

General comments
on recovery
by HFE - Oct 1934

In an effort to assure a high level of national income in the future the Administration has set up two objectives which seem to me of cardinal importance. The first to which it is committed is the introduction of stable money into our system meaning not that the dollar should necessarily be defined as so many grains of gold and therefore the price of gold in terms of dollars ~~is~~ stabilized, but instead ^{is} stable money is a money whose purchasing and debt-paying power shall not fluctuate violently from year to year or undergo a significant variation over a long period of years. As a corollary to this position it ^{is} was recognized that we have undergone a period of disastrous deflation and in order to establish stable money upon an equitable basis we must have a rise in the general price level. The second objective is to obtain a condition of full employment for all members of our society who are able and willing to work. [The President himself has pointed out that our greatest national loss is the waste of human resources through unemployment and has aptly stated that "But as for this country, I stand or fall by my refusal to accept as a necessary condition of our future a permanent army of unemployed."]

In this survey I will indicate how closely the control of money is related to the volume of production, employment and national income and to outline the policies which if adopted would best realize the objectives stated above. Obviously in a short presentation of this type it will be impossible to support with elaborate demonstration all of the statements and claims made. Many of the subjects discussed are highly controversial, but I think the weight of evidence is accumulating as time proceeds which indicates my approach is correct and I will be glad to offer more detailed analysis to

support the program I advocate.

The Situation With Regard To Production.

In the United States we have tremendous productive facilities and natural resources which are available to create a greatly increased output of goods, but our factories lie idle and unused. Moreover, we have a skilled supply of labor but the members of this labor force are unemployed although they only welcome the opportunity to work and to receive an income to buy the goods which they have proved themselves so willing and anxious to consume. Our society as a whole has solved, to a remarkable degree, the problem of production and continually the fertile brains of our technical staffs are introducing new methods and bringing out new inventions that would improve our industrial processes and equipment so that much larger production can be realized with a smaller outlay of effort.

" Paradoxically enough while men are walking the streets in search of nonexistent jobs we find many observers who tell us that the way out of the depression is by hard work, abstinence and saving, and who seek to deal with the economic problems of today with an analysis which is applicable only to an economy in which all of the factors of production are fully utilized. If our trouble were due to famine, war or scarcity of material and human resources, then the only way ^{in which} that we could expect to increase our national income would be by saving, by hard work and by the development of new techniques of production. But ^{with} conditions as they are, we simply need some kind of a device which will bridge the gap and start the economic system in operation again. After five years of the most devastating depression we have ever known we should be convinced that recovery cannot be accomplished along the lines which the orthodox and conservatives advocate.

The Importance Of Money.

Regardless of what were the initiating causes of the depression, it is indeed hard to over-rate the part played by money on the downswing because the destruction of deposits and the ~~increased saving~~ *failure to use the remaining deposits* by the holders of ~~these~~ *these* deposits which remained are among the most important factors in carrying us into the depths which we find ourselves and it is only a ~~conjecture~~ *view* as to where we might have drifted if vigorous action by the Administration in heading off the almost automatic deflation of bank loans and deposits had not been taken in the period subsequent to March 1933.

This process of deflation as it operates through the banking system has long been recognized and commented on by the more enlightened monetary writers; but business men, bankers, and economists generally have never understood its importance in decreasing the volume of business activity, the amount of employment and the level of national income. This misconception is probably because money has been thought of merely as a medium of exchange to effect transfers of goods and services between producers without realizing that the operation of the money system has a tremendous causal influence upon this production and upon the distribution of wealth and income among the producers of it.

A curtailment of the supply of money would not be disastrous if all prices and costs were curtailed in like amount and if no appreciable time-lag were present. But, to expect this to happen in our economic system, which has developed so many rigidities in its price structure, is not to take a very realistic viewpoint. Many prices *are fixed by law,* [such as railroad rates and prices charged by the various public utility industries] and these move upward and downward very slowly. Real estate and certain other taxes introduce another cost which is not amenable to easy adjustment. Other prices

are set by monopolies or quasi-monopolies and show similar immobility, while others, like interest rates, are set by long term contract and only a default or receivership can change the amounts paid. There are many prices which become customary and these do not vary readily. Wage rates also show a strong resistance to change. Moreover, prices in fields which are dominated by large enterprises, although nominally competitive, are prone to vary slightly in face of changed conditions of demand. Under these conditions a contraction in the supply of money and/or a decrease in its velocity of circulation exert a very disconcerting influence upon business activity and employment. When contraction has gained momentum its influence is felt greatly in fields where market forces permit large and rapid price changes, notably in highly competitive industries in which there are a large number of producers engaged. Thus the purchasing power of such producers is curtailed and their demand for goods and services consequently declines. The industries of relatively rigid prices feel the effects of a smaller demand and meet this situation by curtailing production and cutting costs, which means that men are thrown out of jobs, repairs and replacements deferred, salaries cut, and a general tightening up, with a reduction in their money outlays. The workers thus thrown out of work cannot obtain employment elsewhere when all industries are following a similar process. Thus their demand for all goods and services declines, adversely affecting producers of consumers' goods generally.

As prices continue to fall and incomes continue to shrink the loans and investments of banks become of dubious value and certain weaker banks in striving for liquidity bring pressure upon the whole banking system and the deflation of bank loans and deposits is intensified. Some banks fail and runs are precipitated upon others as depositors begin to question the ability of going institutions to meet their deposit liabilities. All banks, weak and

strong alike, feel the effects of this forced liquidation because in efforts to gain liquidity all banks are losing cash and therefore must either borrow from the Federal Reserve or curtail loans. Borrowing at such a time is considered a sign of weakness and is only resorted to when the security markets become completely demoralized. Government credit is weakened as the banks which normally consider their Government securities the most liquid of all investments start selling them in an effort to gain funds to meet adverse clearing house balances and the demands of their depositors for cash. Thus, the process gains momentum as it proceeds with cumulative adverse effects upon business activity, employment and profits. Incidentally business "confidence" practically vanishes in a period of rapid deflation as business slides through one after another of the so-called "rock bottoms of liquidation". All the time that this process is going on the orthodox are insisting that we are simply undergoing a "healthy" liquidation and this is necessary although painful before a "sound" recovery can take place.

During the early years of the depression while a disastrous type of deflation was almost continuously in evidence we witnessed a Federal Reserve system supposedly entrusted with the responsibility of monetary control watch the wholesale destruction of bank deposits with a complacency that would be ludicrous were not its consequences so serious. Beyond a few poorly-timed open-market operations little was done to relieve the banks or to halt the deflationary process. True the Federal Reserve lowered re-discount rates but these rates are of no significance when there is no incentive at all for the banks to borrow in order to increase reserves to permit an expansion of bank deposits through an increase in bank loans and investments. In these depression years, the only time that banks sought

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accommodations from the Federal Reserve was when they were losing cash through currency being hoarded by a frightened public, or when gold was being exported from the country in large volume. Under these circumstances it would not greatly matter whether rediscount rates were high or low.

The Government then in power took an equally inactive position and outside of a few half-hearted gestures towards stopping the rapid contraction of money and national income let the process proceed unchecked. In fact this Government followed, so far as it could, the philosophy that the orthodox are saying we should adopt today. Every attempt was made to curtail Government expenditures in a futile attempt to balance the budget. The gold standard and "sound" money were maintained regardless of the cost to the country as a whole. Everything was done to bolster up the confidence of the conservatives by assurances that property rights and freedom of private initiative and enterprise would be preserved. [There was no fear of "regimentation" but yet affairs drifted from bad to worse.]

In summary, this deflation of money has placed us in a situation where deposits are about 30% below the levels of the prosperous years of 1928 and 1929. Even more significant is the fact that velocity of circulation of the reduced deposits is approximately 50% less than the average rate of turnover in the years under comparison. Our problem therefore mainly resolves itself into adopting policies which will lead to an increase in both the volume and velocity of our money supplies while avoiding measures which tend to invoke a curtailment of money and to increase the disposition of its owners to keep it idle, because increased prices and increased production and employment can be maintained only if the effective money supplies expand concurrently.

What policies should be adopted now?

In discussing what action should be taken today I do not wish to minimize the steps already taken by the present Administration. Most of them have been justified by experience and unquestionably the situation is materially better than in March 1933. The banks have been strengthened by Government aid, while deposit insurance has built up public confidence so there is no fear of disastrous bank runs in the immediate future. The devaluation of the dollar with the gold profit accruing to the Government assures that no concern need be felt in the remote future that increased volume of business will put pressure against the money reserves. Pressure of immediate credit contraction has been forestalled by the building up of large excess reserves as money has returned from circulation, as gold has been imported, and as the Federal Reserve increased its holdings of Government securities. Thus the monetary policy has successfully relieved any worries that the money system might be prevented from supporting recovery by the difficulties presented by arbitrary legal reserves. Nor, as I will point out later, do we need seriously fear an uncontrollable inflation or in the event of too rapid expansion of the money supply we have adequate methods at our command to control the situation provided they are intelligently applied. Moreover, the Government has provided essential refinancing to a great number of private individuals, business enterprises, and financial institutions and the accommodations and lower rates thus obtained have been highly beneficial. The Housing Act has provided the beginnings for the development of sound home mortgage financing in this country. Other reforms such as minimum wages, abolition of child labor, the Securities Act, and the Stock-exchange legislation have been desirable in providing a sound basis for recovery although in themselves they do not produce it.

To promote rapid recovery however, we must strive to increase employment for it is only by greater production of goods and services that national real income can be increased. I do not believe this can be accomplished through any means except those which increase the total money expenditures of the community as a whole for goods and services. We might have on the one hand a decrease in saving and an increase in the proportion of current income which is spent for goods and services but this is almost impossible for the great mass of the average individuals who obtain their incomes from salaries or wages. On the other hand the available cash funds of corporations or individuals of large means that are now held in vast amount as sterilized balances in banks might be used in such a way as to provide employment of labor and thus find its way into spending, or there might be an increase in the total means of payment through an expansion of bank deposits as the result of increased loans and investments by commercial banks. However, both of these are impossible to obtain if we are to rely on them to spontaneously arise from the normal operations of private business enterprise. Business is unlikely to spend or to borrow either on short or long-term until there appears definite prospects of profits and an increased volume of sales. Only after business activity has started to improve does "confidence" return in spite of all we read in the journals of Wall Street.

Under these conditions the Government is the only agency that can reasonably be expected to make new expenditures of funds that will go directly into the hands of spenders and will move through the economic system through purchases of goods and services, and thereby increase sales, production and national income. In order to augment Federal expenditures in ways that will most directly increase employment both in public and private

enterprises I suggest the following program:

1. The public works appropriation should be substantially increased by, say 2 or 3 billions of dollars. These funds should be made available in loans and grants to cities, counties and States for projects that they would submit for approval. However, I think a larger proportion should be made in grants, say 50%, or if necessary two-thirds of the total costs in order to provide for more rapid spending. The application approvals should be made within a limited period of time which might be determined by the President. In order for loans and grants to be approved it should be stipulated in the contracts that the projects will be completed and the funds spent within one year after approval. This would insure rapid spending and the letting of contracts on a basis which would insure large employment of men.

2. A more intensive program for new housing should be developed. There are two fields here that should be concentrated upon. First, the construction of new homes. A considerable volume of new building might be promoted by a subsidy of some percentage of the cost of construction, say not to exceed 20%. This program might be limited to a total subsidy of 500 million dollars which would be paid by the Federal Government on the new homes constructed under the mortgage insurance section of the Federal Housing Act. This would enable the Government to have a check to determine whether the funds were actually being spent for new construction. Here again it would be wise to grant the subsidy only for construction that was begun within one year. Second, low cost housing projects on a larger scale should be started with active Governmental support. This might be done by having a Government corporation established which would have capital stock

sufficient to finance not less than 40 to 50% of the cost of the projects, the rest to be provided from the sale of bonds by the municipalities in which the projects are located. In order to obtain decentralization in the management of the housing facilities the leasing of the units should be handled by local administration and the income received from rents would be used to pay local taxes, interest and to provide retirement for the bonds issued by the cities over a period of, say 20 years. The Government itself would receive no interest on the part of the cost which it provides, but there might be some provision under which part of the principal would be recovered over a period of years. Or, the Government might handle the construction and put up all the necessary funds and then lease the buildings to the municipalities who would have the responsibility of receiving payments from the tenants and to repay the Federal Government at low rates over a period of 20 years or more. It should be recognized that certain subsidies must be granted by the Government to enable low cost housing projects to proceed rapidly and that they cannot be expected to be fully self-liquidating in the sense that the entire cost including interest can be recovered. However, new low cost housing is a desirable type of Governmental expenditure and would prove of incalculable value in solving the social problems which arise out of large numbers of people living in crowded tenement areas.

3. A comprehensive program for the insurance of the aged and the unemployables, meaning the physically incapable of productive labor, should be introduced on an established basis by the Federal Government. This would not only provide additional income for these classes of individuals but would relieve the friends and relatives who now bear the majority of the

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cost of supporting them, thereby freeing income for expenditure on other goods and services.

4. The activities of the Civilian Conservation Corps should be extended so that more people would be employed and supported in doing this very useful type of work.

5. The R. F. C. might make loans of a certain percentage upon the delinquent taxes of local bodies. This would relieve the pressure which such taxes have caused towards the closing of schools and the curtailment of necessary public services. Thus municipal credit and municipal spending would tend to be increased and this indirectly would be beneficial to business generally.

6. The expenditures through the Federal Emergency Relief Administration should be maintained to take care of individuals who cannot be provided for under the above programs. I am not in favor of simply providing a dole for the idle and we should make sure that the individuals who apply here are incapable of work or cannot be employed either through public works or private enterprise. In other words, the operations of the Federal Emergency Relief Administration would be merely the catch-all for individuals who cannot be taken care of in other ways. In this connection, however, we should not demand that individual States and municipalities pay an appreciable share in taking care of the relief burdens. There is no justification for the contention that relief burdens should be borne locally in a country where local income is so dependent upon the general level of economic prosperity for the country as a whole. When we have regional specialization of industry and national interdependence to the extent we do the deep depression that one locality finds itself in has nothing to do with the industry and frugality of the local population. This philosophy

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of relief would only be applicable if local communities were essentially self-sufficient in their economic life.

There are those who point to the record of the last two years and say that it has proven impossible for a Government to spend its way into prosperity and therefore would condemn a further spending program. Such an attitude seems to me to have entirely misread the facts in the situation. The country was faced with terrific deflationary pressure and the spending while it turned the tide of deflation was offset by other factors to such an extent that little real expansion of money has taken place. For example, from December 1932 to December 1933 there was an actual decline in the amount of demand deposits available to individuals and corporations for expenditure, which indicates that bank closings and contraction of loans by banks had more than offset the increase of deposits resulting from the purchases of Government securities by the Federal Reserve and the banks. Moreover during this period the expenditures of local Governments were severely curtailed so that there was actually a decrease in the public debt of municipalities and States in the calendar year 1933, further offsetting the effects of federal expenditures. The rise in business activity during the summer of 1933 is to be explained mainly by the increased purchases of inventories by corporations instead of by the development of new primary consumer purchasing power. Only in 1934 was there any noticeable expansion of deposits and even then the increase was not of such a volume that would merit giving serious consideration to the "inflationary fears" which have gained wide publicity in the conservative press.

I cannot emphasize too strongly the importance of getting these funds out rapidly because it is only if there is a considerable increase in the volume of new expenditure that business as a whole feels the impetus and

enters the picture by increasing production and employment. These large expenditures should not cause anxiety when we consider the probably effects which they will have. As men are employed they will receive purchasing power that would not otherwise be spent and hence there would be an increased demand for goods which would be met at first by drawing down of stocks on the shelves of retailers but as business in the United States has adjusted itself to carrying small inventories the retailers would soon reorder from wholesalers and jobbers and they in turn from manufacturers and so on back to producers of raw materials. With increasing business there would be the necessity of rehiring workers who had been laid off and this reemployment would swell the volume of purchasing power which would be spent, increasing the demand for goods and services and consequently for labor. When business showed signs of sustained improvement there would develop a need for working capital and corporations would either start borrowing from banks who would be glad under these circumstances to make loans, or would draw against their idle cash balances and make increased payments for supplies and labor thus giving velocity to existing deposits. Only later as productive facilities become more completely utilized would there develop a need for capital equipment that should be financed by true saving.

If this process continues and we realize a higher level of business activity many of the problems which the National Recovery Administration, the Agricultural Adjustment Administration, the Farm Credit Administration, and the Home Owners' Loan Corporation are attempting to deal with would be solved. Likewise many of our railroad and banking problems would be materially improved. Many of the emergency agencies are dealing with symptoms of depression and these would disappear if the depression itself was allayed.

Measures to be Avoided

There is definitely a danger that the effects to be expected from a spending policy of the type described above would be offset by the inauguration of certain unwise measures which have been gaining considerable support in some quarters. For example, a shortening of hours and raising of wages by legislative or administrative action would be unwise if they lead to increased costs and a curtailment of profits before a sufficient volume of business had been realized to bring with it lower unit costs. Thus we might find a contraction of business and a decrease in employment that would mean lower national income. Also higher wages might lead to a more rapid introduction of labor-saving equipment which would lead to an uneconomic displacement of existing capital and increase our problem of unemployment relief. Another type of development would be the paying of too high wages on public construction which would tend to draw people out of private employment where they would not be replaced. Also certain types of relief programs which set up competitive production with private enterprise are not of enough importance to offset the bitter feeling that will be engendered on the part of the people engaged in these lines.

We must think in terms of greater production, employment and consumption rather than solely in terms of higher prices as the detriment of good business. Lower prices in some lines if combined with largely increased production mean profitable operations. Also lower hourly wages should not be distasteful to labor if higher labor income were insured. Thus, the giving of power to certain groups to raise prices at the cost of restricted production might be fatal to rapid recovery.

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Sources of Funds.

The question naturally arises as to where the funds are coming from for this spending program that must of necessity be of large volume at least for a certain length of time. In view of the present banking situation I see no reason why the banks should not take more Government securities. They hold large excess reserves and therefore could have quite an appreciable expansion of investments in Governments without jeopardizing their position. It doesn't make a great deal of difference whether these Government securities are sold on a short-term or a long-term basis and if the banks are more willing to take short-term obligations I think we should sell them this type. After all, the banks are being paid for simply creating new money and considering the scarcity of suitable bank investments there is no reason why bankers should not be willing to furnish it. In case there were difficulties, I would suggest that the Federal Reserve be

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"encouraged" to support the Government market and to make purchases in as large amounts as necessary in order to assure the Government of the funds to carry out its announced program. There might be an objection to the Federal Reserve increasing its holdings of Governments because this would increase the member bank reserves in like amount which would give the possibility of a multiple credit expansion by the commercial banks. In addition, excess reserves are now very large and apparently there is no good reason to increase them further at the moment. However, these factors do not seem to me to necessarily entail a serious objection to further Federal Reserve purchases because the Federal would have them to sell in the future thereby decreasing member bank reserve balances by that amount and placing a severe restriction upon an unwarranted credit expansion. However, if the borrowing operations were handled properly I see no need to use any additional powers other than the normal operations for supporting the Government market while issues are being floated. Of course if present holders of deposit accounts that are now sterilized with no checking against them were purchasing Government bonds this would be desirable for the ^{Spending by the} Government would make the accounts active.

The Budget Program

So far as I am concerned I believe that any attempt to balance the budget at this time could only exert a deflationary effect upon all business and industry and would be a disastrous policy to pursue. Naturally it is essential to balance the budget over a long period of time but I think we must use a great deal of care in determining the periods when the Government shall have an excess of receipts over expenditures. If this program works and no really conclusive argument has been presented to the contrary there will be no difficulty in balancing the budget in the

future. As business revives the necessity of Governmental expenditure will decrease, while Government revenues will increase even without any significant change in the tax rates as increased national income is built up. Thus we can be assured of a balanced budget relatively soon in the future and the debt incurred to revive business could be rapidly cut down in a period of relatively full employment and more complete utilization of our productive facilities. Even if it were necessary to keep a more or less permanent public works program in operation which would mean a larger normal federal budget, this would not be serious provided we had a much enlarged national income. A budget which called for 8 billion dollars a year would not be particularly burdensome if our national income were at a level of, let us say, 100 million dollars a year with a price level approximating that which existed in 1928.

The Prospects of Deflation

There is a great volume of comment to the effect that we are menaced with the possibility of an uncontrollable inflation developing in the future. These fears seem to me to be largely unjustified. The only way that such an inflation can take place is for the volume and use of monetary supplies, including currency and bank deposits, to be increasing at a faster rate than goods are being brought on the market and this possibility is one which is far remote in the United States. As was pointed out before, we have a large amount of unutilized capacity which can be brought into use to greatly increase the supply of goods. Also, we have a great volume of unemployed which would have to be absorbed in trade and industry before a dangerous inflation could take place. In fact they would be brought into production without an appreciable rise in prices in many lines of production because of the proportion of fixed costs to total costs. Thus,

as the volume of sales increased unit costs would tend to decrease for some time and therefore at the present level of prices or at a slightly increased level most industries would enjoy greatly increased profits. There is little danger that we would see a development of hoarding of goods as business activity increased and some prices rose. Also, as business improved there would probably be no flight of capital from the country, but if there was it could be effectively controlled. We have a balance of payments situation which does not demand large outward payments which were so very important in promoting the disastrous currency inflations in post-war Europe. Moreover, our tax system is so arranged that we could easily balance the budget with an increase in business activity and hence there would be no need for Government financing and a continued unbalanced budget and printing press currency. The individuals who profess fear of inflation have simply not analyzed the situation and are not aware of the circumstances that must be present in order for an inflation to get out of hand. Finally it should be pointed out that historical evidence is far from conclusive, that "inflation" is uncontrollable.

Granted, because of the large excess reserves which are held by the Federal Reserve banks there exists the possibility of an unwise expansion of loans and investments and hence deposits provided certain conditions arose in the future. However, we have methods for control of this. The Federal Reserve system has always been much more effective in restricting money expansions than in replacing contractions. The System now has approximately $2\frac{1}{2}$ billion dollars worth of Government securities which could be sold and these would wipe out completely the excess reserves which are now present. If the banks of the country were willing to borrow from the Federal Reserve to make further credit advances to customers the rising

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rediscount rates of the Federal Reserve banks would have their effect upon curtailing bank loans, to say nothing of the effect caused by our tradition against bank borrowing. Also, the Federal Reserve has the power under emergency conditions to increase the required reserves for member bank deposits and this power if used certainly would be effective in bringing about the curtailment of an excess expansion.

My fear all along has been that we could not effectively control and offset deflation rather than that of our danger of running into a period of uncontrollable inflation.