

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEMOffice CorrespondenceDate January 26, 1939.To Chairman EcclesSubject: Treasury chartFrom Lauchlin Currie*LC*

Attached are some comments I prepared at the request of Mr. White on the accompanying chart. The chart was presented by Mr. Haas.

THE TREASURY CHART AND THE DOWNTURN IN 1937

The chart conveys the impression that the increase in reserve requirements in 1937 was responsible for the downturn in business activity and that the decline in the "net cash deficit" was not an important factor as it began fifteen months before business turned down.

Judging from the series presented, as well as those omitted, the line of reasoning appears to be as follows:

1. The rise in reserve requirements led to sales of Government securities and a fall in bond prices.
2. This, either through undermining confidence or through a decline in new security issues, led to a fall in new orders.
3. After a time the decline in new orders was reflected in a decline in business activity.
4. All other factors that could have affected business activity are assumed not to have been sufficiently important to be charted.

These successive steps in the line of reasoning will be examined in turn:

1. It may, in the first place, be conceded that the rise in reserve requirements in the spring of 1937 (together with the gold sterilization policy) had something to do with the weakness in bond prices, although the evidence is by no means clear. It is worth noting

that the substantial cut in excess reserves in 1936 passed with hardly a ripple in the bond market. Bond prices fell sooner and further in England than here. Again, the peak of bond prices here was reached in early December although the announcement of the proposed increase in reserve requirements was not made until January 30th. It appears, in other words, a moot question whether a reaction in the long sustained bull market in bonds would not have taken place regardless of monetary action, although monetary action, and the failure to support to bond market in March through open market purchases, doubtless intensified the reaction.

2. The next important step in the chain of causation, judging from the chart, is the connection between the fall in bond prices and the decline in new orders. Such a connection might either be a direct psychological one, or through the new issue market and capital expenditures.

Considering the time that must elapse between capital issues and actual expenditures, one could hardly expect an instantaneous reaction on new orders from this source. In any case, the volume of new corporate issues in the first six months of 1937 was nearly double the volume in the first six months of 1936. Expenditures by railroads and utilities on new plant and equipment for 1937 as a whole increased 66 percent over 1936, whereas the rate of increase of 1936 over 1935 was only 51 percent. Expenditures by mining and manufacturing for new plant and equipment, despite the bad last quarter, increased 36 percent over 1936, which was the rate of increase of 1936 over 1935.

As for the direct psychological reaction, one would expect this, if at all, either to follow immediately upon the announcement of the new reserve requirements, or upon the fall in bond prices. Actually the peak of new orders, as shown on the chart, occurred two months after the announcement of the new reserve requirements and contemporaneously with the fall in bond prices in March. Machine tool orders reached their peak in April. It is difficult to establish any reasonable connection between the course of bond yields and new orders.

No attempt was made in this chart to relate the trend of new orders to more obviously related factors. For example, how much of the bulge in steel orders was attributable to orders placed before higher prices became effective? How many orders were placed because of threats of delayed delivery because of strikes? Was the level of orders attained in March 1937 in line with current consumption? We know, from the evidence of the excessively rapid increase in inventories at that time, that new orders were far in excess of current consumption. Consequently they were due for a sharp decline, and could only have been sustained at the March level at the expense of an increasingly unbalanced economic structure.

3. The next implication of the chart is that the decline in new orders was the causal factor resulting in the later decline in business activity. To establish such a connection would require a careful and extended study of many factors bearing upon the level

and trend of orders in relation to the level and trend of production, consumption and inventories, which has not been done here. Actually, it can be established that the level of new orders in the early part of 1937 was far in excess of current consumption and indeed, in many places, in excess of productive capacity. A decline was inevitable. Whether or not such a decline would later result in a business recession, however, depended upon the course of incomes and consumption. If consumption had increased, and if production was in line with consumption, new orders would have come in as the backlog of old orders was being exhausted. This point leads to --

4. The final implication of the chart is that all factors other than those shown on the chart that could affect business activity remained neutral in their effect. Two exceedingly important series that are omitted are consumption and inventories. These are shown in an accompanying chart. They bring out clearly the highly unbalanced and unstable conditions that were developing in 1937. It is impossible to conceive of production continuing to increase in the face of falling consumption and rapidly increasing inventories. Obviously, any explanation of the downturn in 1937 must be related to the movements of these series and it is difficult to see how the decline in bond prices in March, 1937, can be related either to the excessive accumulation of inventories or to the downward trend of consumption in the first three quarters of 1937.

Changes in certain budget items, on the other hand, have an immediate and obvious effect on consumption. A decline in W. P. A. expenditures decreases buying power through decreasing incomes, an increase in payroll taxes decreases buying power either directly or indirectly through the medium of higher prices not compensated by higher incomes. Both these forces were at work in 1937. During the first six months of 1937 state and federal payroll taxes were accruing at a monthly rate \$60 million higher than in the last six months of 1936. W. P. A. expenditures fell from \$191 million in December 1936 to \$144 million in June and \$100 million in September. In addition, income taxes, part of which would have otherwise gone into consumption, averaged \$87 million a month more in 1937 than in 1936.

These were the main factors in the fall in the "net cash deficit", as shown in the Treasury chart, from an average monthly figure of \$300 million in the last quarter of 1936 to an average monthly figure of \$40 million in the first quarter of 1937. The drastic nature of the reduction is obscured on the Treasury chart by the elongated horizontal scale and the compressed vertical scale. The effect of varying the scales is illustrated in the accompanying chart. Moreover, this particular series tends to exaggerate the contribution to buying power in the middle of 1936 by including all the bonus bonds cashed, whereas we know from other sources that a substantial portion of the proceeds of such bonds was used not for the purchase of goods but for the liquidation of debt.

Conclusion

There appears to be a lack both of factual evidence and of theory to support the implication of the chart that raising reserve requirements played a significant role in the downturn of business. The failure of consumption to continue its advance was the most important single factor and this in turn was associated with certain drastic changes in federal taxes and expenditures, in the downturn in residential construction that followed upon rapid cost advances, and in the dependence of the growth in income, in too large part, on the growth of inventories. In order for consumption to have gone ahead throughout the first three quarters of 1937 either private capital expenditures or the government contribution would have had to be considerably larger than was actually the case.

EXCESS RESERVES, BOND YIELDS, NEW ORDERS, PRODUCTION AND NET CASH DEFICIT



* WEEKLY † MONTHLY (NET CASH DEFICIT IS THREE MONTH AVERAGE, CENTERED)

Index of New Orders Confidential



Consumption
1929 = 100

PRODUCTION AND CONSUMPTION OF CONSUMER GOODS AND INVENTORIES

Inventories
Billions of
1929 dollars

