

AN ADDRESS
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OF THE
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BY
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FEDERAL RESERVE SYSTEM

It is particularly gratifying to me to have this opportunity today to speak before the American Farm Bureau Federation. Your leaders and members, to a much greater extent than some of the other organized groups in this country, are approaching fundamental economic problems from a broad public-interest standpoint. I feel, therefore, that I can discuss here some of the problems as I see them at this time, knowing that you are interested, as we who are charged with certain monetary responsibilities must be, in finding wherever possible the solutions which will be of the greatest benefit to the nation as a whole.

I do not need to tell you that your daily life and prosperity are dependent on developments in industry and trade, and that the proper functioning of the monetary mechanism is of great concern to you. Accordingly, you will understand why I wish to confine my remarks largely to an interpretation of the present situation in the industrial and monetary field, rather than to attempt to discuss the agricultural problem which you know so much better than I do. I would rather listen to you on that subject.

During the past three years I have lived continuously with the

problem of how to achieve and maintain full and continuous employment of the country's human and material resources. I have been chiefly concerned with the contribution the Federal Government in general and the Federal Reserve System in particular could make to the solution of the problem. As time has passed, I have become increasingly impressed with the danger to our common goal resulting from conflicting policies of different economic groups. Before we can achieve a larger measure of stability we will have to find some way of ensuring that the policies of private business and organizations, whether of farmers, of labor, or of business men, are not in conflict with our common objectives.

From 1934 up to the last quarter of 1936, we had an orderly recovery movement. The steady expansion in consumer incomes and buying power, in considerable part attributable to what the Government spent in excess of what it collected, led to a steady growth in production. The Index of Industrial Production moved gradually upward from 86 in December, 1934, to 110 in October, 1936, while the Index of Payrolls rose 39 percent in the same period. Wholesale commodity prices remained practically unchanged, so that the expansion in the national income from 1934 to 1936 of some \$14 billion represented not merely more money received by our people, but an increase in the amount of goods that they could purchase.

The orderly character of the recovery movement, under which such steady progress had been made, underwent a drastic change in the final

quarter of 1936, and in the six months following October of last year prices began to rise rapidly. It was in this six months' period that the groundwork of the present recession was laid.

Among the factors contributing to the upsurge in costs, prices and inventory buying, were the bonus payments coming on top of already heavy Government expenditures and giving a sharp additional impetus to consumer buying. The organizing campaign of labor, together with the drive for higher wages and shorter hours, added to expectations of higher prices. The rearmament program in various countries contributed to the general inflationary sentiment. A sellers' market developed and widespread advantage was taken of it to increase prices. Various important sectors of industry which had not added to their productive capacity in the preceding years found themselves unable to promise quick delivery, leading to still further piling up of orders and higher prices. The prices of various internationally-controlled raw materials skyrocketed, while bond prices declined.

The longer this condition persisted and the further wage costs and prices advanced, the more severe the inevitable reaction was bound to be. Therefore, before the movement acquired further momentum, the President, on April 2, issued a warning statement. The previous announcement by the Board of Governors of raised reserve requirements for member banks, which I shall discuss in more detail later, tended to diminish the fear or expectation of credit inflation. In any case, a damper was put

on inflationary sentiment. Prices temporarily leveled out. Industrial production, though interrupted here and there by strikes, was broadly maintained. But it was maintained on the basis largely of forward orders and part of the output was piling up in the form of inventories rather than moving forward to consumers.

The backlog of orders which had accumulated in the winter and spring in anticipation of price advances kept business going until well along in the summer. Balance sheets of industrial corporations and mercantile establishments reveal that in the latter part of this summer inventories were in excess of what they were last year while at the same time sales were declining. If sales to consumers had continued to increase, inventories could have been rapidly absorbed. As far as can be judged from available figures, however, consumer buying did not increase after last spring. The income of consumers apparently ceased to expand after May and the volume of their purchases likewise failed to increase.

An important factor in the arrested growth of buying by consumers was the failure of building activity to expand. There was every reason to expect residential building of substantial proportions this year. The national income was running considerably above 1936, rents were rising, and the accumulated housing shortage was growing more acute. As has frequently been pointed out, we should be building an average of some 800,000 housing units a year for five years to make up for the

shortages, to offset demolition and to provide for the normal growth in the number of families.

Yet, instead of increasing, residential building actually turned down in May, and it is doubtful whether the number of units built this year will much exceed 280,000, the number constructed in 1936. The only explanation that can be offered to account for this disappointing showing is the sharp advance in construction costs last spring while rents did not advance as rapidly, so that it became less profitable to build.

Coupled with these developments, there was a decrease in Government expenditures and an increase of tax collections, particularly on social security account. In the first eleven months of this year, the excess of cash expenditures by the Federal Government over cash receipts declined by three billion dollars as compared with the same period last year. Owing to the failure of consumer incomes and buying to increase, industry found that as forward orders were filled there were not enough new orders coming along to keep up the volume of production and thus of employment.

The various factors which I have enumerated were chiefly responsible, in my judgment, for bringing about the current decline of business. Other factors may have been contributory in some degree, but upon careful analysis they appear to be entirely insufficient to account for the recession. The more I have considered other explanations, the more I

have been led to the conclusion that the cost and price advances of last winter and spring were the principal causes of the subsequent downturn.

There are critics who contend that monetary policy has been primarily responsible for the present recession. They think that sterilization of incoming gold by the Treasury and the actions of the Board of Governors of the Federal Reserve System in increasing the reserve requirements of member banks caused a reversal of the upward movement. Upon careful searching of the record, I cannot find convincing evidence to support this analysis. At the time these actions were taken member banks had a volume of reserves that could have become the basis of an inflationary expansion of credit which under the law it was the duty of the Federal Reserve authorities to prevent. At the time final action on reserves was taken the aggregate of bank deposits and of currency in circulation was larger than it had been in 1929. If no action had been taken, excess reserves would by now have been about \$5 billion, sufficient to support an enormous and inflationary increase in deposits.

Even after the excess reserves were reduced, member banks still had enough left to meet all current demands for credit, and money rates remained at exceptionally low levels. In effect, the actions of the Board did not "put on the brakes", as some critics have said, but merely took up a large part of the slack so that the Reserve System was placed in the

position it was intended to occupy in which, as was stated at the time, it would be able to use the traditional and flexible instruments of open-market and rate policy either in the direction of further monetary ease or in the opposite direction as changing conditions and the public interest might require. As a matter of fact, last spring the Board eased conditions through open-market operations and again this fall, in cooperation with the Treasury, further steps were taken in the same direction by desterilization of gold and by subsequent open-market operations. Similarly the Reserve System put into effect last August the lowest discount rates in the history of the System.

If the actions taken last winter had a psychological effect in restraining the inflationary developments which were clearly underway at the time, then these actions were definitely in the public interest. If this be so then my only regret is not that the actions were taken, but that they were not taken earlier.

Another explanation of the recession that has been advanced ascribes it primarily to the undistributed profits and capital gains taxes. There are some who consider this explanation so obvious and so important that they urge the immediate repeal of these taxes or a revision so drastic as effectively to destroy them. I would be the last to contend that these levies are perfectly drafted; but I would urge that changes in these taxes be made only after careful consideration of

such reforms and modifications as would ^{make them more equitable and} improve the working of the mechanism without prematurely abandoning the principles of these taxes.

It should be recalled that the undistributed profits tax was designed to correct evils appearing in the economy of the twenties, as well as in more recent years, such as the avoidance of individual surtaxes in the upper-bracket incomes through non-distribution of profits,

the inequalities in the taxation of incorporated and unincorporated businesses, the piling up of corporate earnings ^{which resulted in greater} for the purpose of effecting monopoly control and the elimination of competition, the ^{concentration of} ^{reduction}

accumulation of large balances that boosted security prices through ^{financing}

^{To} the call money market and that, later on in the depression, were shunted around from place to place and were an important ^{indirect} cause of

numerous bank failures. We must remember that a general liquidation

of debts in the economy or a gradual accumulation of idle reserve funds

could well intensify deflationary forces at this time, whereas, if the

tax were so modified as to exempt earnings which were used for capital

account, the effect would be to increase the use of funds and hence business activity.

It would be well to consider how this tax can be made to function more equitably, particularly with respect to small business.

It would, however, be shortsighted to be stampeded into hasty abandonment of a tax principle which is fundamentally sound and equitable.

Likewise, while I agree that the capital gains tax should be improved, *and made more equitable*, we should remember that this tax is designed simply to make effective the progressive taxation of income in accordance with ability to pay—a course on which I think the American people are soundly determined. There is little convincing reason why the realized income from a rise in property values, including speculative profits, should be dealt with more leniently than the realized income, for instance, from personal earnings. There is little in the history of security prices to indicate that they have fluctuated more widely when this tax was higher than when it was lower. The stock market has gone up and down when the capital gains tax was much smaller and less restrictive, as in 1929, and when the capital gains tax was much larger as in 1936-37. We should also remember that both the undistributed profits tax and the capital gains tax were in force in 1936, when industrial plant and equipment expenditures and general investment were expanding at a rate quite as rapid as could reasonably have been expected. And during the first nine months of this year the volume of industrial plant and equipment expenditures was maintained at a level approximating that of the pre-depression year of 1928. The recession, therefore, cannot logically be ascribed to the curtailment of expenditures because of this tax *to the extent claimed,*

The basic causes of the present situation are not to be found either in the capital gains tax, the undistributed profits tax, or in monetary

policy, but, as I have indicated, in the rapid price and cost advances of last winter and spring. The experience of this past year illustrates again the limitations of monetary and fiscal policy. Fiscal policy, in particular, cannot be quickly adjusted to sudden changes in business activity because such policy depends largely upon prior legislative enactments.

When the disruptive price factors became intensified last spring and proposals were advanced in some quarters to correct the situation through monetary action to tighten money rates, I issued a public statement for the purpose of refuting the notion that monetary action should be invoked to correct such conditions. I pointed to the fact that the price rises were the result primarily of non-monetary factors including foreign armament demands, strikes and monopolistic practices by certain groups both in industry and organized labor and that these factors had led in turn to speculative security and commodity buying which served to accelerate the price advances. I suggested at the time that other means than a restrictive money policy must be used under such conditions to control unwarranted price advances which result in a rise in the cost of living. *for a majority of the people without a commensurate increase in incomes.*

It is, of course, easier to raise problems than it is to solve them. When we review the events leading up to the current recession, it becomes apparent that a basic difficulty in achieving full and continuous utilization of our human and natural resources lies in the con-

flict between immediate private interests and the general welfare. Those groups that contributed to the upsurge in costs and prices last winter and spring were not acting either in the public interest or in their own ultimate interest.

We must recognize the fact that competition has declined and monopoly elements have increased over large sectors of our economy. For example, it could only have been the absence of competition that permitted building costs to soar on the low volume of building that took place last spring. It is only the absence of competition that can explain the maintenance of fixed prices and wage rates when the volume of activity declines sharply. The gradual increase in the non-competitive elements in our economy, so strikingly illustrated in the developments of the past year, raises some highly important questions:

How are we to achieve and maintain full employment if private groups and organizations raise prices and costs whenever increased demand appears? Does this necessitate steady increases in consumer buying power through deficit spending? How long can we pursue such a course? Are we to attempt to return to a truly competitive laissez faire economy? If not, are the alternatives facing organizations of capital and labor either self-government in the public interest or increased regulation in the public interest?

I earnestly hope they will choose the former alternative. So far as a return to laissez faire is concerned, I doubt that this is possible. The development of the industrial process itself has created

Although there are millions of idle men + an abundance of raw materials + idle production facilities

larger units and has brought into being various forms of organization of both capital and labor. Rather than attempt to revert to earlier forms of organization, it seems to me that our best hope lies in developing that form of organization for capital and labor which will best further the public interest. Thought must also be given to the best form of organization that will insure an adequate representation of the public interest involved in price, wage and production policies.

The ultimate self-interest both of capital and of labor is identical with the public interest. I am hopeful that individual business men in strategic positions, and the various local, trade and national associations of business men, will act upon a recognition of the fact that their long-run interests are bound up with the largest possible volume of production at the lowest possible prices. For their own ultimate benefit, as well as in the interests of a stable economy with a steadily rising standard of living, they must resist the temptation to secure larger returns through the adoption of policies that restrict output.

Likewise, I am hopeful that labor policy will increasingly take into account the fact that after a certain point the gains of labor are dependent upon increased productivity. Advances in wages which are in excess of increasing productivity and result in increased prices react against labor itself, as well as against the community at large. If they result in advancing prices, they encourage speculative inventory

buying, or shut off demand, or both, as we have recently seen. If they reduce profits below a point that encourages new investment, they lead to decreased plant, equipment and other capital expenditures. Similarly, general shortening of hours not offset by increases in efficiency is bound to result in a lower standard of living for workers generally. Accordingly, it is to the interest of labor leadership to take into consideration the effect of its policies on the general price level, on the standard of living, and on progress toward as full and as continuous employment as possible of the human and material productive resources of the nation.

We are prone to take for granted a steadily rising standard of living without inquiring too closely into the basis for this belief. Actually there is only one way in which the general standard of living can rise and that is by an increase in the production and consumption of real goods and services per head of the population. This stubborn fact, though incontrovertible, is too often ignored or forgotten. We are inclined to think too much in terms of money incomes and not enough in terms of what the incomes will buy.

In the final analysis, the national income is measured by the total output of goods. If there is less to divide, all groups of the population, including capital, labor, and agriculture, will suffer. The national standard of living will decline.

I have sought to state in the broadest and most fundamental terms

what I believe to be some of the major economic problems raised by our recent experience. These long-range, fundamental problems cannot be solved overnight or without hard and realistic thinking. They must be solved eventually, however, if we are going to be able to realize our enormous productive potentialities and maintain full and efficient employment of all our resources. We are only doomed to disappointment if we place all our faith in monetary management or fiscal policies and ignore the problems raised by the decline in competition and the growth of restrictive policies. The problems to which I refer are not all new and they are not exclusively the problems of any political group. They are the basic problems which must be successfully met if we are to preserve our capitalistic system, and they will confront whatever group may have the responsibility for government.

Although I have been thinking mainly of the basic problems raised by the current recession, much of what I have been saying is applicable to the immediate problem of stopping the contraction and resuming the recovery. Two of the principal causes of the recession were excessive inventory accumulations and the failure of building construction, railroad and utility expenditures to increase sufficiently to offset the decline in the Government's contribution to community buying power. Considerable progress has been made since September in rectifying the inventory situation. Production has declined much more rapidly than consumption.

If consumer demand can be sustained, we may be hopeful that production may soon begin to increase. Local, state and Federal provision for the unemployed ^{can} afford a support to consumer buying power that was lacking prior to 1933.

At the same time, it is highly desirable for business men, both in their own and in the public interest, to review carefully their present and prospective inventory, plant and equipment requirements. Further curtailment of expenditures for these purposes at the present time will mean that many lines of business will be physically unable to meet the orders that will come to them when the recovery movement is resumed.

In addition to measures to sustain buying power and production, we need an impetus that will bring about an actual increase. For this, we must look primarily to the building industry. Building has demonstrated in the past its ability to move against a general downward trend if the relation of costs to rents is favorable for construction. In legislation now pending, the Federal Government proposes to bring about more favorable terms for financing housing both on a small and on a large scale. It has, among other things, taken steps to place the opportunity for acquiring a new home within the reach of people who can afford only a few hundred dollars down payment.

In order for this opportunity to be fully availed of, however, building costs should be lowered to around the levels of 1936. Business and labor organizations connected either directly or indirectly with the building industry can serve their own and the public interest by doing

and must find themselves buying against each other, at advanced prices in order to meet back of supply to expand production

and may find themselves in

what they can to reduce unit costs and in this way increase their aggregate returns. Lower financing costs, and the mechanism proposed in the pending housing bill, for large scale housing production will also contribute to this end. Lower real estate taxes on new construction as well as lower land values would likewise greatly aid the housing program. In the more competitive parts of the building field, costs have already declined substantially.

Fundamental solution of the railroad problem is bound up with increasing traffic. ~~of consolidation elimination of duplicating facilities~~ I trust that the importance of a building revival in this connection will not be lost sight of. I question whether any steps to help the railroads that would have the effect of increasing building costs or reducing farm income would be in the real interest of the railroads or of the general public.

Insert → In conclusion, let me say that in my opinion the extent of the present recession will depend upon how rapidly the more serious maladjustments between prices and buying power are corrected. An adequate treatment of your particular problem of agricultural income must be a ^{major} part of a ^{successful} program of recovery. I feel that the Government in its policy of taxation and spending must adapt itself to changes in the national income created by ^{the action of} private enterprise and, finally, I feel that the monetary authorities should exert their efforts to keep the availability, supply and cost of money at such a level as to encourage continuous expansion

by decreased labor and material costs

of the real income of the nation in goods and services and to prevent or moderate an expansion of monetary income in excess of the nation's productive capacity. I am confident that monetary authorities are prepared to contribute their full share to the end that the nation's economic health may be regained and preserved.