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MEMORANDUM ON CONFIDENCE

The business and banking groups are practically unanimous in their explanation of the present hesitancy in business activity. It is "lack of confidence". It is said that "If the President should declare that the budget will be balanced by July 1, 1935, and that the dollar will be stabilized immediately at its present value and definitely pegged at this figure, business confidence will immediately start the wheels of industry humming". It is proposed in this memorandum to inquire into (a) the concept of confidence, (b) into means of restoring confidence.

Why are business men not making larger commitments for plant and equipment? Why are individuals and corporations not building more houses, apartments, hotels and office buildings? Why are municipalities not spending more on public works? The business men and bankers have the same answer in each case, — lack of confidence. But the question immediately presents itself, lack of confidence in what? Is it not really in the case of business men and individuals, lack of confidence that increased investment will prove profitable? If, in other words, the costs of building and operation were less than the probable returns from a building, would speculative builders refuse to build? Would a manufacturer refuse to extend his plant or equipment if he saw a likelihood that orders on a profitable basis would overtax his present capacity? Would a municipality hesitate to extend its public buildings if the incomes and property values of its residents were rising?

We see, therefore, that lack of confidence means the absence of belief that new investment will prove profitable. The question then becomes, why not? The proximate answer is in almost every case the existence of unused productive capacity. While existing plant will be used if anything at all can be earned on it, new capital will be invested only if it is expected to earn more than the going rate of interest on new borrowings. Only two industries in 1933 suffered from a shortage of productive equipment -- Breweries and Distilleries and gold mining. In both cases capital was invested in new equipment.

The absence of residential construction, on which in the years 1923 - 1928 some three billion dollars was spent annually, requires a special explanation. The excess capacity in housing is low relatively to that in office buildings and factories and yet there has been virtually no pick up in this field. The answer is again simply. The decline in peoples' incomes has brought about a decline in rents. Building costs, however, are almost as high as they were in 1929. This is due to (a) the maintenance of wages in the building trade and (b) the increase in the cost of building materials resulting from the NRA and (c) the high cost and difficulty of obtaining mortgage money. Consequently, in the great majority of cases, it is cheaper to rent or buy than to build. This condition will continue to prevail until either rents rise or costs fall.

To return to the question of confidence. It might be said that

although in practically all industries it is not economical to provide new equipment to meet existing demands, still it would be profitable to build now if there was assurance that in say two years such new facilities could be used to capacity. It is said that this assurance will be lacking as long as (a) the price of gold in dollars is not permanently fixed and (b) the Federal budget is unbalanced. If "uncertainty" on these points were removed construction and equipment buying of all kinds would get under way.

This argument may be met in two ways. In the first place we may question the reality of the economic motivation implied. Secondly, we may follow out the economic consequences of the adoption of these two measures regardless of their immediate effects on business attitudes.

Conservatives are opposed to both the present character of our gold standard and to the unbalanced budget for the same reason, — the possibility of "inflation" under such conditions. Inflation is used in many senses but it appears to connote generally among business men and bankers the condition of rapidly increasing demands for goods of all kinds culminating in their rapid rise of prices. A full gold standard and a balanced budget would lessen the possibility of such a rise in prices, and would make far greater certainty that the present level of prices and costs would persist. It is difficult to see why the less likelihood there is of rising prices, the more eager industrialists will be to extend plant. Yet this is what in effect the people who advocate the above proposals are maintaining. Certainly, an unquestioned gold standard and a budgetary surplus in

1929-30 did not prevent a decline in business and a gold standard and serious efforts on the part of the Administration to balance the budget in 1931-32 did not prevent a further decline in business.

Let us now consider the direct possible economic effects of fixing the gold price permanently and balancing the budget.

Suppose that we fix the price of gold permanently and that then most of the other countries devalue at such points as to afford them favorable balances of payments with the United States. We would lose gold. It is true that at present we possess such large stocks of gold, that we could lose an enormous amount before we would have to restrict bank reserves. It cannot, however, be doubted that the financial and business community would interpret a heavy loss of gold bearishly. Secondly, it cannot be doubted that a rapid and considerable fall in foreign exchanges would effect adversely the prices of some of our big export crops. This, in turn, would mean inventory losses, curtailment of incomes for large sectors of the community and a generally depressing psychological effect. By refusing to commit ourselves finally on the price of gold before other countries have done so we lessen the possibility of such eventualities occurring. It is significant in this respect that England has not even committed herself to the extent that we have.

Balancing the budget requires either a curtailment of expenditures or an increase in taxes, or both. Governmental expenditures are also individual incomes. A contraction of expenditures, therefore, means, other things being equal, a contraction of incomes with a probable

contraction of the demand for goods, which in turn involves further contraction of incomes. With each decline in incomes the ability to pay taxes and the yield of taxes at given rates decline. An increase in taxes, in so far as taxes are paid out of current income, has a tendency to decrease current expenditures. This results in increased unemployment, business losses and decreased ability to pay taxes. People who advocate a balanced budget as a recovery measure are gambling that a certain reduction in monetary incomes will be more than offset by the increase in incomes which will result from the increased spending of business men and individuals which will follow an increased certainty that prices will not rise. The Administration can hardly be blamed for refusing to take part in such a gamble.

In the writer's opinion the real deterrents to building are to be found in the existence of unutilized capacity and the gap between costs and rents in the residential housing field. The only effective way to decrease unutilized productive capacity is to bring about a large increase in the demand for goods of all kinds. Should consumers income and expenditures increase considerably, more and more industries will be able to approach capacity production and adding to plant would again become profitable. Similarly, if incomes increased, the demand for housing accommodation would increase, rents would rise and it would again becomes profitable to build.

Federal expenditures in the form of relief cannot increase

income sufficiently above the present level to lead to an increased demand for goods sufficient to result in new buildings. The average payment per family is around \$20 per month. Relief expenditures merely tend to prevent the demand for goods from falling below present levels. We might drift along for years at the present level while supporting seventeen million at a bare minimum of subsistence.

Increased expenditures on durable goods not only increase the demand for the products of industries in which the bulk of unemployment occurs, but also actually increase incomes. Hence, from the standpoint of recovery, Federal expenditures which result in an increase in construction are far superior to expenditures for relief.