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THE BRITISH EMBASSY,
WASHINGTON, D. C.,

December 5th, 1939.

No. 1364.

My Lord,

I transmit to Your Lordship
herewith a copy of a memorandum by the
Financial Adviser to this Embassy regard-
ing 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,
(SGD) LOTHIAN

The Right Honourable
The Viscount Halifax, K.G.,
etc., etc., etc.,

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FINANCIAL AND ECONOMIC SITUATION IN THE
UNITED STATES OF AMERICA, NOVEMBER, 1939.

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(cf. memorandum of 23rd August, 1939,
accompanying Washington Despatch
No. 972 E of 29th August, 1939.)

General Conditions.

1. In the debate in Congress on the Neutrality Bill Representative Wadsworth of New York said "This legislation is being proposed largely because we are afraid of our own emotions". This same fear of his emotions, even of his instincts, characterises the attitude of the American towards the prospects of business.

2. When war broke out, instinct at first got the upper hand. A rush out of fixed-interest-bearing securities into equities in expectation of war profits caused stocks to soar and bonds, especially Treasuries, to slump. Although the Federal Reserve Banks bought in over \$400 million of Treasury Bonds - acting rather at cross-purposes with the Treasury which wanted to see the market settle down by itself - the index for long-term Treasury bonds fell by 22% in September. High grade utility and other bonds were less affected. The stock index rose erratically from 84 to 96.

Prices of many commodities jumped sharply. There was a rush of domestic orders to manufacturers, and even a little household hoarding for a short time.

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3. In October-November the Bond market, including Treasuries, recovered practically all the ground lost in September. Shares weakened only slightly and steadied down somewhat. The market was still disturbed by contradictory rumours about Allied purchases, but has slowly approached a better measure of probabilities.

4. When the dust had cleared somewhat it was seen that the principal movement had been the endeavour to increase depleted stocks in most branches of the system towards a more normal level. Steel production (Iron and Steel Institute) rose from 63% at the beginning of September to 94% in the fourth week of November. The demand for steel has been increased by very good automobile prospects (somewhat damped more recently by strikes), and by the fact that the railways have had to place substantial orders for new rolling stock to cope with the anticipated increase in traffic, their carrying capacity being lower now than in 1937. The "New York Times" business index rose from 91 at the beginning of August in a progressively steep curve until it checked slightly after reaching 107 in the second week of November. Unfulfilled orders in many industries, especially steel, are sufficient to maintain activity at a high level for several months to come.

Up to date this is hardly a war boom at all, but rather a revival of normal structure, the conditions for which were already existing in latent form, and the trigger of which was pulled by the war.

The Money and Capital Markets.

5. The gold stock has increased from \$16,227 million at the end of July to \$17,257 million on November 22nd, and excess reserves of Member Banks have increased from \$4,590 million on August 16th to \$5,170 million on November 22nd. The rate of increase in excess reserves has been raised this year by the fact that the Treasury has financed the budget deficit in part by drawing on its general fund. Since the market steadied down in October the Treasury has replenished the general fund to some extent by fresh issues, and this, coupled with the slowing down of gold shipments owing to the war, has caused excess reserves to drop a little from the peak of \$5,530 million reached on October 25th. Money rates have not altered to any appreciable extent.

6. Reserve banks have now allowed their Treasury Bills to run down to the low level of \$77 million, so that in spite of the large purchases of Treasury Bonds referred to in paragraph 2 above, their total holding of Government securities has now returned close to the level of the first half of 1939.

7. Increased purchasing for stock has led to a moderate rise in bank advances. The commercial, industrial, and agricultural loans of reporting member banks rose from an average of \$3,930 million in August 1939 to \$4,388 million on November 22nd.

8. Capital issues fell off sharply in August and September. Only after the market steadied

in October did the Treasury cautiously enter the market for new money (apart from the sale of "Baby Bonds" which itself dropped from \$89 million in July to \$47 million in September). \$150 million was raised mostly in October by increasing the issues of Treasury Bills. The Reconstruction Finance Corporation made an issue in October of 1% 2½ year notes, the proceeds of which were used to repay \$245 million previously borrowed from the Treasury - a convenient scheme which replenished the Treasury's coffers without increasing the official Federal debt which is subject to the \$45 billion limit. Finally on November 27th the Treasury made an offer for cash of \$500 million 2% 9-11 year Treasury Bonds - the first offer of direct Federal obligations with a long maturity since 1938, and the longest dated 2%'s ever issued. These were taken up rapidly and went to a premium of 2%, and the market for Government bonds improved at the same time. The market has in fact been starved for 3 months, during which there had been no substantial corporate issues until the appearance on November 27th of \$52 million of Public Service of Colorado bonds.

Federal Finance.

9. The deficit to 27th November on the 1940 Budget is \$1,676 million, as compared with \$1,367 million for the same period last year. Though income tax is yielding less than last year there has been a slight recovery in customs and excise duties, so that the total revenue to date (\$2,145 million) is only

\$47 million/

\$47 million below that of last year. With the increase in business since the outbreak of war a further recovery in excise duties is expected, and there may be some savings on relief, so that unofficial prophets now estimate the deficit for the year at about \$3,500 million (with a wide margin of error) instead of the \$4,000 million or nearly that estimated in my memorandum of 23rd August last.

10. The war has brought the question of defence again into prominence. The President, who is now preparing his 1941 Budget, has told the Press that he will propose an increase of about \$500 million in the War and Navy Department appropriations for next year. He is searching in other directions for compensating economies, but a net increase in expenditure seems inevitable and the President is revolving the question whether to cover this increase by more borrowing or more taxation.

11. New Dealers, while opposed to increased taxation in general, are quite prepared to tax war profits 100% (so that some manufacturers are reported to be prepared to make contracts with the Allied Governments on a no-profit basis). Another cross-current here is the examination of the tax structure which is being carried out by Under Secretary Hanes. He is known to be in favour of the abolition of the income tax exemption on Federal securities, coupled with a revision of the tax rates which will put a higher proportion of the burden on the middle and lower incomes - all controversial questions.

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12. The statutory debt limit of \$45 billion is looming unpleasantly near. After certain adjustments to the present debt of \$41,797 million have been made there remains about \$3,800 million of unused borrowing power. Some of this must be set aside for the automatic growth in the value of outstanding Baby Bonds and the remainder of this year's deficit must be financed. It seems unlikely that next year's budget expenditures can be met without increasing either taxation or the debt limit. The Administration is reluctant to take the initiative and will probably leave to the Congress the responsibility for the necessary decisions.

13. A side issue of some importance has been the continued agitation for increased old age pensions. Special schemes were submitted to the vote in California (the "Ham and Eggs" scheme) and Ohio, and though they were both defeated by large majorities, the results of the elections were unpredictable, and the issue is by no means closed. The authors of various schemes are giving some of their energy to abusing one another, but there may be enough popular pressure behind the whole movement to force administrators to seek credit for putting forward reforms themselves.

General Outlook.

14. The facts that the recovery of the last months has arisen in the main from the filling up of domestic inventories and that the volume of

war purchases may not be as great as was at first assumed, has led many people to take the view that there will be a halt in recovery, or even a fresh recession, in a few months time. This view may, however, be partly the product either of the political desire of the New Dealers not to see their case vanish in to the thin air of a real revival, or of the American business man's distrust of his own instincts, awakened by the successive blows of the crisis and the New Deal.

15. As every revival starts in precisely this fashion, I think that the reasons, if any, for doubting the prospect of a continued revival lie elsewhere. The pressure which has been applied by the Administration to prevent a rise of industrial prices may slow the pace of revival - though this may be salutary rather than otherwise. The most conspicuous example is the investigation of steel prices by the Temporary National Economic Committee (the "Monopolies Committee") whereby the steel makers were forced to eschew any material change in their prices for the first quarter of 1940, notwithstanding an alleged rise in costs. Another important factor is the disposition of labour to put forward fresh wage or other demands on the least sign of returning prosperity.

16. If a price boom can be prevented, it seems that war purchases can have only a limited effect on the American economy, helping to give employment in certain branches (while creating difficulties

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for others) rather than stimulating activity all round to any material extent. On the other hand, the Administration fear that there may be a substantial rise in the prices of industrial raw materials which would be a serious disturbing factor.

17. Owing to the war New Deal politics seem likely to play a smaller part in the 1940 elections than would otherwise have been the case. An increase in defence expenditure will be approved by all parties, and will to some extent replace recovery expenditure. The Republicans have recently started a campaign against Mr. Hull's Reciprocal Trade Treaties Act and they may possibly choose this as one of their campaigning grounds. The war, with its sudden turns, is however still competing with internal politics for public interest, and the character of the 1940 campaign is still very obscure.

(SGD) G.H.S. PINSENT

1st December, 1939.