

October 30, 1937

The situation

After two and one-half years of steady improvement business conditions flattened out in the first half of this year and have definitely turned down since last August. The decline is widespread. In steel, for example, which was operated at 92 percent of capacity in the spring, there has been a precipitous drop to 56 percent of capacity at the present time. Activity in the textile and shoe industries has also declined sharply. Prices of staple commodities have had a severe drop. Building activity, which had begun to show signs of recovery from an extremely low level, has ceased its advance. The market for new securities to finance plant ~~exp~~^{an} expansion has become demoralized and practically dried up. Security prices have had the worst drop since 1932.

It is impossible to predict whether this decline in business is temporary or whether it will develop into a major recession or depression. The opinion is currently held by many business men that the decline is going to be sharp and prolonged. This attitude in itself is a contributing factor working towards a continued decline.

The Government cannot afford to permit this decline to continue. The Administration has accomplished a great deal in bringing this country out of a depression and the development of a new depression before the damages of the old have been fully repaired would have disastrous consequences. When a depression gets under way it feeds upon itself. It is much easier, more effective, and less costly to take action in time to prevent a serious recession rather than to attempt to reverse the trend after a deflationary movement has gotten under way.

The causes - not monetary

In order to determine the proper course of action, it is essential to analyze the conditions that have brought about the present recession. It is evident that these conditions are non-monetary in character. The banks of the country have a large supply of funds available for further expansion of credit. Interest rates are at record low levels. The volume of deposits in the banks available for current operations and investment is as large as it has ever been. With the proper impetus to business there is nothing in the financial situation of the country to interfere with the progress of recovery. On the contrary, monetary conditions continue to be a highly encouraging factor in the situation.

Nor can the recession be attributable to Government regulation of the stock market. High margins established by the Board of Governors have contributed to the market's resistance to a sharp decline. Now that prices have reached a lower level the reduction in the margins by the Board offers additional encouragement to stability. Neither have regulations by the Securities and Exchange Commission been an important influence in holding up the capital market. These regulations have done a great deal more good by protecting investors and giving them assurance against manipulation and misrepresentation than they have done harm by imposing some restrictions on the issuance of securities. When prospects for business were good security issues were rapidly increasing, notwithstanding existing regulations. Their present decline is due not to the regulations but principally to the market's appraisal of the business outlook. The drop in security prices is a reflection

of the turn in the business situation, which began several months earlier, rather than its cause. If it continues, however, the drop may aggravate the decline.

Costs

The principal reason for the decline in business activity is in the fact that there has developed a serious maladjustment between production costs on the one hand and prices on the other. In the autumn of 1936 and the early months of 1937 there was a rapid advance in prices due to many circumstances, including large armament demands from abroad. This rise in commodity prices was accompanied by a great increase in labor costs which in turn was a factor in further price advances. Under the stimulus of rising prices and costs there was in the spring a scramble for the purchase of raw materials and for the placing of forward orders. This was done in anticipation of further advances. During the summer and early autumn business activity reflected work on these forward orders, while the volume of new orders began to decline. When the old orders were largely filled business activity decreased sharply.

The industry in which these developments were the most pronounced is building and other construction. A much more rapid rise in the cost of labor and of materials than of rents has made building an unattractive enterprise. A reduced volume of building has been the consequence. During prosperous years the number of dwellings produced per month was as much as 900,000 units. In the depression years this declined to only about 50,000 units. In 1936 the figure advanced to 300,000. Unless the number of dwellings considerably more than doubles from its present

level we cannot have complete recovery, because building and the industries that go into building constitute an enormously important part of the country's economic activity.

In a separate memorandum there is proposed a program for improving conditions in the building industry. These proposals include methods of reducing cost of financing small houses and the encouragement of large scale housing enterprise.

Labor

In order to make these proposals and other undertakings by the Government successful in arresting the business recession, it is essential to make it clear that the Government does not view with favor monopolistic advances in labor costs. Wage advances have occurred for the most part in fields where there is an artificial scarcity of labor of the classes that receive the highest compensation. This is true particularly in building trades and in railroad operation. Increases in the cost of labor and materials for the railroads have been such as to absorb their entire net income in 1938, unless the volume of operation increases, and to bring about a serious deficit if the volume declines. It is necessary for the Administration to make it clear that unwarranted advances in wages are just as harmful to the community as unreasonable profits for employers. Such advances are obtained at the cost of consumers, of the great mass of working men, and of agriculture. They are an important reason for the present disequilibrium and the consequent decline in business. They react unfavorably even on those who are supposed to be beneficiaries of

the advances, because they diminish their opportunity for employment. A labor policy calculated to assure some of the labor groups more adequate annual compensation in return for reductions in their hourly or daily wage should be worked out. Machinery for arbitration of labor disputes must be developed.

Materials

Another element in the high cost of building and of railroad operation is the rapid rise in the cost of materials. Leading producers of materials have made much larger profits in 1936 than at the peak of activity in 1929 and have derived these profits from only about one-half of the volume of operation. A reduction in prices of materials by stimulating the volume of output would not only be beneficial to the country but would benefit the producers themselves because it would result in a larger volume of orders.

Taxes

In the field of taxation certain measures may be undertaken that would tend to improve the situation. The undistributed profits tax, which is sound in principle and should be retained, might be modified so as to encourage plant expansion during the next year. For this purpose a deduction from income subject to the tax may be permitted to the extent that the income is used for plant and equipment expenditures in excess of depreciation allowances. Companies may be permitted to deduct such expenditures made during 1938 from their income subject to the tax in that year and in the two following years. This would encourage plant expansion at this time. It may also be desirable to exempt from the operation of the tax net income up to about \$15,000. This exemption would relieve

a large number of small enterprises with little cost to the Treasury and would have a greatly beneficial psychological effect.

Spending

Finally, the Government should be prepared to continue its expenditures on a basis adequate to meet the relief requirements of the country. Government expenditures in excess of receipts have greatly declined. It may be estimated that they are less by \$2,500,000,000 in the fiscal year 1938 than they were in the fiscal year 1937. This has been due partly to the bonus and partly to the fact that the Government is now collecting a large volume of taxes for social security purposes. Although the budget is technically out of balance by \$700,000,000, the fact is that the Government is actually proposing to take from consumers about \$400,000,000 more than it expends. The difference is represented by funds that are placed in trust, largely for social security. The Government must not decrease its spending at a time when business spending is declining, because that results in a diminution of the national income and leads to depression.

Budget

It is futile to attempt to balance the budget by reducing public expenditures, unless private expenditures fill the gap, because such a course of action results in a decline of the national income, a consequent decline in tax receipts. The budget gets more and more out of balance. This was demonstrated clearly from 1930 to 1932 when every effort was being made to balance the budget and nevertheless large deficits developed.