ADDRESS BEFORE THE NEW JERSEY BANKERS ASSOCIATION CONVENTION IN ATLANTIC CITY, MAY 13, 1938

BY

MARRINER S. ECCLES
CHAIRMAN OF THE BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Not to be released until 4:00 p.m. E.S.T.

Friday, May 13, 1938.

THE CURRENT BUSINESS AND ECONOMIC OUTLOOK

Before reviewing what seem to me to be the principal developments leading up to the present depression and what can be and is being done about it, I should like to make a statement of general principles as a broad background of this discussion.

Deficit-spending on the part of government should be undertaken in a recession to compensate for the liquidation of private debt and declining private expenditures. Conversely, the paying down of public debt offers a means of compensating for too rapid an expansion of private debt and expenditures. However, at a time when national income has attained a high level and is rapidly increasing, there should be an increase in taxes on an equitable broad basis, not only for the purpose of reducing the public debt if private credit is expanding rapidly, but also in order to provide for necessary social services. This would be desirable not merely on humanitarian grounds but it would also be economically sound as a means of maintaining a balance between savings and investment on the one hand and consumption on the other. By thus keeping up consumption at a sufficient level to absorb production, protection would be afforded to existing investment and encouragement given to new investment. Such a policy of maintaining a large volume of government expenditure, on the basis of a balanced budget and through a broad tax base, has been successfully pursued in England and some of the other democratic countries.

Since 1933 the government has taken action on many fronts to meet the maladjustments and problems created by the disastrous deflation after 1929. The steps taken by the government were largely enforced by the necessity for meeting intolerable economic and social conditions. During this period the public debt was increased by about $16 billions gross. This increase was far less in the aggregate than the contraction of private debt had been and was necessary to fill in part the gap created by deflation and to restore to solvency on a national scale the country's business, which was insolvent.

Deficit-spending by the government for the restoration of activity was a major influence in increasing national income from less than $40 billions in 1932 to approximately $70 billions in 1937. In other words, the additional national income in this one year, 1937, as compared with 1932, was nearly twice as large as the total increase in the national debt over a period of four years. In view of this record, what becomes of the claim that this expenditure of public money was wasted or that the program of deficit-spending was a failure?

The increase in the government debt was brought about at a constantly decreasing interest cost due, in part, of course, to the excess reserves which accumulated in the banking system largely through the importation of foreign capital as reflected in gold imports. In fact, for the nation as a whole, the burden of debt was lightened, despite the increase in government debt. From 1932 to 1936, inclusive, net interest payments for the entire country, as reported in the national income estimates of the Department of Commerce, declined from $4.9 billions to $4.4 billions, or from 12 per cent of the national income to less than 7 per cent. In effecting this program, the government sold its securities to individuals and business corporations which had idle balances, as well as to commercial banks after they had been provided with reserves. Thus the government was able to put to work existing idle funds of individuals and corporations as well as newly created deposits in the banking system. In addition to building up deposits, which had shrunk by nearly 40 per cent due to the deflation, the effect of the government's action was to create business that otherwise would not have been created.

The resultant debt is debt to our own people. The interest being paid on it is being paid to the individuals and to corporations and banks that are the holders of these obligations, and as they are refunded or paid off the proceeds go to our own people and institutions. This interest paid out is an expense of government. It is a charge against all of us, but the payment of this interest returns these funds to the spending and investment stream. Stated otherwise, the operations of the government in borrowing, spending and lending money, not only created new money, but resulted in a more active use of the existing supply by increasing production and distribution of goods and services, which are the only real wealth.

The greatest difficulties in dealing with the problem of deficit-spending and of management of public debt seem to me to be problems of correct timing. Obviously, public debt must not be piled up to a point where unsound inflationary results destroy the very purpose of the policy

I have in mind--which is to manage fiscal and monetary policy, despite the definite limitations of the effects of such policy, so that it has a stabilizing and moderating influence to offset distortions in the functioning of the general economy--distortions and violent swings between booms and depressions that impoverish and demoralize and threaten the very existence of the whole system.

Consider for a moment the importance of proper timing: Even though we had no public debt whatever, deficit-spending could be very inflationary if it came at a time when our economic machine was already working at full capacity. Merely to increase government spending, if offset by increased taxation derived from increased income, would not be inflationary. It is the spending above receipts that brings about an increase both in the supply and velocity of money. Conversely, deficit-spending at a time when private spending is declining, tends to compensate for this by increasing buying power.

The danger in wrong timing is illustrated by our experience since 1929. Although there was an unprecedented contraction in private activity, adequate deficit-spending and lending was delayed for more than three years, during which time deflationary forces gathered so much momentum that it required a far greater amount of money and effort on the part of the government to turn the tide than otherwise would have been necessary.

Then, beginning in 1934 and through 1935 and up until the end of 1936 we experienced on the whole an orderly recovery. The general average of wholesale prices rose from the depression lows and a reasonably sound relationship of prices was brought about, particularly as between agricultural prices, which had been out of balance during the twenties, and the rest of the price structure.

The year 1936 witnessed the most pronounced forward movement by private capital since 1929. According to estimates of our Division of Research and Statistics, expenditures on durable producers' goods in 1936 had grown to more than \$4½ billions, a gain of \$2½ billions above 1933 levels; similarly, expenditures on consumers' durable goods--houses, automobiles and household goods--amounted to over \$8 billions in 1936, a gain of \$4½ billions above 1933. The volume of domestic corporate security issues in 1936 exceeded \$4½ billions, of which \$1,200,000,000 was for new capital purposes, and commercial bank loans expanded by a billion dollars. In other words, private business expansion was going ahead at a very satisfactory rate, business indexes uniformly reflected a broad recovery, corporate profits in most lines were very largely restored and in some instances even exceeded 1929 levels, despite a smaller volume of business. However, government relief and other expenditures were not reduced and, in addition, between \$1½ and \$2 billions of bonus funds was poured into the spending stream in the last half of 1936. I want to make clear that I am not now talking about the merits of the bonus, but merely the timing of its payment. It might have been very desirable from an economic standpoint had it been paid at the bottom of the depression instead of in the year of greatest recovery. Similarly, the collection of $1 billion of social security taxes in 1937 diminished buying power at the very time an increase in retail sales was most needed. Had it not been for these two measures, national buying power would have increased less in 1936 and more in 1937. As it was, we had a very large concentration of both public and private expenditures in 1936 which gave a pronounced impetus to buying and generated, along with other factors, an inflationary psychology.

It played a large part in stimulating the probably unprecedented wave of inventory buying that took place late in 1936 and during the first quarter of 1937. In the following year, 1937, in sharp contrast there was, of course, no bonus payment and, as I have said, in that year the government began collecting social security taxes taken largely out of consumer buying power. The amount the government contributed to the spending stream declined by $3 billions in a single year. In the first nine months of the current fiscal year cash receipts of the federal government actually exceeded cash expenditures by $100 millions.

This drastic reversal could have been offset only by a compensating private expansion. Yet where could we look for that? The three major depressed fields, where depression had struck the hardest, where unemployment was greatest, where deferred maintenance and needed expansion were greatest, were housing and construction above all others, and in the railroad and utility industries.

In housing the deficit was so great that we needed to build an estimated 700,000 new units annually for five years in order to make up for the deficiency caused by the depression and take care of current requirements, assuming that we were going to maintain a standard of housing which at best for most of our people would be inadequate measured by reasonable living standards and the capacity of our economy to provide modern housing. Measured by the ability of our people to pay for housing, either through ownership or rent, on the basis of present housing costs and greatly reduced incomes, we may soon even have an excess, although we are not building at present more than 40 per cent of the amount we normally should be building.

These conditions are due to the fact that beginning in the fall of 1936, basic material prices, hourly wage rates and contractors' margins in the building trades rose sharply to what proved to be prohibitive levels so far as mass buying power was concerned. Instead of a continuation of building activity which had begun to revive in 1935, the revival was checked in the spring of 1937. Accordingly, there was no increase in activity and expenditure in this most important of all fields to offset the decline in the government's contribution.

As for railroads, the Class I roads showed net earnings of $165 millions in 1936. Programs were under way, as fast as earnings and ability to finance them made it possible, for the purchase of greatly needed new equipment and to meet the large amount of deferred maintenance resulting from the depression years. At this juncture, however, wage increases effective in the last half of 1937 amounted to $130 millions while $70 millions more were required to meet increased social security taxes, or combined additional costs of $200 millions. Under these circumstances, the railroads, lacking sufficient earnings and in many instances unable to obtain new credit, were forced to a curtailment in their capital outlays for equipment and deferred maintenance.

In the private utility field there was a prospect for a considerable investment of private capital on replacement, modernization and extension, but it could not be expected that private funds would readily flow into this field so long as uncertainty prevailed as to the legal and financial status of the industry. Public expenditures in this field did not nearly compensate for the absence of private expenditure.

As I have attempted to show, the transition from large deficit-spending to no deficit-spending was not successfully completed due primarily to the fact that private capital did not expand sufficiently in the three great fields enumerated. It is evident that a condition favorable for expansion of private investment must be created or public spending and investment must be continued. Otherwise, depression is inevitable.

The combination of forces beginning late in 1936 led to a wave of inventory buying that probably has never been exceeded in so short a period. Business and banking leaders and organizations very generally were anticipating and some were predicting an inflationary development, even though warned by government that an inflation could and would be controlled. The predictions of inflation, the sharply rising prices of basic materials, widespread labor troubles, foreign demand for war materials, the policy of many lines of industry of advancing prices, all combined to generate forward buying which was not geared to current consumption or consumer buying power. For a period of five months wholesale prices of durable goods, which had been virtually stationary since the end of 1933, rose at the rate of 24 per cent per annum. Between October of 1936 and May of 1937 average hourly earnings in manufacturing rose 13 per cent. Between September and April the index of machine tool orders rose from 118 to 282. A survey by Dun & Bradstreet of 17,000 firms indicates that inventories of manufacturing and merchandising companies increased by $2 billions in 1936 and $3 billions in 1937.

The profits of many industries were larger than they had ever been, yet prices were advanced and it was only natural that under such circumstances labor should seek to obtain a larger share in the rising profits. In some cases industry increased prices far more than enough to offset increased wages, or increased wages in the hope of avoiding labor organization in their plants.

Incomes of the great mass of the consuming public did not keep pace and were, therefore, not sufficient to buy housing and other products of industry that had rapidly advanced in price.

The responsibility for these developments must be widely shared by business, organized labor and government. Business capitalized on a sellers' market, and in many instances, advanced prices more than was justified by increasing costs. Organized labor, in many cases, sought to increase wages and decrease hours faster than efficiency, and this resulted in rising unit costs. The rapid decrease in net government expenditures was unstabilizing. In addition, the announcement of the British rearmament program and the emergence of inflation propaganda also contributed to the excessive forward commitments by business.

While the Board of Governors of the Federal Reserve System raised reserve requirements in the summer of 1936 and again in the early part of 1937, the Board took pains to emphasize that the System's policy of monetary ease would be maintained. In March, 1937, in order to refute the contention by some banking leaders that the way to meet the situation was to tighten money, I issued a public statement in which I said:

> "I do not believe that sharp price rises in certain basic commodities should be controlled at this stage of the recovery by a restrictive money policy * * *. The price rises to which I refer are the result primarily of non-monetary factors including foreign armament demands, strikes and monopolistic practices by certain groups both in industry and organized labor. These conditions have in turn led to speculative security and commodity buying which serves to accelerate the price advances."

As for the effects of wage and price policies, I said:

"Increased wages and shorter hours when they limit or actually reduce production are not at this time in the interest of the public in general or in the real interest of the workers themselves. When wage increases are passed along to the public, and particularly when industries take advantage of any existing situation to increase prices far beyond increased labor costs, such action is short-sighted and indefensible policy from every standpoint.

"Wage increases and shorter hours are justified and wholly desirable when they result from increasing production per capita and represent a better distribution of the profits of industry. When they retard and restrict production and cause price inflation, they result in throwing the buying power of the various groups in the entire economy out of balance, working a particular hardship upon agriculture, the unorganized workers, the recipients of fixed incomes and all consumers. The upward spiral of wages and prices into inflationary price levels can be as disastrous as the downward spiral of deflation."

It is unfortunate that the speculative buying continued as long as it did, for the more intensified the unbalanced condition became, the worse the aftermath was bound to be. It was also unfortunate that consumers were encouraged to purchase automobiles and innumerable other products of industry in such volume that installment consumer credit expanded at a much more rapid rate than national income. According to studies of the Russell Sage Foundation, the volume of outstanding consumer credit last year actually got back to the 1929 level. The encouragement thus given was not in the interest of the public, of business, or of labor.

Continued delay on the part of business, banking and labor leadership and upon the part of Congress and government generally, in recognizing the reasons for and the nature of the unbalanced state of the economy only defers a realistic and effective application of basic remedies. The more momentum deflationary forces accumulate, the more the country loses in real wealth because of idle facilities and idle man power, the more the national income shrinks, tax revenues decline, and the more the budget becomes unbalanced because the condition of the budget ultimately depends upon national income.

We have seen by the experience of the past six months, as well as that from 1929 to 1933, that permitting nature to take its course does not solve the problems, but only accentuates them. The longer we wait, the more difficult the problems become. Yet, we hear from some of the leaders in banking and business that we should have a breathing spell; that we should drastically reduce government expenditures in an attempt to balance the budget; that we should repeal the excess profits and undistributed earnings taxes; that we should lift regulations on the stock market and the issuance of securities, and do away with machinery devised for collective bargaining. However, these alleged deterrents were not present before 1929 and did not prevent economic collapse. They were not present between 1929 and 1933 and there was no recovery. They were present when we had a large degree of recovery.

The prospective virtual repeal of the taxes complained of does not appear to have benefited business. On the contrary, business indexes have steadily gone down. I have always advocated exempting small corporations from the undistributed profits tax, and I have favored exempting from this tax all funds applied to new capital expenditure that would create employment. But the outright repeal of the tax at this time can only have the effect of accelerating deflationary forces, because business will not be inclined to pay out the sums thus saved, either in dividends or for plant purposes that would give employment while excess plant capacity exists. Instead, the disposition will be to build up idle bank balances or to pay off debts, both of which are deflationary.

Even assuming that removal of taxes and so-called restrictions on the stock and security markets to be psychologically favorable to business, the basic problems would still remain and will confront this or any other government until they are faced and dealt with effectively.

As for the budget, the only road to a balance is through restoration of national income. For the government to reduce its expenditures radically at the very time that business is doing the same thing could only accentuate and not alleviate deflationary forces. Desirable as it is for the individual or for a business concern to be out of debt, we cannot preserve our system, we cannot have a debtor-creditor economy without creation of either public or private debt as a necessary mechanism of business activity.

I have favored all along and still favor compensatory action by the government and offsetting deficit-spending to counteract deflationary forces and to create a condition for revival of private activity. I see no other practical way to deal with economic forces that, if left altogether alone, disrupt and threaten to destroy our system. Reversion to a laissez faire philosophy under conditions prevailing in the modern world is out of the question and the sooner this is clearly recognized, the sooner banking and business leadership can contribute in a constructive and enlightened way to finding practical solutions for the common problems of democracy.

Since early last fall, when it became evident that we were facing a prolonged decline, I strongly advocated prompt government intervention on a broad scale to deal with the maladjustments and to restore a more balanced condition. At that time I favored a comprehensive program developed along the line of stimulating private activity quickly and directly through special inducements in the housing, utility and railroad fields, and through stepping up expenditures that would tend to maintain consumer purchasing power, which is essential for the revival of business.

The conditions which now confront us have become more acute as time has run on. Our plant capacity, which was more than adequate to meet the requirements of a national income of approximately $70 billions, has become excessive for today's rate of income. Under such circumstances, what inducement is there for industry to expand plant now? What reason do we have to expect a natural upturn quickly?

Inventory accumulations, while reduced, are still large. According to the survey I mentioned previously, the accumulated inventories in manufacturing and merchandising were $5 billions heavier than at the close of 1935. At that time production and sales were increasing. Since last fall they have been declining, and the trend of sales has a lot to do with the business man's attitude toward inventory. To work off billions of dollars of inventories in the face of steadily declining sales is a long, slow and, of course, deflationary process. Money received from consumers is not passed along again in the form of wages, etc., but is used to retire debt or accumulate cash balances. In short, a decline in inventories, while it is taking place, is as deflationary as an expansion of inventories is inflationary.

As national income declines, imports are falling off with a consequent decline of dollar balances and ability of foreign markets to absorb American products. Likewise, foreign travel and immigrant remittances decline as national income goes down, which also has the effect of reducing foreign trade.

Business profits which were larger in 1936 and in 1937 than at any time since the boom of 1928-29 have declined drastically. According to Standard Statistics reports, profits of 367 industrial corporations declined 66 per cent for the first quarter in 1937 as compared with the same quarter a year ago. This inevitably means a slowing up or stoppage of expenditures for maintenance in an effort to conserve existing funds, or to pay off debt, both of which are deflationary.

Due to more abundant crops the agricultural outlook is for lower prices and hence lower incomes. Through 1936 and 1937 the restoration of balanced conditions between agriculture and industry and the revival of farm income tended to prevent the deflation from being more severe than it was. If natural forces are allowed to prevail and agricultural income declines sharply, what prospect is there of a revival of business activity arising from purchasing power in this great section of our consuming public?

Whereas automobile production for 1936 and the first three quarters of 1937 was exceeded only by the peak year of 1929, due in large part to high-pressure salesmanship and a large expansion of installment credit on unusually favorable terms both as to time and down payments, this installment indebtedness is now being reduced on balance, with the consequent result that automobile production this year is not expected to be more than one-half of what it was in 1936 or 1937. This leaves a gap of some $2 billions in expenditures and hence in production and employment.

These are admittedly depressing factors which I have purposely painted in black colors because I am convinced that these are the factors which we must consider and be prepared to remedy without further delay. In the face of these facts, can private business be depended upon to go ahead of its own accord and to solve the social and economic problems thus presented, even though business be assured of an extended breathing spell? I wonder how long it would be before business decided, as it did in 1932, that it was experiencing strangulation and not a breathing spell.

The problems are not self-adjusting unless we are willing to risk a prolonged depression with all its evil train of human misery and social and economic upheaval. In the light of existing conditions, government assuredly would be subject to criticism if it failed to feel a responsibility for undertaking remedial action and failed to assert leadership of which only a government is capable in cooperation with business, labor and agricultural leadership.

Business, labor and agricultural organizations, as well as government, have grave social responsibilities. The responsibility of government is recognized by everyone, but, by and large, I do not believe that the responsibilities to the public of privately organized groups have been either recognized or discharged. I have heard much about cooperation. I have yet to hear of any organized group of industry or of labor proposing to make a serious study as to how their policies and practices may contribute to economic balance. That apparently is regarded as the exclusive responsibility of government and, yet, to complete the picture, the efforts of government to discharge that responsibility are all too frequently condemned and resisted.

In the light of present economic conditions as I have outlined them, would not the government be neglecting its responsibility if it failed to act to counteract the current deflationary forces, pending efforts on the part of government in cooperation with private groups to bring about some of the adjustments necessary to establish a better balanced relationship in the various elements in our economy, so that recovery may go forward again?

The recently announced spending and lending program of the government is modest, if anything, too modest when measured by the need and gravity of the problem. It provides for a continuation of the current levels of WPA, CCC, Farm Security, and public roads expenditures. The only substantial increase is for public works, public housing and the RFC. The efficacy of the program will depend in large part on the speed with which these agencies can get under way, and to the degree to which the ordinary expenditures of the government, including armament, can be speeded up. Every effort must be made to overcome the obstacles to a quick inauguration of public works and public housing. In addition, great reliance must be placed on the degree of stimulation that the RFC can quickly create.

In this latter connection I hope that the opportunity for bringing about increased expenditures in modernizing railroad and utility equipment will not be overlooked. If sufficiently favorable terms and conditions are offered for a limited period by the RFC, I see no reason why hundreds of millions of dollars worth of needed new equipment and deferred maintenance should not be contracted for without delay. This would put a large number of men back to work and relieve the pressure on relief agencies. It would reach into heavy industries where the situation is the most depressed. Modern equipment is badly needed and as recovery proceeds great shortages will exist. Therefore, the time when its construction should be done is now when it will do the most good. If we wait for a recovery and a restoration of earning power, very likely there will be a combined rush to buy needed equipment at the same time, with a resultant driving up of costs and prices and creation of bottlenecks, both with reference to labor and productive facilities.

It would also help to bring about a constructive adjustment if the added wage costs imposed on the railroads in 1937 were to be suspended until such time as railroad traffic will justify them.

I feel strongly that in a time like the present, when the government is committed to a policy of restoring national income and employment, a government agency, free from demand liabilities, can safely make loans on terms and conditions that private lenders could not make because they are necessarily more concerned with immediate prospects and liquidity considerations.

The stimulus to utility construction would be more effective if the relations of government to the industry could be definitely determined. Personally, I believe that public funds should not be used in any way to subsidize public competition with private industry, if this can possibly be avoided without detriment to the general public interest.

The output of electric power in this country in 1937 was 27 per cent over the output in 1929. The comparable figures for Great Britain are 84 per cent, for Sweden 61 per cent, and for practically all of other important countries, except France, substantially more than the United States. This is a rough indication of the extent to which the depression set the utilities back in their growth. While all of this lag cannot be made up, a large portion can be and this will entail the necessity of billions of dollars of new construction in the future. To the extent that some of these future requirements can be anticipated now through the offer of very favorable financing terms, a major contribution toward greater economic stability both now and in the future will have been made.

Although I believe that our present economic difficulties are not monetary, nevertheless the recent monetary measures taken in conjunction with the government's program may be helpful and certainly will remove all possibility of doubt, where doubt did exist, as to the adequacy of banking resources to finance, on a most favorable basis, any public or private credit requirements. Desterilization of $1,400,000,000 of gold not only provides additional bank reserves as the proceeds are spent, but by putting this unused gold to work, reduces the required new government financing by this amount.

So much for the spending and lending program. How soon it will be effective and its ultimate magnitude depend on the rapidity with which the necessary adjustments I mentioned earlier will be made. Thus in housing, while the recent amendments to the Federal Housing Act are definitely helpful, further progress to reduce building costs is urgently needed. We are still in the position where many of the building trades unions have high hourly rates, on paper, but no jobs, and manufacturers of materials have high prices, but no orders. Action is still called for to readjust the out-of-line costs down to a point where people can afford to build houses.

Certain other prices and costs, particularly in the durable heavy goods field, are still at their 1937 peak levels and are standing in the way of increased sales and production. Reductions here would be helpful. Wholesale prices of durable goods have fallen only 3 per cent since last March, while farm prices have dropped 36 per cent. In other industrial fields, where competition is severe, and in agriculture, efforts must be made to prevent the continuation of a further deflationary spiral. For this reason I favor putting a bottom under certain wages and prices by the establishment of minimum wages. In agriculture, to prevent a cumulative deflationary process, I favor the policy of benefit payments and of putting a bottom under those farm prices, through commodity credit loans, where world markets determine the price.

By correcting, on the one hand, the unbalanced cost and price situation that has developed and, on the other hand, by increasing consumer buying power, I am confident that our difficulties could be solved and that we could recover the ground lost in recent months. If balance can be regained only through government deficit-spending and lending, our progress will be slower and the cost in dollars and in unemployment will be greater.

Banks can assist in restoring prosperity by affording every possible constructive aid to the revival of sound private financing, and in adapting the lending functions of the banking system to present-day conditions. Federal and state bank examination policies, as well as the Comptroller's regulation governing investment policy, need to be brought into conformity with changed conditions and modern requirements of business and industry. Bankers cannot justly be held responsible for such restrictive governmental banking policies as confuse soundness with liquidity or true worth with current depressed market values. I favor modernization of these practices and regulations, to encourage the bankers to meet changed credit conditions and needs within their own communities, and thus to discourage the alternative which is multiplication of governmental agencies set up to provide credit accommodation that the banking community could and should in normal times be adapted to extend to the public. That accords with my fundamental view that the responsibility of government banking and monetary agencies is to assist the banks to function in the most efficient way to serve the public interest.

I have covered a great deal of ground but I am convinced that a diagnosis of our economic ills cannot be sound unless it takes account of all of the principal lines of governmental and private activity. All parts of the economic organism react on each other and only by united action, under the leadership of government, with the support of the organizations of business, finance, labor and agriculture, can recovery be assured.