March 1, 1938.
(E.T.)

Orderly recovery up to end of 1936 when price structure began to get out of balance as industrial prices-wages, especially in building field, rose rapidly. Until then price level had risen from depression lows and wholesale prices had been reasonably stable, with parity restored between agriculture and industry.

Private expenditure began to take hold heavily in 1936; commercial bank loans expanded by $1,000,000,000; securities issued by corporations to obtain new capital, as distinct from refunding issues, amount to $1,200,000,000. At same time, government spending not only was continued in undiminished volume but on top of it came the $2,000,000,000 bonus. Then in 1937 there was no bonus, other government spending was curtailed and the government began to collect social security taxes, coming largely out of purchasing power. The net difference was that the Government in 1937 contributed 3½ billions less to community spending than in 1936. The shock to the economy of this factor alone would be enough by itself to account for a considerable setback. This illustrates the point that government fiscal policy must be more flexible, better timed. Also the experience up to then proves that government-spending for recovery did not fail to catch on. The shift from federal to private spending was in fact being made, and on the basis of budget estimates for the fiscal year ending this June, the budget was balanced, and the costs of the spending were beginning to be recovered out of the restoration of business and national income.

At the end of 1936, however, strong inflationary factors developed, feeding on themselves, including a rush of inventory buying--not for current consumption but to stock up against the fear of higher prices, strikes, interrupted deliveries, etc. Foreign demand for basic materials for armament purposes added to the upward spiral of prices in the industrial field. Labor groups, representing a small minority of the workers of the country, but strategically located, notably in the building trades, took advantage of the opening to advance hourly rates sharply; restrictive measures to limit membership in trade unions, jurisdictional and other practices also interfered with production. All of these factors added to inflationary psychology.

This private expansion, and the large profits which industry and business began to reap, comparable to the boom years of 1928 and 1929, took place despite the taxes which so many business men like to blame for the subsequent downturn, and despite the allegedly too restrictive governmental interference with the stock markets, etc.

Continuance of orderly recovery required restraint upon the inflationary factors, upon maintaining a balanced price level, and upon better timed government withdrawal of spending as private spending increased; the action of reserves and the President's statement tended to put a damper on inflationary psychology. The Government warned against, but could not control the price-wage factors that were throwing the economy out of balance. The President vetoed the bonus, but it was voted over his veto. In other words, the Government foresaw, warned against and tried to stop the unhealthy developments.

In view of the drastic shift in fiscal policy, it would have been necessary to have a counterbalancing expansion in private industry to offset the $3\frac{1}{2}$ billion net withdrawal of government funds from the spending stream. The three fields where expansion might be expected were (1) housing and construction, (2) railroad equipment, and (3) utilities. Automobiles were close to a saturation point and the market was probably oversold in 1936 by high pressure and over-extended credit. In all three fields, special conditions blocked the way. Housing costs rose prohibitively so that potential builders and buyers were discouraged. Both building materials and hourly wages rose sharply and various labor practices tended further to slow up or make production expensive. This despite the great housing shortage accumulated during the depression. In railroads, organized labor obtained wage increases that absorbed a large share of the net earnings, and with prohibitive raw materials prices, the roads stopped orders for new equipment, began curtailing by discharging unorganized workers, with repercussions in the equipment field likewise. In utilities, expansion possibilities probably have been exaggerated, but in any case, the uncertainty as to legal status, and prohibitive costs, were a discouraging factor. Instead of the upturn in these three major fields which was necessary to offset government withdrawal, housing dropped off counter-seasonally, equipment-buying stopped and there was no forward movement in utilities.

In the face of these conditions, it is superficial to ascribe the recession to taxation, market regulation, or lack of money, the supply of which was and continues to be greater than at the peak of the boom, with interest rates at the lowest levels in history. Making full allowance for possible contributory influences of taxation, etc., these are incidents of rather than causes of the downturn.

The backlog of orders kept business running until well into the summer, but new orders did not develop as old ones were filled; deflationary effects began to appear as workers were discharged and buying began to dry up; the effects were felt first on mass purchasing power, and upon farmers. Not so much because of monopoly or conspiracy, as it is generally understood, but by the very nature of business processes, the business man holds his prices, liquidates his inventory. The farmer can't do that. As a result, deflationary forces once underway spread rather than narrow the unbalance between industrial prices and prices affecting the farmers and the unorganized masses who are subject to laissez faire.

If this is the correct diagnosis, what are the remedies? There is no monetary or gold magic to correct the unbalanced condition. The point is not that the wholesale price level, as measured by a price index—a somewhat dubious measure--was too low or too high, but that within the price structure unbalance developed. The longer deflation is allowed to run, the more it will cost in the end to turn it. We should have learned that after '29. We can't balance the budget by reducing government expenditures now any more than we could then. The way to a balance again and to debt reduction is restoration of national income. If both private industry and government reduce spending simultaneously, the result is to accentuate, not alleviate, the unbalance of the budget and the shrinkage of national income. Nor will brickbat throwing, or hunting personal devils, correct the situation. Nor can it be met simply by liquidating regulatory laws, or repealing the capital gains and undistributed profits taxes, though both could well be modified with a view both to equity and to stimulation of private enterprise.

Fundamentally, the choice before the country is either a readjustment downward of the industrial prices that are too high in relation to the rest of the economy, or inflating the rest of the price level up to that point. Time works some readjustment, but deflationary forces tend to aggravate the unbalance rather than correct it. A readjustment of the too-high prices would be preferable. Inflating the low-prices up does not correct the basic troubles or provide a safeguard against a recurrence. The guide to private policy should be simply that neither labor nor business shall force prices up to a point that is beyond the reach of consumers and that thus curtails production. Labor should have larger income and more leisure, but both can come only out of producing more. High prices and no orders are bad for business exactly as high hourly wage rates and no jobs are bad for labor. Both would benefit, as well as the whole economy, by price-wage policies that are in line with mass buying power and that will maintain and expand production.

This is a crucial problem of democracy and capitalism. Either business and labor must impose restraints and pursue policies in the public interest, or government will have no choice except to attempt to enforce policies in the public interest. A do-nothing, hands-off attitude is not possible in a democracy today. If we must look to government intervention, we want neither regimentation nor dictatorship. The former is hopelessly complicated and incompatible with a reasonable freedom of functioning in a capitalist economy; the latter is the negation of free institutions. We can't go back to more laissez faire; to a break-up of industry into small units by trust-busting methods. The problem can't be dodged, nor is it a political problem--it will confront whatever administration is in power.

An economic program on which conservatives could well stand would call for government intervention limited to a functional basis; to acting, through monetary and fiscal powers, as a balance wheel, seeking the objective of greater economic stability by compensatory action. Thus as inflationary conditions develop, the Government should impose restraints; it should balance its budget and pay off federal debt, which is deflationary; conversely, as depression threatens, it should remove restraints, and incur debt if necessary to sustain buying power and encourage business expansion. Such action is functional, affecting the economy as a whole, in contradistinction to price-fixing, which deals with individual situations. Monetary powers alone cannot maintain stability, and while capable of and appropriately used for restraint at a time when material and human resources are being used fully, are incapable alone of inducing expansion. Fiscal powers need to be closely integrated with monetary powers. Thus, taxes should be considered not merely in the light of revenue-raising, but with regard to general economic effects and purposes. The public debt is not comparable to private debt, but the burden in both cases is heavy or light in relation to income.

Proceeding from this general premise, the current recession should not be permitted to continue; it is cheaper to intervene promptly to sustain buying power than to risk further decline of national income and hence of revenue; government held off after 1929 in the hope that natural forces would correct and cure the deflation; we tried that once; the risk should not be taken again; conditions are not comparable; there is no such credit, stock market and real estate inflation to liquidate now; there is no such danger of gold and currency hoarding now; on the other hand, the public debt is larger and government spending has replenished bank deposits until they are at pre-depression levels; also, it is necessary to look into the assumption that if "restrictive" New Deal measures were liquidated there would be a great surge of private capital into productive enterprise; prospects are not comparable now with the '20's, when the wartime housing shortage was so acute that between June, 1920 and June, 1924 rents rose 25%; there was a vast transition of plant from a war to peacetime basis; the number of registered automobiles rose from 12.2 million in 1922 to 26.5 million in 1929, with accompanying expansion of related industry, oil refining, filling stations, etc., and highway construction; electric power production doubled and central power stations increased their plants and equipment from about 4 billion dollars in 1922 to over 10 billions in 1929; there was enough surplus, despite four major tax cuts, to pay down the war-incurred debt by about 10 billions; 10 billions were loaned abroad; there was a vast expansion in office buildings, hotels, skyscrapers, etc., in large cities. Also, population is no longer increasing as in the past when there were great waves of immigration and a higher birth rate.

Making full allowance for needed housing, rail equipment and utilities, the assumption that there would be a spontaneous, large flow of private capital, if "unfettered" by taxes, restrictions, etc., into replacements, expansion and new enterprise, sufficient to absorb most of the unemployment and to recreate "prosperity" appears to be misleading. Is the trouble today that capital lacks "confidence", that it is intimidated by government, that it is hampered by taxes and regulations? Or is not the basic trouble that there are not, relatively, the outlets for long-term investment today compared with the '20's? Aside from housing, which holds out the most promise for employment of private capital and absorption of the unemployed, is there any assurance that capital would flow into automobiles, radio, the oil industry, utilities, offices, hotels, skyscrapers, plant modernizing and expansion, on any such scale as in the '20's? There is no outlet now in foreign loans--and should not be unless we are willing to take payment in goods or gold. The automobile and utility industries hold out no comparable outlets for expansion, apart from replacement. The era of rail expansion is over, though new equipment is needed. There is no such pressure now behind housing and construction as existed in the '20's, despite shortages. Radio and other industry hold out no such promise of utilizing capital and giving employment as in the '20's.

If this be so, the implications are not that the Government should retreat all along the line in the hope of liberating private capital, but that it will in the end have no choice except to maintain taxation and regulation to prevent speculation, and beyond that to channel capital flow into productive fields, and surplus savings into parts of the economy, such as through farm relief, old-age pensions, where buying power needs to be sustained.

Basically today the stoppage is not mechanical or psychological, but due to lack of buying power, either because of prohibitive prices or lack of better distribution of incomes, or both.

Modifying the mechanisms, such as reducing financing costs for housing but without reducing labor, material and other costs; or repeal of the capital gains and undistributed profits taxes, or modifying or repealing so-called restrictions otherwise, might create a temporarily more favorable psychology and induce some private activity, but would neither <u>insure</u> a recovery sufficient to utilize productive resources and man power with a minimum of waste (unemployment), nor correct the basic lack of adequate capital outlets or the unbalanced price structure which is mainly responsible for stopping housing and rail equipment buying.

Instead of government retreat, would it not be the best safeguard for conservatism to advocate expenditures promptly, before conditions deteriorate further, to induce private capital expenditure and to sustain purchasing power? Funds can be raised from the capital markets or from further desterilization, if necessary. There is no budgetary difficulty in the way. Federal credit is sound. Not only is the debt burden relative to national income, but timing of expenditure is more vital than the size of the debt. (Thus the bonus should not have been paid at the time it was, had there been no debt. And to try to economize now is to risk greater costs and larger unbalance of the budget.) Government expenditures now to halt further drying up of buying power, should be with a view to encouraging private expenditures. A dollar of government money that will induce spending of $3 or $4 privately would be good economy in the long run. Government dollars that discourage or displace private expenditure are, by the same token, uneconomic. With this general policy in view, prompt assistance in the form of subsidy affecting primarily heavy and durable goods industries would be sound government policy. This is not pump priming in the sense of spending for raking leaves, but with the specific view to inducing private capital, which is superabundant, into productive fields where it will not flow spontaneously.

(Dr. Currie's comments)

General

Covers too much ground.
Stress inventory buying more -- inevitable aftermath.

p. 2 - last sentence of 1st paragraph -- too bold? (Remember Secretary's November speech with White House approval.)

2d paragraph - see attached sheet of railroad and utility expenditures in '37 over '36.

Railroad equipment buying is normally bunched in late winter and early spring. Employment in r.r. equipment industry maintained until late fall. Maintenance fell after September (not much).

No basis for statement no forward movement in utilities (see charts of durable and non-durable production in 1937 in our chart book).

p. 3 - 1st paragraph - not just a question of unbalance but of rate of movement - inventory buying, etc.

2d paragraph - Not sure that there are alternatives. Would reduction of too high prices be sufficient in itself to do the trick? Think you need spending also.

3d paragraph - Is 2d sentence compatible with 1st para. p. 4?

p. 4 - 2d paragraph - Have these figures been checked? (Auto registration looks too high). Electric power capital expenditure $750-$950 m. pre-depression; with continuance of recovery estimated to need $600-$800 a year.

Not four major tax cuts. Are you sure of $10 b. loaned abroad?

p. 5 - 1st paragraph is a bit strong for the next few years.

last paragraph - see p. 4, 1st paragraph.

p. 6 - 2d sentence from end. Chairman may be called on this. It is pretty specific.

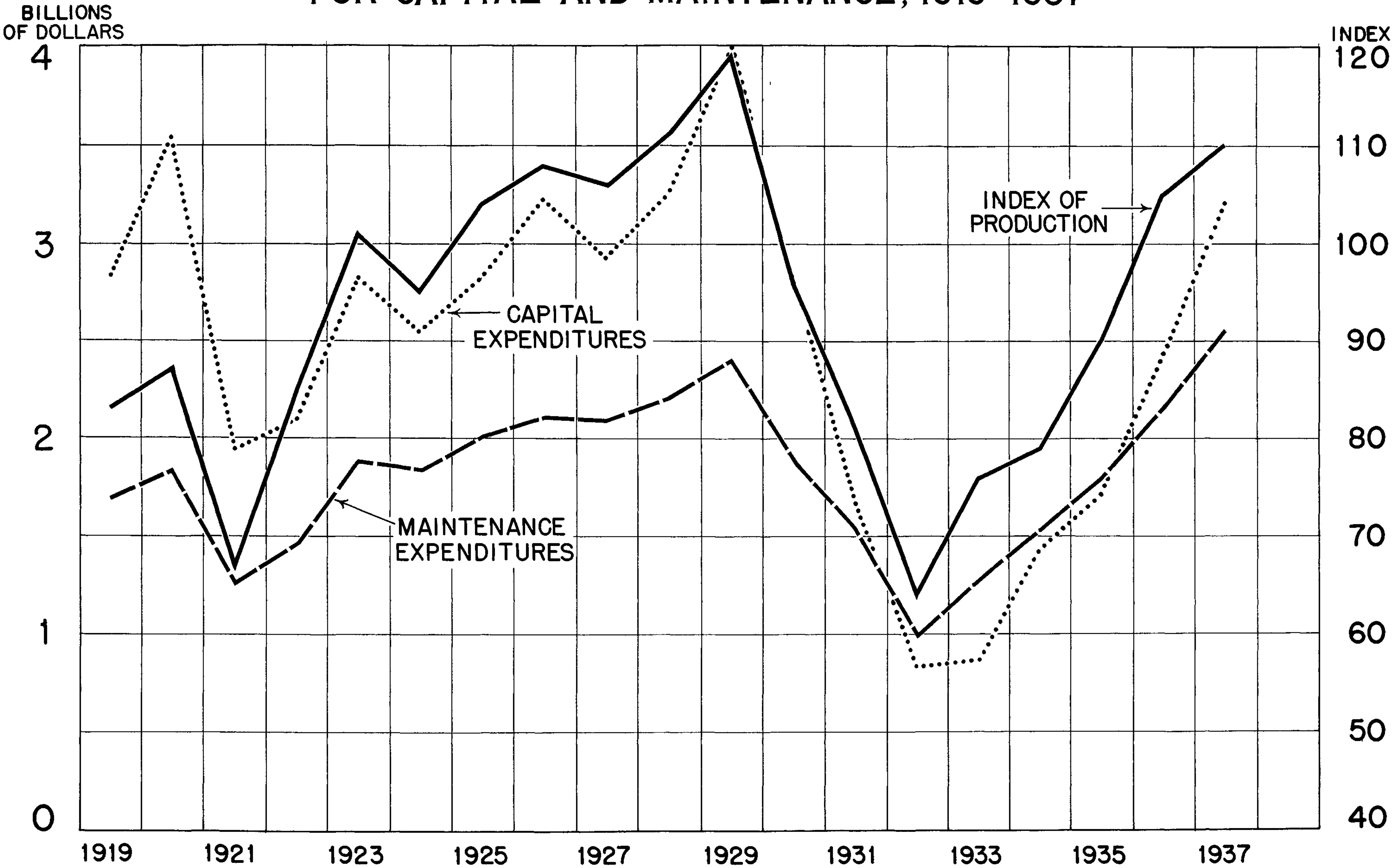
MONEY AND INCOME VELOCITY

(Amounts in millions of dollars; velocity in times per year)

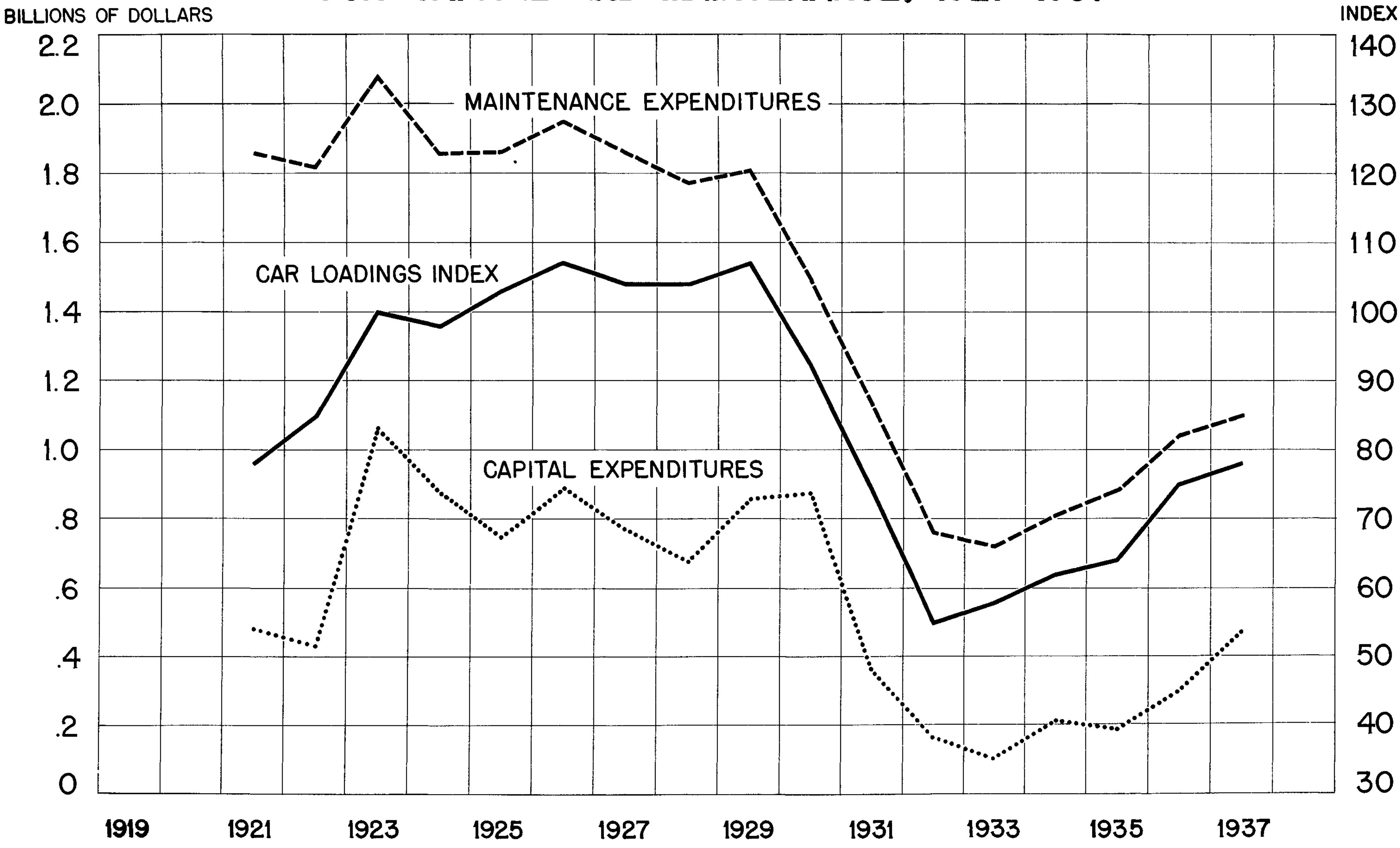
	Money	Income Produced	Income Velocity
		KUZNETS 1/	
1921	21,358	56,488	2.65
1922	21,826	57,355	2.63
1923	23,376	66,788	2.86
1924	23,987	67,370	2.81
1925	25,510	71,792	2.81
1926	26,051	76,207	2.93
1927	26,680	74,036	2.77
1928	26,899	77,271	2.87
1929	27,142	80,484	2.97
1930	26,110	70,664	2.71
1931	24,616	55,769	2.27
1932	20,909	40,622	1.94
1933	20,285	39,636	1.95
1934	23,287	48,700	2.09
		DEPARTMENT OF COMMERCE	
1934	23,287	49,575	2.13
1935	26,537	54,955	2.07
1936	31,442	63,799	2.03
1937	32,303	68,000	2.11

1/ After adjustment for treatment of income produced in government service.

INDUSTRIAL PRODUCTION AND EXPENDITURES FOR CAPITAL AND MAINTENANCE, 1919-1937



FREIGHT-CAR LOADINGS AND RAILROAD EXPENDITURES
FOR CAPITAL AND MAINTENANCE, 1921-1937



EXPENDITURES* ON

(In millions of dollars)

	Producers' Goods						Consumers' Goods		
	Railroads and Utilities			Mining and Manufacturing					
	Total	Capital	Maintenance	Total	Capital	Maintenance	Total	Housing (New)	Passenger Automobiles (New)
1919				4,421	2,831	1,590			1,708
1920				5,376	3,540	1,836	3,272	1,122	2,150
1921	3,513	1,262	2,251	3,197	1,945	1,252	3,314	1,841	1,473
1922	3,768	1,516	2,252	3,564	2,097	1,467	5,157	3,115	2,042
1923	5,152	2,598	2,554	4,709	2,818	1,891	6,872	3,980	2,892
1924	5,004	2,651	2,353	4,369	2,535	1,834	6,784	4,244	2,540
1925	4,803	2,398	2,405	4,822	2,815	2,007	7,845	4,754	3,091
1926	4,988	2,553	2,435	5,324	3,220	2,104	7,621	4,314	3,307
1927	4,863	2,513	2,350	5,008	2,918	2,090	6,663	4,064	2,599
1928	4,631	2,363	2,268	5,456	3,254	2,202	6,845	3,813	3,032
1929	5,166	2,825	2,341	6,390	3,990	2,400	6,014	2,623	3,391
1930	4,858	2,824	2,034	4,725	2,827	1,898	3,488	1,456	2,032
1931	3,342	1,739	1,603	3,195	1,665	1,530	2,423	1,005	1,418
1932	2,073	904	1,169	1,825	826	999	1,078	282	796
1933	1,633	520	1,113	2,138	866	1,272	1,161	204	957
1934	1,924	696	1,228	2,958	1,436	1,522	1,498	214	1,284
1935	2,100	785	1,315	3,505	1,712	1,793	2,451	585	1,866
1936	2,580	1,085	1,495	4,506	2,342	2,164	3,542	1,202	2,340
1937(Prel.)	3,385	1,805	1,580	5,650	3,200	2,450	3,870	1,250	2,~~620~~ 411

*Estimated by George Terborgh

ELECTRIC POWER PRODUCTION AND UTILITY EXPENDITURES FOR CAPITAL AND MAINTENANCE, 1921 TO 1937