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BRITISH EMBASSY,

No. 235 WASHINGTON, D.C.

11th March 1940.

My Lord,

I have the honour, with reference to my despatch No. 1364 of December 5th last, to transmit to you herewith a copy of a memorandum by the Financial Adviser to this Embassy regarding the present financial and economic situation in the United States.

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2. It may be noted that since this memorandum was written the Senate Appropriations Committee has approved the addition of $212 million for farm parity payments and $85 million for surplus commodity removal. Though at the same time savings of $90 million were made on paper by striking out certain appropriations and substituting authority for advances by the Reconstruction Finance Corporation, this action, if endorsed by the Senate, has made a definite breach in the defences of the economy group.

3. A copy of this despatch is being sent to the Treasury, the Department of Overseas Trade and the High Commissioners for the United Kingdom at Ottawa and Canberra.

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

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(Sgd.) LOTHIAN.

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

FINANCIAL AND ECONOMIC SITUATION IN THE UNITED STATES OF AMERICA

February - March, 1940.

(Cf. Memorandum of 1st December accompanying Washington despatch No. 1364 of 5th December 1939).

General Conditions.

1. The halt in business activity, which was already being anticipated last November, has developed rather sharply. The Federal Reserve adjusted index of production, after rising from 103 in August to 128 in December, dropped to 120 in January and is expected to stand just below 110 in February. Two-thirds of the decline is accounted for by the steel industry alone. In general, industry is to a large extent still working on the rush of orders received in the autumn months. Meanwhile manufacturers' inventories have risen in many cases above the level of the end of 1937, when the recession of that year had already made itself felt (inventories now are however below the peak of October 1937). As consumption has not kept pace, new orders have fallen off and the outstanding unfulfilled orders are being steadily reduced. In the characteristic case of the steel industry, steel mill operations were reported in the second week of February at 71½ per cent. of capacity, while consumption of steel was estimated at 65 per cent. of the steel mill capacity and new orders were coming in

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at 45 per cent. of capacity only.

2. The situation is, however, in many ways better than it looks at first sight. The seasonal adjustment of the Federal Reserve index somewhat exaggerates the actual drop in business. Though steel mill operations have slipped back to 65 per cent. at the end of February, new orders, which had dropped to 40 per cent., showed their first rise at the end of the month. The strength of the automobile market has been remarkable, production in the first seven weeks of 1940 being 20 per cent. higher than that in 1939. There was heavy domestic buying of copper in February, with a slight rise in price. While the recession is bound to develop a little further in the next month or two, the general view is that it is no more than a necessary - if somewhat rapid - adjustment of the excessive buying of the autumn, and that the recession is not of the self-developing type. There are signs that industry has enough confidence to be ready to hold higher stocks than a year ago. An improvement by April or May is generally expected.

3. The position with regard to construction is, however, not favourable. Since last September the Federal Reserve adjusted index has been between 5 and 13 points below the corresponding figures for last year. For the first half of February the fall was 12 points (an index of 61 against 73 for February 1939). This is, however, mainly due to the reduction of relief expenditure and the consequent fall of public contracts. Private building is about 5 per cent. above the level

of a year ago, and the prospects for a further increase seem good, especially in the range financed by the Federal Housing Administration and the Home Owners' Loan Corporation, which reduced their interest rates from 5 per cent. to 4½ per cent. last August.

4. Moody's index of prices stood at 160 on February 24th, as against 140 on August 31st last, and 145 a year ago. But this covers some diversity. While prices of wheat, corn, cotton, butter, eggs, hides, copper and steel scrap are higher than a year ago, those of hogs and lard are lower. As a net result, however, it is clear that cash farm income (including subsidies) is running appreciably above the level of a year ago, though the degree of improvement is very variable from month to month.

Money and Capital Markets.

5. The gold stock has risen further from $17,257 million on 22nd November to $18,166 million on 28th February. Excess reserves of Member Banks have increased rather less - from $5,170 million on 22nd November to $5,690 million on 28th February. Excess reserve actually fell to $4,800 million on 13th December, but rose fast thereafter till January 24th, and then remained steadier. These irregularities resulted in part from the issue of $500 million Treasury Bonds at the end of November; from a remarkable success in the net sale of Savings Bonds in January, which reached $264 million against a previous peak of $155 million in March 1937; and from the

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collection of social security taxes in early February. Further increase of excess reserves is to be expected, though March tax collections and any Treasury financing operations may cause temporary halts or dips.

6. The currency circulation has risen by about $740 million in 1939, a greater increase than in any recent year. Some part of this increase may be due to the export of dollar notes. It has served to some extent to limit the increase in excess reserves.

7. Reserve Bank holdings of Treasury Bills have now been allowed to run off entirely. Their total holdings of Government securities show however only a trifling drop as compared with a year ago.

8. The commercial, industrial, and agricultural loans of reporting Member Banks, which stood at $4,388 million on 22nd November, barely rose above that figure, and have now slipped back to $4,324 million on 28th February. This is no doubt a reflection of the decreased purchases of industrial goods.

9. The extra $150 million of Treasury Bills issued in October and November, over and above the usual weekly offering of $100 million, were allowed to run off in January and February without replacement. There has been no appreciable alteration in money rates, and some of the late December and early January issues were actually sold at a premium owing to special circumstances connected with local taxes on bank deposits.

10. Apart from the sale of Savings Bonds - the gross figures for which were: November, $56 million;

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December, $76 million; January, $275 million - there has been no Treasury issue for new money since the late November issue referred to in my last report. There was a refunding operation in December, viz., the redemption of $1,378 million 1 5/8ths per cent. notes due March 15th, 1940, against new issues of $1,018 million 2¼ per cent. fourteen year bonds, and $283 million 1 per cent. 4¾ year notes. The balance was covered by the sale of a further $73 million of the fourteen year notes to Government investment accounts. Another refunding operation is just announced, viz: the refunding of $738 million 1½ per cent. notes maturing on 15th June next by an issue of new 5 year notes at ¾ per cent. But no new money will be raised this March.

11. The Commercial and Financial Chronicle's review of capital issues for 1939 shows that corporations only raised $371 million of new money against $872 million in 1938, though their refunding operations at $1,808 million were nearly 50 per cent. higher. States and municipalities raised $938 million of new money - a slight decrease - while Government agencies raised $924 million of new money against $481 million in 1938. New money raised by these three groups in the three months November, December and January, was only $277 million against $682 million a year ago - the figure for corporations alone being $80 million against $109 million a year ago. The Commercial and Financial Chronicle also lists privately placed corporate issues amounting to $718 million in 1939,

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compared with $680 million in 1938; but it is not stated what part of these issues was for new money.

12. First class corporate bonds have fully recovered their pre-war level, and Treasury bonds very nearly so. Stocks have been unsteady; a slight weakening at the beginning of December was soon recovered, and at the beginning of January the market looked strong. In the second week of January, however, the Dow-Jones average dropped from 51.1 to 48.9. About half the loss was recovered in early February, but this recovery has not been completely sustained.

13. The Stock Market was in fact fairly quick to discount the fact that the buying wave of the autumn could not be sustained, and in consequence it has been relatively little affected by the more recent fall in business activity. But it is far more difficult to account for the fact that stock prices are practically at the level of a year ago, in the face of the substantial increase in corporate earnings. A tabulation of 658 leading manufacturing corporations shows that their 1939 net profits were more than double those of 1938, and represented 8.4 per cent. of their "net worth".

<u>Federal Finance.</u>

14. There have been no special developments regarding the 1940 Budget since the review in paragraph 4 of the enclosure to Washington despatch No. 66 of 18th January 1940. The deficit to date (29th February) is $2,646 million.

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15. Congressional procedure on the 1941 Budget is still extremely confused. An account of the first reactions was given in Washington despatch No. 147 E of the 12th February 1940. Amid many cross-currents, the House of Representatives appears to be trying to cut down 1941 appropriations to the point at which both an increase in taxation and an increase in the $45,000 million debt limit can be avoided. In the eight appropriation Bills which have been passed by one or both houses, over $290 million has been cut from the President's estimates, including large cuts in Defence and Agricultural appropriations. The House of Representatives hopes to achieve the necessary remaining cuts on the appropriation Bills yet to be passed. The Farm Group, while they have voted for other cuts in the hope of making room for their own favoured items, was unable in the House to defeat the agricultural cuts or to make any serious attempt to put in an additional appropriation of $200 million for farm parity payments which they are strongly advocating.

16. The scene is shifting to the Senate where, although some of the House cuts have been restored, the position is not much clearer. Expenditure on rivers and harbours is generally regarded as "pork barrel" expenditure of the plainest kind. The House voted $84 million only for this. The Senate Commerce Committee first added $329 million to this sum, and then recalled its report to discuss a proposal to divide the measure into four parts - only to reach a deadlock. The assault of the Farm Group

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in the Senate Committee on Agriculture has begun, with a demand for the restoration of the cuts made by the House and the addition of $200 million for farm parity payments. In the background is a scheme favoured by Secretary Wallace for meeting this expenditure by means of a new kind of processing tax called "certificate payments", which has so far been strongly opposed by the Treasury, and apparently by the President, on the ground that it is a tax on consumption. Further developments are to some extent dependent on consultations now beginning between Congressional leaders and the President, who has expressed strong disapproval of some of the cuts made.

17. There is a movement afoot in Congress to force the Treasury to reduce its working Balance in 1941 in order to finance part of the deficit and avoid increasing the debt limit. The Treasury balance is already being reduced this year by an estimated amount of $1,150 million, but it is expected to amount still to over $1,000 million on 30th June next. The Treasury view is that a balance of this magnitude is necessary in order to allow the Government complete freedom in the management and timing of its financing operations.

Discussion of the Gold Problem.

18. Since Washington despatch No. 152 of the 13th February 1940, there has been no significant discussion of the gold problem, although it continues to be mentioned at intervals in the press and elsewhere. Senator Thomas, the protagonist of inflationary measures in 1933, has introduced a bill to authorise the

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resumption of the coinage of gold, and the use of the American gold hoard for making gold loans through the Export-Import Bank to solvent nations which stabilise their currencies. The bill is not likely to make progress. In contrast to this, Senator Townsend has returned to the charge with a bill to withdraw the powers of the Treasury to purchase foreign silver. Although these monetary problems will not be allowed to rest, I can see no real signs of danger for the Allies. On the contrary Mr. Morgenthau, after showing for some time past signs of nervousness at the possibility of intervention by Congress in this delicate subject, now seems to have recovered his confidence altogether.

The Outlook.

19. The Temporary National Economic (Monopolies) Committee continues its investigations. After an enquiry into Investments Trusts, as a result of which the Committee is now preparing a bill for the regulation of these institutions, it is now examining Insurance Companies. With the war and the 1940 elections occupying the foreground of public attention, the Monopolies Committee is now the chief forum of New Deal theory, which is seeking in every way to prove that the monopolistic practices of large corporations obstruct the free flow of capital into new investment.

20. A favourite New Deal thesis at the moment is that one of the obstacles to new investment is the over-conservative habit of large and wealthy corporations in setting aside depreciation, etc., reserves

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which greatly exceed the true depreciation of the plant. This is an echo of the theory which led to the 1936 tax on undistributed profits, now abandoned. It does not seem to have occurred to those who expound this view that corporation reserves, even if they exceed actual depreciation, are not necessarily "idle capital" but are normally invested either in the business or otherwise; that the industrial revolution grew largely by this process in the 19th century; and that in recent times profits ploughed back into the business have financed great technical progress by American corporations. The whole practice may indeed be open to criticism from two angles: first, if it leads to excessive liquidity and thus has a deflationary effect; and secondly, if it leads to unprofitable investment owing to the fact that the companies are not forced to submit to outside scrutiny before obtaining their capital. But it is doubtful if these criticisms could be sustained as regards recent developments, and in any case these are not the criticisms which are made.

21. The stagnation of the capital market and the paradoxically low level of stock quotations, referred to in paragraphs 11 and 13 above, are however facts, and are at least symptoms of a grave lack of resilience in the American economy, the fundamental causes of which are still obscure.

22. The Wall Street view, that the whole troulbe is caused by Government interference which paralyses initiative, has received a fresh stimulus from the recent activities of the Securities and Exchange

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Commission. In December the Commission had before it a proposal of the Consumers' Power Company for the issue of (1) \$18½ million of bonds for refunding purposes, (2) \$3½ million worth of shares privately for new cash, and (3) \$10 million of bonds publicly for new cash. The Commission approved the first two items, but rejected the third on the ground that it would lead to an unsuitable capital structure and should be replaced by a public issue of shares. Although the Commission certainly acted within its statutory powers, its apparent interference with the management of the Company's finances occasioned much unfavourable comment, and the Company proceeded with the first two items only. Shortly after this the Commission, by refusing permission for a bond issue to the Associated Gas and Electricity Company, forced that company into bankruptcy.

23. Meanwhile the Commission had announced that it would shortly proceed to put in force the "death sentence" provision of the Public Utility Holding Company Act of 1935, which gives it power in the last resort compulsorily to reorganise "uneconomic holding company structures" on a properly simplified and integrated regional basis. Within the last week or two it has given notice to seven holding companies to show cause why they should not be reorganised under this provision, and two other companies will shortly receive similar notice. These nine companies hold nearly two-thirds of the assets, totalling \$14,000 million, of the fifty-one registered utility holding

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companies. Thirteen others have voluntarily filed reorganisation schemes, of which seven have been completed. Two others are under judicial reorganisation.

24. The whole of this big group of public utilities (excluding only the seven smaller companies which have complied with the Act) is practically disqualified from raising any substantial amounts of fresh capital for development until the reorganisations, or threatened reorganisations, are completed, although development is decidedly needed in this field. It is true that the position has been much the same ever since the Act was passed, and that this definite action by the Commission may bring the suspense sooner to an end. But the proceedings are likely to be protracted, and it is not impossible that some of the companies may try once more to challenge the constitutionality of the Act. Meanwhile the general effect on the capital market is certainly discouraging.

25. There can be no really substantial return of prosperity without a revival in the capital market. With the improvement in profits and, to some extent, in the relations between capital and labour, it might seem as if it were time for the position to loosen. But there are still too many uncertainties to permit a real advance. Though the question "war or peace?" is now resolved, the war has hardly begun and no one knows what kind of a war it will be or how business will be affected, especially in the long run. While a Republican victory in the 1940 elections would, justifiably or not, give a strong stimulus to business,

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the re-election of Mr. Roosevelt and a Democratic majority in the House would probably presage new labour demands and fresh Government pressure on business - even though these would probably be on a smaller scale than after the last two elections. The breach between the old business methods and the new ideas of social justice is no doubt healing but is yet far from healed. It will be difficult to take any real stock of the situation until the 1940 elections are over.

(Sgd.) G.H.S. PINSENT.

BRITISH EMBASSY,
WASHINGTON, D.C.
7th March 1940.