 1939 compare as follows with those in 1938, according to the Commercial and Financial Chronicle:-

	<u>January-July</u>	<u>1938</u>	<u>1939</u>
	( Million \$ )		
Corporate		493	260
State, Municipal etc.		481	684
Government Agencies		417	639
U. S. Government Market issues (Mainly Savings Bonds)		605	560
		<u>2,001</u>	<u>2,173</u>

The figures are well known to be incomplete, but so far as they go they show a shift from private to public financing. A small encouraging sign lies however in the fact that the corporate issues in 1939 included \$54 million of common stocks against only \$7 million in 1938.



In addition to the above there were special Government issues to Trust Funds etc. amounting to \$584 million in January - July 1938 and \$762 million in 1939. These are however internal transactions only, most of the money having been raised by a form of taxation.

11. The Stock Exchange has recovered to some extent from the break in April, though not to the level of last November when the Dow Jones stock and bond indices reached 52.7 and 91 respectively. Prices weakened again with the intensification of the European crisis in August, but not so much as might have been expected. The Dow Jones index for stocks stood at 45.7 on August 18th as against a low point of 40.4 in April, and the bond index was 89.2 on August 18th as against 87.06 at its lowest in April. To some extent the renewal of the crisis must have been discounted in advance.

The average current yield on United States Government bonds, which were hardly affected by the April break, has fallen from 2.34% in March to 2.16% in mid July. The yield on Moody's Aaa bonds, which was 2.99% in March and flickered up to 3.02% in April, had fallen again to 2.89% in mid July. In both cases the latest figures are the lowest on record.

#### Public Finance

12. 1939 closed with the highest figure of Federal expenditure which has ever occurred - \$9,268 million - and a net deficit of \$3,542 million, second only to the deficit of 1936, the Veterans' bonus year.

13. The appropriations recommended for 1940 in the President's Budget message, including probable supplemental items, amounted to \$10,190 million. The message compared this with a corresponding figure (based on appropriations actually voted) of \$10,929 million for 1939; but the correspondence may not be complete as the allowance for supplemental items for 1939 was calculated half way through the fiscal year, and that for 1940 six months before the year began.

The appropriations actually voted for 1940 by Congress amount to about \$10,470 million (the official figure will not be available till next month). This figure presumably does not include any allowance for probable supplemental items. Further the supplemental items may be heavier in 1940, for Congress has approved a number of new commitments. As usual the full appropriations for relief remain to be made later in the year. This year the plans have been based on a roll of 2 million relief workers as against 3 million last year, and unless recovery proceeds faster than anyone expects, the supplemental appropriations will have to be correspondingly large.

14. Expenditure always falls short of appropriations, but there is every reason to expect that Budget expenditure in 1940 will materially exceed that for 1939. The "New York Times" estimates that 1940 expenditure will reach or even exceed \$10,000 million, as against \$9,270 million in 1939. Revenue may exceed that of 1939, but not by much, since, while excise duties are on the upturn, income and corporation taxes are not yet thought to have reached their lowest point. Thus the 1940 deficit may very well run to about \$4,000 million, as against \$3,540 million/



million in 1939. Moreover the recent amendment of the Social Security Act will reduce the surplus revenue of the Unemployment Trust Fund and the Old Age Reserve Account, available for investment in Government stocks, by perhaps \$300-400 million, and the Budget deficit must pro tanto be covered by increased borrowing in the markets.

15. In fact the defeat of the Works Financing Bill (paragraphs 3-4 of Washington despatch No. 871 E of August 8th, 1939) does not in any sense signify a step back from deficit financing or pump-priming, but only a failure to expand that policy on one side. Those who will may interpret it as a defeat for the theory - of which we have not heard the last - that in the main the era of geographical and industrial expansion in the United States is over, and a structural change has occurred which can only be handled by substituting Government borrowing to a large extent for private borrowing. But in fact the bill was defeated more by the clash of sectional interests and the revolt of a part of his own party against the President's methods.

#### Some General Observations

15. Recent events have thrown little, if any, additional light on the problems of America's economy. There might be something like a consensus of opinion that the recession of 1937-38 was due to four or five main factors, viz:-

1. The reduction or disappearance of the Budget Deficit.



2. The sterilisation of gold and increase of reserve requirements, reducing excess reserves of Member Banks from a high point of over \$3,000 million (August 1936) to a low point of \$700 million (August 1937)
3. Excessive increase in stocks of commodities and over-speculation.
4. The steep rise in wage rates which followed Mr. Roosevelt's second election as President.

and perhaps: -

5. The fall in prices of agricultural produce due e. g. to the increasing overproduction of cotton both in United States and abroad, and the rapid recovery in United States production of wheat in 1937 following the drought.

But in the first place there would be many differences of emphasis. And in the second place these considerations hardly touch on the main question, which is: Why has there been such a small degree of recovery in spite of the renewal of deficit financing in 1939 and the certainty of its continuance in 1940 and perhaps later, in spite of the fresh increase in excess Member Bank reserves to some 50% above the earlier peak, and in spite of the liquidation of excess stocks? And what is to be done to bring prosperity back?

17. There is no consensus of opinion on this. Some moderates hold the comfortable view that prosperity will return in its own good time and that the present Government spending is necessary and unobjectionable as an interim measure. Others have become somewhat

discouraged/

discouraged by the stagnation of last spring and fear that Government spending, though it may have stimulated activity at first up to 1937, is now, like a narcotic in the second stage, having a depressive effect. The Republicans as a party have no positive nostrums; they may defeat the President's new "spending-lending" scheme, but they dare not endorse the extreme conservative view that prosperity will return if business is only left to itself, nor dare they suggest that, if they returned to power, they would sweep away more than a small proportion of the New Deal reforms. The field for active thinking is in fact left clear for the New Dealers and some outside observers.

18. The theory of the Structural Change, referred to in paragraph 15 above, has for the last year been the favourite of the New Dealers, who have to produce some theory to explain the failure of pump-priming to stimulate private business, and now seek to prove that the pump is obsolete and that the Government must permanently take the place of private borrowers. Advocates of this view indulge in a good deal of loose thinking and question-begging, and tend in particular to ignore monetary factors. Certainly structural changes are proceeding (as in every country). The era of expanding agricultural acreage is over, and contraction is only avoided by artificial measures - which may have come to stay. The railway era is over and railways are losing ground to road and air transport. Even the motor industry in the United States of America may have reached the limit of its expansion, though some believe there is a large field for cheaper and lighter cars. Probably the theory was put in its most reasonable form by Mr. Marriner Eccles in his

recent/



recent evidence before the Senate Banking and Currency Committee (Washington despatch No. 860 of August 7th 1939) when he concluded: - "In view of our changed conditions one of three alternatives faces the country: (1) either an unforeseen and unforeseeable very large outlet for investment must develop in new or old industries, or (2) a very considerable increase must be brought about in the proportion of the national income that goes into consumption, or (3) the Government must provide an outlet for idle funds through deficit financing of work relief, public works, armaments and so forth or through a programme such as" that of the Works Financing Bill.

19. It will be noticed that Mr. Eccles left himself three alternatives - and if pressed he would no doubt have agreed that the country was faced by one or more of these. Certainly, if it were true that the country already had or was by way of acquiring all the capital plant necessary to satisfy all foreseeable needs, it would follow that a smaller proportion of its energy than hitherto need be set aside for constructing plant for future needs, and a larger proportion would be available for supplying goods for immediate consumption or use, for constructing amenities and public utilities, etc. In fact, provided that it could organize a state of full employment, it could afford to save less and live more luxuriously; and a part of the luxuries would no doubt be communal luxuries - roads, parks, bathing establishments, better hospitals etc. - which can be better provided by public than by private enterprise. But this conclusion falls far short of that of the New Dealers. Though one may concede that State borrowing  
and/



and spending has some part to play in bringing about a state of full employment, the New Dealers entirely fail to prove that it is the only, or even the principal, means.

20. Another view which has gained some prominence lately is that the decisive factor in the situation is the level of wages. This was suggested on pages 9-10 of the last annual report of the B. I. S. and was one of the themes of an article in the "Economist" of July 1st which attracted some attention here. I have heard the American position strongly contrasted with that in Sweden, where workmen accepted reductions of wages in the crisis and reaped their reward in continued prosperity and the restoration of the wage cuts. In the United States, on the contrary, there were steep rises in the wage curve in 1933 and in 1936-37, each time after the Presidential election (the fact that President Roosevelt accepted financial aid from Mr. Lewis' Congress of Industrial Organizations will not be forgotten.) Each time the rise in the wage curve outdistanced that in the curve of the price of industrial products - more sharply in 1936-37. While from 1933 to 1936 the two curves closed up again, the gap created in 1937 has never closed up.

21. This theory is beautifully simple and plausible, but it is at least partly vitiated by the fact that improved manufacturing methods and organisation have materially increased the productivity of labour. Mr. Lubin, the Commissioner of Labor Statistics, maintained, in a letter to the "New York Times" of August 12th, that while hourly rates of wages rose by 23% between 1929 and 1938, the productivity per man-hour rose by 27%

between/

between 1929 and 1935. The Wall Street Journal admits that industry has adjusted itself to the new order of things, and calculates that the index of labour costs per unit volume of output fell from 100 in 1929 to 72 in 1933, then rose to 100.9 in 1937 and 101.8 in June, 1938, and fell and rose again reaching 96.8 in June 1939. An increase in the total volume of production would bring labour costs down again. In the steel industry, the "Annalist" observes, "It is readily apparent that towards the end of 1938 labour charges per ingot had again reached the 1928 and 1929 levels, although average hourly wages paid were 24% higher than in those years."

22. The difficulties of industry seem to arise rather from the lowered prices of finished goods, which in June 1939 were still nearly 16% below the 1929 level. It is difficult to say whether changes in in come distribution through rationalisation of industry and consequent economy of labour may have had some influence on prices.

23. It should be possible to trace the effect of these movements on profits. The available statistics show that the rise in profits of leading Corporations, which began in 1933, was checked before the end of that year. Profits rose again however from the end of 1934 until in 1937 they were approaching the 1929 peak. With the beginning of 1938 they fell back sharply below the 1933-34 level, but recovered nearly half this loss with the last quarter of 1938 and the first two quarters of 1939.



24. Unfortunately the sample taken in these statistics, mainly large and well run corporations, may not be altogether representative. Many of the larger corporations are in a semi-monopolistic position which enables them to maintain their profits by adjusting prices when costs rise for any reason, so that the effect of such rising costs is to diminish their sales rather than their profits. This tends to be confirmed by the fact that a complete analysis of corporation profits in 1936, classified by order of the size of the corporations, showed that losses occurred mainly among the smallest corporations and the rate of profit rose with the size of the corporation up to a certain point. An up-to-date analysis of this kind is not available.

25. One must, I think, conclude that the effect of structural changes and of wage increases, as abiding causes of depression, has at least been much exaggerated. In many respects the United States has been in a state of transition since 1929. Labour and social conditions were behind those in other countries, and an improvement was overdue. Unfortunately the "rugged individualism" of many Americans was still too strong for them to bow to the inevitable and take their part in an orderly adjustment. The change has taken place in a series of struggles, complicated by contests for power between rival labour organizations. But on the whole it seems impossible to find any definite ground for the belief that the existing capitalistic organisation is incapable of adjusting itself to the necessary social reforms which have been effected, and which have come

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to stay. The erratic course of Government policy (not to mention the international political situation) creates indeed so many uncertainties that a lack of initiative on the part of business is understandable. But even so it seems impossible to believe that the American economic system, which has already shown surprising elasticity, will not sooner or later achieve a full recovery.

(SGD) G.H.S.PINSENT

BRITISH EMBASSY,  
WASHINGTON, D. C.  
23rd August, 1939.

*Wk.*  
Sent to W. in P.L. No. 756 July 8 20  
of Australia D.O.T. Treasury  
and Ottawa No. 63.

Seen by Mr Mallett  
Sir S. Chubb  
& Mr. H. Miller.

Close of United States Budget for 1939

1. The Secretary of the Treasury issued on the 1st of July, 1939, a summary statement of the outturn of the financial year 1939. Copies of this statement are annexed.

2. The following table summarises the results of the last four financial years, following the classification now adopted by the United States Treasury.

	1936	1937	1938	1939
	(Million \$)			
Revenue	4,116	5,294	6,242	5,668
Expenditure	<u>9,069</u>	<u>8,546</u>	<u>7,691</u>	<u>9,268</u>
Gross Deficit	4,953	3,252	1,449	3,600
Debt Retirement	<u>403</u>	<u>104</u>	<u>65</u>	<u>58</u>
Net Deficit	4,550	3,148	1,384	3,542

If account is also taken of the surplus of receipts over expenditure of the trust accounts, including the Unemployment Trust Fund and the Old Age Reserve Account, the cash deficit for 1939 is reduced by 884 million dollars to 2,658 million dollars, as against 1,129 million dollars for 1938. Further the expenditure of the trust accounts etc. includes investments on the part of the Unemployment Fund, the Old Age Reserve Account, and the Railroad Retirement Account amounting to 910 million dollars in 1939 (1,020 million dollars in 1938). These

investments/

investments served to reduce the amount of the budget deficit which had to be financed by borrowing on the market.

3. The revenue shows an appreciable fall as compared with 1938, mostly on account of the income tax. On the other hand there was an improvement as compared with the budget estimates except in the case of customs and miscellaneous revenue.

4. The expenditure side shows the largest total ever achieved by the Federal Government, and exceeds even the total for 1936 which was swelled by the bulk of the payments on account of the veterans' bonus. The increase over 1938, resulting from the renewal of the spending policy after the slump of 1937-38, amounts to nearly 1,600 million dollars. The net deficit has jumped up once again, from 1,384 million dollars to 3,542 million dollars, and if this deficit is still less than that of 1936 it is due to higher taxation which brought in even in 1939 a substantially greater revenue than in 1936.

5. It is of interest to note that the increases in the 1939 budget which balanced the disappearance of the veterans' bonus and served to bring the 1939 total above the 1936 level do not occur in the items for recovery and relief, which actually fell from 3,441 million dollars in 1936 to 3,104 million dollars in 1939, but in a number of other services which have grown up in the interval. Departmental expenditure  
increased, /



increased, and there was a large jump in expenditure on public buildings, highways, harbours, reclamation work, the agricultural adjustment program and similar items. Further, expenditure on defence rose from 764 million dollars in 1936 to 1,074 million dollars in 1939, and interest on the public debt rose from 749 million dollars to 940 million dollars.

6. Nevertheless the 1939 expenditure was less than the estimates, the shortage arising mainly on those items in which the spending program was started or re-started in 1938 and progress was slower than had been planned. However, a short expenditure of 63 million dollars compared with estimates, in respect of the Agricultural Aid sub-head of the recovery and relief item, was due mainly to the failure of Congress to vote the necessary sum to cover the loss of the Commodity Credit Corporation.

7. The figures of the gross public debt, and the net amounts after deducting the balance in the general fund, in the last four years, are as follows:

	Gross Public Debt	Balance in General Fund	Total Net Debt
	(Million \$)		
June 30, 1936	33,778	2,681	31,097
June 30, 1937	36,424	2,553	33,871
June 30, 1938	37,165	2,216	34,949
June 30, 1939	40,440	2,838	37,602

If allowance is made for the investments made by the trust funds, referred to in paragraph 2 above, the increase in the gross public debt issued

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on the market is \$2,365 million in 1939, while in 1938 this part of the public debt actually fell by \$280 million.

8. The computed rate of interest on the total interest-bearing debt increased from 2.589 per cent on June 30, 1938 to 2.600 per cent on June 30, 1939, and the total interest payments increased from 926 million dollars in 1938 to 940 million dollars in 1939.

9. The details of the Treasury issues during the year are given on page 7 of the Treasury statement. There are two points worth noting in this connexion. In the first place, owing to the fact that revenue slightly exceeded the estimates, while expenditure fell below, the Treasury has had ample funds inhand, and therefore decided to make no public issues for cash after December, 1938, until next autumn. The issues in March and June were for conversion purposes only.

10. In the second place the Treasury has to some extent changed its policy and is now issuing a higher proportion of medium to long term securities than before. The total issue of bonds rose on June 30, 1939 to 28,000 million dollars, and the Treasury has therefore sought the enlargement of the limit of 30,000 million dollars at present fixed by statute to the issue of bonds. Congress has, however, not yet approved this proposal, which has become entangled with the Tennessee Valley Authority finance.

11. The debt guaranteed by the Government increased from 4,889 million dollars on June 30, 1938 to about 5,485 million dollars on June 30, 1939; the largest increases being on account of issues by the Reconstruction Finance Corporation (524 million dollars) and the United States Housing Authority (115 million dollars).

12. No up to date figure is available to show what portion of the public debt is held by the Government and Government agencies.

13. Some observations regarding the outlook for the fiscal year 1940 were given in my despatch No. 737 E of July 3rd, 1939, while the recent tax measures are described in my despatch No. 749 E of July 6th, 1939. With Congress still in session, the final shape of the 1940 budget is not yet determined. It might be thought that, with the public debt at 40 billion dollars, the time was not far distant when the statutory limit of 45 billion dollars must be revised. The tendency now, however, is towards financing the Government spending schemes outside the Budget, in such a way as to minimise the Budget deficit. There has been indeed much talk about the advantages of a "double budget" in which current receipts and expenditures will be distinguished from investment - in fact our old friend the "ordinary" and "extraordinary" budget. Though no formal steps have been taken in this direction, the new tendency is once more exemplified

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in the President's new scheme (which was outlined in my despatch No. 737 E above referred to) for a revolving fund to finance certain public improvements. Issues made by Government agencies and guaranteed by the Government are not included in the direct public debt which is subject to the statutory limit of 45 billion dollars. Nevertheless the items likely to be included in the budget proper for 1939 will be sufficient to bring the direct public debt fairly near the 45 billion dollar limit.

14. There seems no reason to anticipate that the Treasury will have difficulty in financing the Government programs within any measurable space of time. The slight increase in the average rate of interest paid on the debt in general is immaterial. Government stocks, with some intermissions, have been strong since the winter, and some of them are even quoted at rates which are hardly remunerative. Treasury bills are being currently taken up by the market at the microscopical rate of 0.005 per cent. Though a slow revival of business is confidently hoped for in many quarters, it is much hampered by the numerous uncertainties which beset the business man, and there must be considerable time at least before gilt edged quotations fall even to a more or less normal level - a consummation which would be only too welcome if it meant a real revival.

(SGD) G.H.S. PINSENT