BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM
Division of Research and Statistics

RECENT BUSINESS AND CREDIT DEVELOPMENTS

CONFIDENTIAL

February 26,1938
Cr. 15

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Outlook

Economic activity after the precipitous decline from August to December decreased much less rapidly in January and February. The Board's index of industrial production in January stood at 81 compared with 84 in December and 117 in August. It is estimated that in February the index will be in the neighborhood of 80 and that this will be the approximate average for the first quarter of the year. At this level the index is 36 points lower than a year ago, about the same as in 1934, and about 18 points above the depression low of the first quarter of 1933. Earnings of industrial workers have also suffered a marked decline, but the aggregate level of national income has declined considerably less as the result of maintenance of incomes in agriculture, trade, and services.

In the situation as it exists today there are a number of factors favorable to recovery. Retail buying of textiles and other nondurable consumption goods has continued in substantial volume, while output of these products has been sharply curtailed, and inventories have been reduced. Among industries producing goods for immediate consumption some increase of activity is reported for shoe factories, and there are indications that the downward movement of output at textile mills is being reversed. In the building industry there has been some downward readjustment of costs. On the security markets, prices of stocks and lower-grade bonds, excepting those of railroads, have remained at a fairly constant level since the latter part of November, and prices of high-grade corporate bonds and of Government bonds have advanced.

There are, however, factors operating against recovery. Contracts for residential building and for other private construction work have declined sharply, activity in the railroad equipment and machinery industries has been further curtailed, and sales and output of automobiles, furniture, and other durable goods bought by consumers have been reduced. As a consequence, there is little immediate prospect of increased demand for steel, lumber, and nonferrous metals. Furthermore, consumer demand for goods is likely to decline as current income has been reduced. The outlook for commodity prices continues to be uncertain. The general index recently fell below 80 for the first time since the middle of 1936, while prices of some products, like steel and automobiles, have continued at high levels. Supplies of basic raw materials, both agricultural and industrial, are ample for prospective needs, and there is consequently little likelihood of an advance in prices in the near future, unless it is brought about by greatly increased foreign demands for war purposes. Industrial activity abroad appears also to have turned down and that is likely to have an unfavorable effect on world prices of commodities and on the demand for exports.

On balance, the longer-time outlook is for a substantial advance in activity from its present level -- either as the result of private enterprise or, failing that, of governmental action. The more immediate prospect is for a mild advance in some lines, such as shoes and textiles, as inventories are used up, but there are no indications of a prompt upturn in the durable goods industries, where recovery hinges on increased capital expenditures by producers and increased consumer buying of houses, automobiles, and other durable products. In the absence of such an upturn, the general level of activity will remain low. This would be similar to developments in the spring and summer of 1921. It would differ from developments in 1931, when the underlying financial situation, both here and abroad, was much less favorable to recovery, and output continued to decline sharply.

The general outlook for the next few months is for a sideways movement at a low level.

Three charts with brief comments follow.

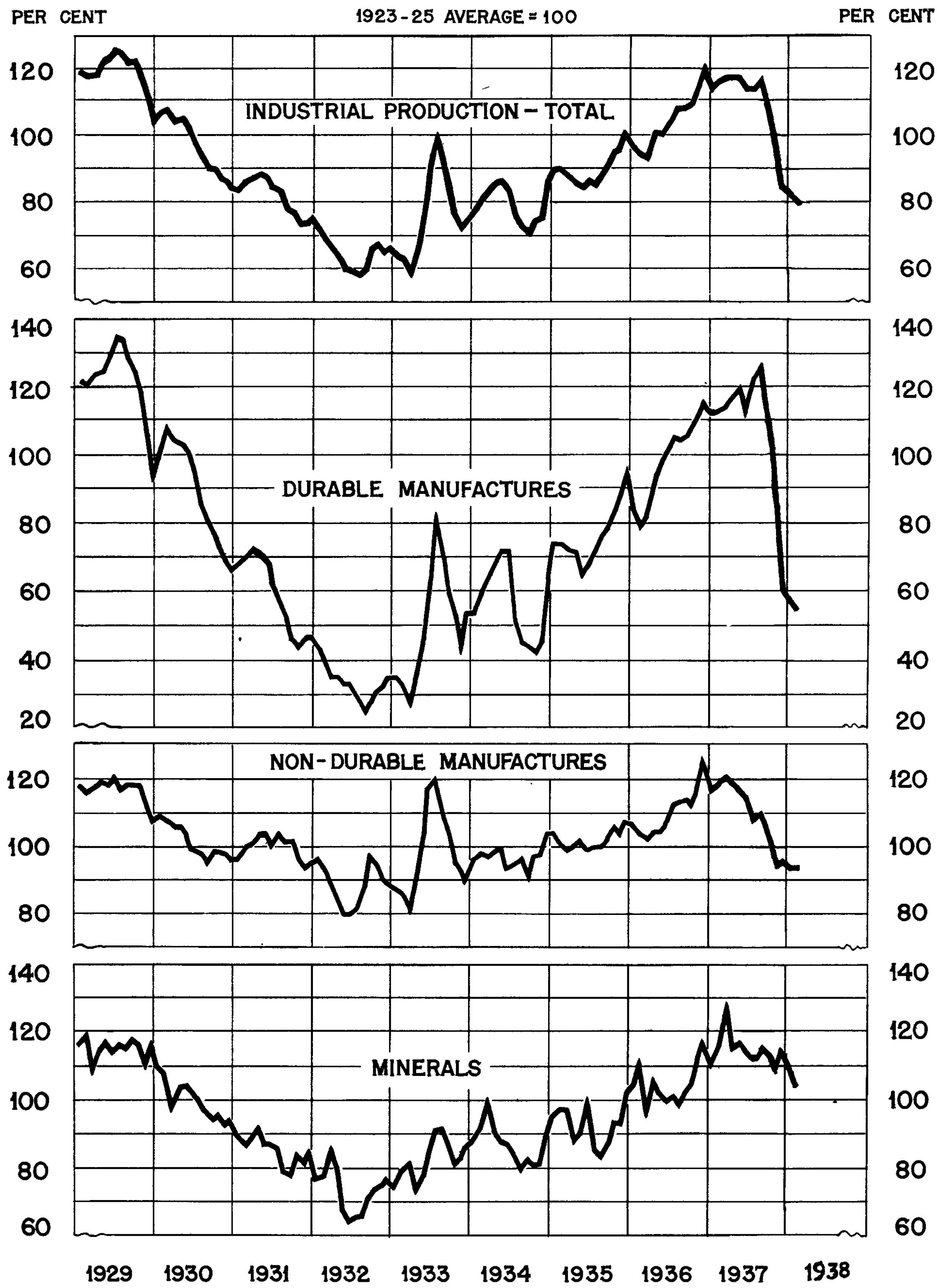
Industrial Production

The Board's indexes of the physical volume of industrial production are shown in the chart on the next page. Figures for February 1938 have been estimated on the basis of information available on February 24.

As indicated on the chart, output of nondurable goods has shown little change since November of last year, following a decline of over 20 percent from April to November. Output of durable goods has declined less rapidly in recent months than during the autumn, but the current volume is about half that maintained during the first eight months of last year. Mineral production has shown a substantial reduction in the first two months of this year from the high level maintained throughout 1937.

INDUSTRIAL PRODUCTION

ADJUSTED FOR SEASONAL VARIATION

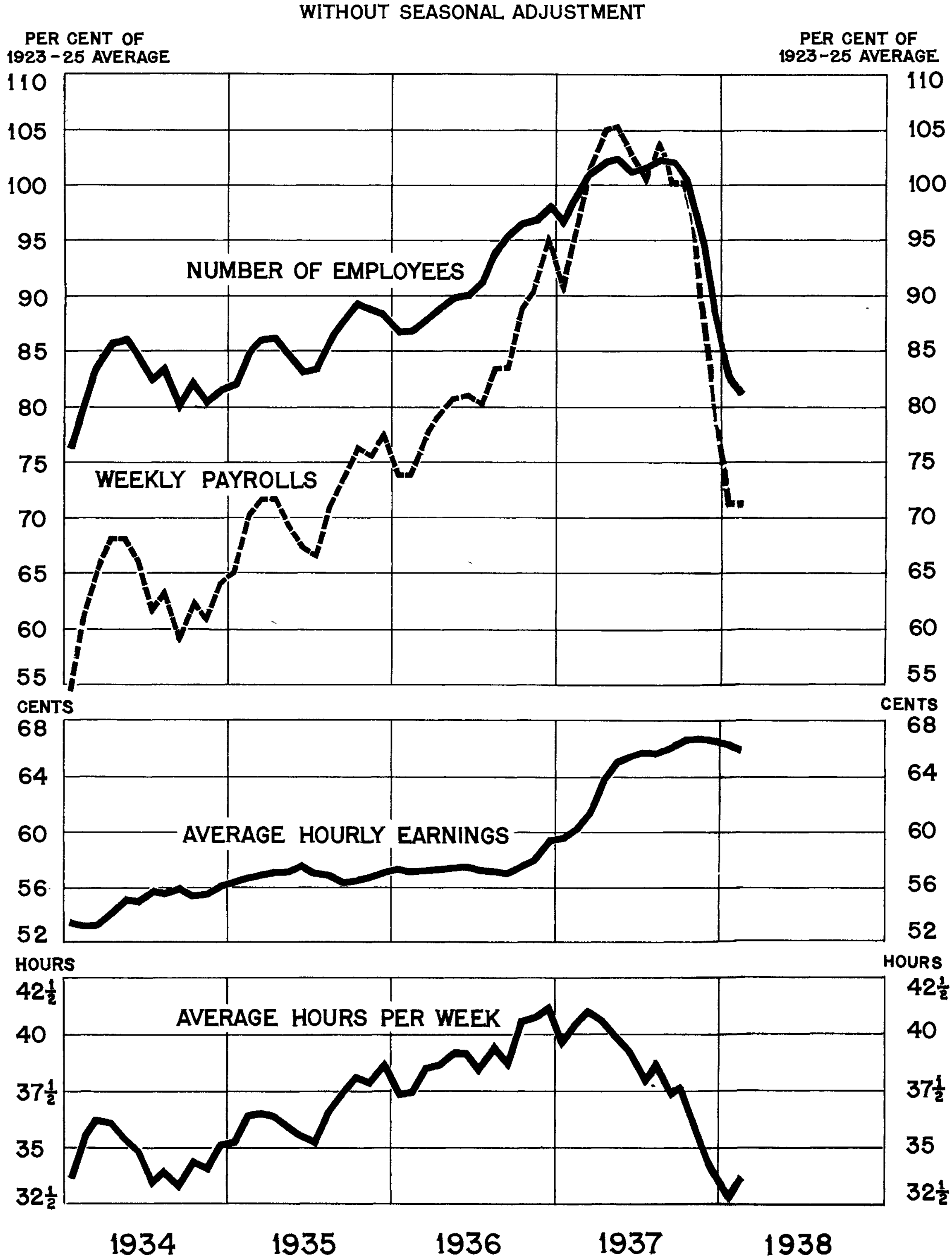


Employment

The accompanying chart shows the extent of reduction in employment and payrolls at factories since last summer. The decline in payrolls has been much greater than in employment, reflecting decreases in the average number of hours worked per week as well as in the number employed. Average hourly earnings have continued near the levels of last autumn, although there is some evidence of a decline since the beginning of the year. Reductions have occurred recently in the textile and shoe industries. The figures for February 1938 are estimates.

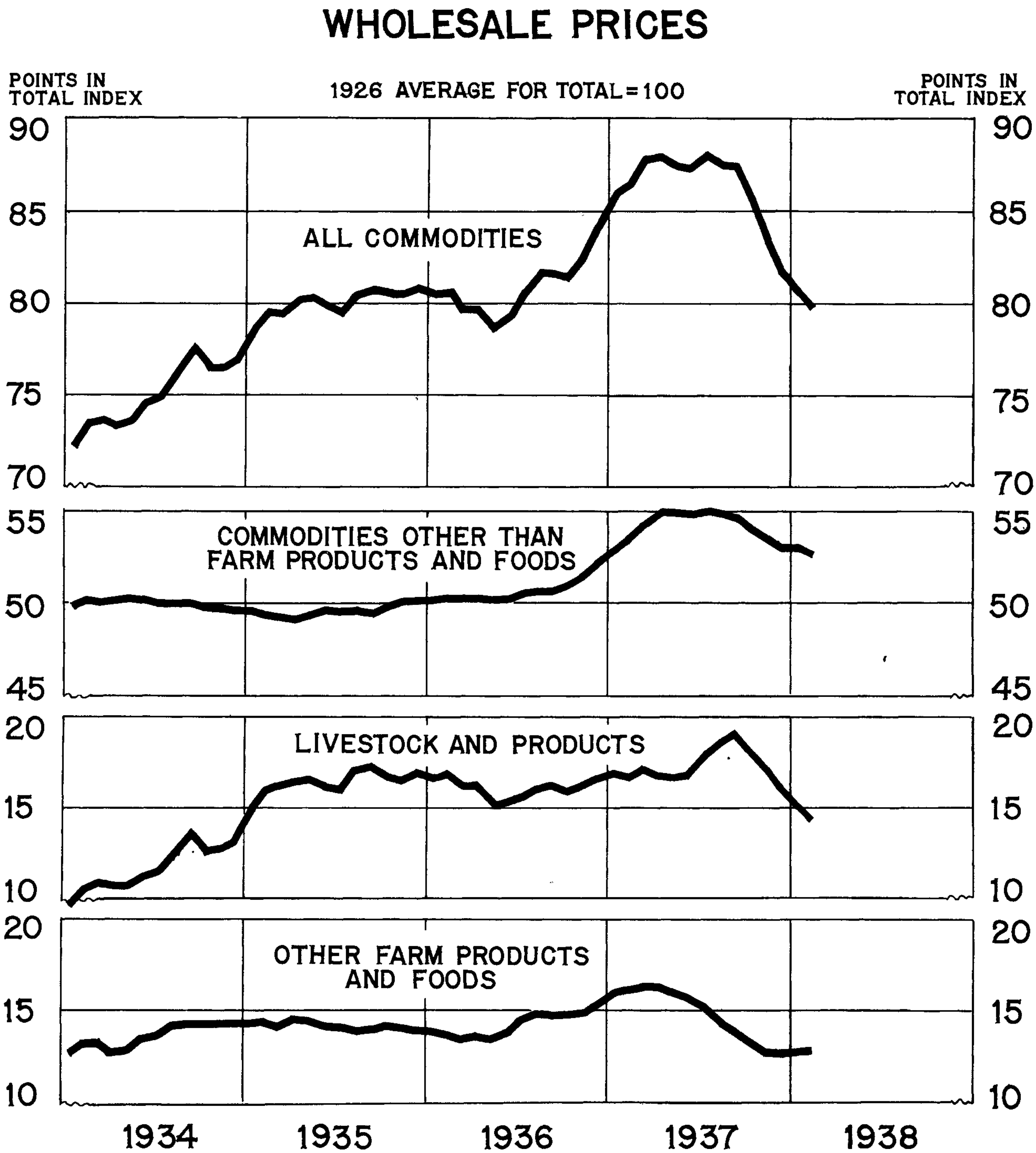
In other lines than manufacturing industries, to which this chart is confined, employment and payrolls have not declined as much, so that total employment and total earnings of employees have declined less than this chart would indicate.

FACTORY EMPLOYMENT, HOURS AND EARNINGS



Prices

The accompanying chart on wholesale prices, expressed in terms of points in the total index, shows that the decline in the general level since November 1937 has reflected chiefly a further decrease in livestock and products, reflecting gradual increases in supplies which previously had been reduced as a result of the 1936 drought. Prices of other farm products and foods, particularly grains and cotton, are higher than in November. Other commodities as a group have continued to decline since November, reflecting chiefly further reductions in prices for such nondurable commodities as hides, leather, and textile products. Prices of durable commodities have shown little change from the advanced levels reached early last year.


WHOLESALE PRICES
POINTS IN TOTAL INDEX
1926 AVERAGE FOR TOTAL=100
POINTS IN TOTAL INDEX
90
85
80
75
70
ALL COMMODITIES
55
50
45
COMMODITIES OTHER THAN FARM PRODUCTS AND FOODS
20
15
10
LIVESTOCK AND PRODUCTS
20
15
10
OTHER FARM PRODUCTS AND FOODS
1934
1935
1936
1937
1938

Credit Developments and Security Markets

An analysis of the reserve position of individual member banks for the second week of January and a discussion of member bank credit developments in 1937, prepared for the March Bulletin, is attached to this memorandum. Since the turn of the year loans of reporting banks have declined further and investments have increased somewhat.

In the following paragraphs are brief discussions of the outlook for excess reserves, of the Treasury position, and of recent developments in securities markets.

Outlook for excess reserves

Excess reserves may be expected to show a moderate increase over the next six months. Purchases of newly-mined domestic and other gold may amount to as much as $150,000,000 and Treasury silver purchases to $90,000,000; in addition some reduction may be expected in Treasury deposits with the Reserve banks, which have now amounted recently to somewhat over $150,000,000. It is likely, therefore, that by next August excess reserves will be approximately $1,700,000,000, close to the amount held immediately after the first increase in reserve requirements in August 1936.

During the next few weeks, however, excess reserves will not rise appreciably above the present level of about $1,400,000,000 and probably will be temporarily reduced through Treasury fiscal operations in March. The Treasury is issuing $50,000,000 of additional June tax date bills weekly beginning March 2. These receipts in addition to the heavy March income tax collections should exceed gross expenditures, including the redemption of $400,000,000 of tax date bills at the middle of March and quarterly interest payments. The Treasury's balance at the Reserve banks should, therefore, increase and continue at a high level until after the sale of the June bill series is completed. According the privilege of payment in book credit to the new bills will probably not be effective in holding down the Treasury balance at this time. The June tax date bills are practically three-month bills and should sell at not over 1/10 of 1 percent. As this is only slightly above the Federal Deposit Insurance premium, which applies also to Government deposits, most of the yield would be absorbed if banks paid by book credit. Consequently, it appears that payment will be largely in cash and excess reserves will be temporarily reduced. Excess reserves are nearly $500,000,000 at New York City banks where most of the bills are sold, so that even a substantial loss of reserves should have practically no effect upon money rates. The actual amount of reserves that may be withdrawn by Treasury operations in March is difficult to estimate, owing to the many uncertainties regarding various receipts and expenditures.

Recent Budget developments

The outlook for Federal finances for the current fiscal year and for the fiscal year 1939 has changed in recent weeks along the lines indicated by the President's comments in presenting the Budget estimates in January. An additional $250,000,000 is to be made available in the current fiscal year for Works Progress Administration expenditures for a growing number of unemployed. The President has recommended to Congress a further increase in armament. Furthermore, the farm bill recently enacted may increase outlays for Agricultural Adjustment and lending operations of the Reconstruction Finance Corporation are to be resumed.

Of these only the additional relief expenditures will affect the current year materially. The estimates in the Budget indicated a deficit, exclusive of statutory debt retirements, of $1,090,000,000 for the current fiscal year which ends next June and of $950,000,000 for the fiscal year 1939. The additional relief expenditures will increase the deficit for the current fiscal year to $1,300,000,000. If relief costs in 1939 continue at the level of the current year, the 1939 deficit will increase to $1,700,000,000. There may be further increases in the 1939 deficit as a result of Agricultural Adjustment Administration expenditures in excess of recent Budget estimates, the armament program, tax legislation, or a more than anticipated falling off in tax receipts.

On a cash basis, an excess of cash expenditures over cash receipts which may be as large as $400,000,000 is now indicated for the period January - June 1938. This deficit compares with a cash deficit of only $38,000,000 indicated by Budget estimates.

The marked increase in volume of unemployment accounts for the change. Not only have relief requirements increased but it now appears that withdrawals of State agencies from the Unemployment Trust Fund for making unemployment benefit payments may exceed the Budget estimate. In January, 21 States and the District of Columbia became eligible to make their first benefit payments and withdrawals by State agencies in that month amounted to $34,000,000, as compared with the Budget estimate of $100,000,000 for the entire six months January - June.

A major part of the additional cash which the Treasury will need to meet larger cash disbursements will come from sales of United States savings bonds. Net receipts of about $280,000,000 are expected from this source in the period January to June.

Securities markets

During the first two months of this year, a marked weakness in railroad bonds of medium- and lower-grade has been an important factor in the security market. After declining sharply in January to the lowest point since early 1933, prices of these obligations recovered slightly during February, but at the middle of the month they were still about 8 points below their December level.

Reflecting the prevailing easy money conditions, yields on long-term Government and highest-grade corporate bonds have remained fairly stable during the past two months at the low level reached in December, which was slightly above the all time lows reached at the end of 1936.

Industrial and public utility bonds of the medium- and lower-grades, as well as common stocks, have continued to fluctuate irregularly about their low levels reached in the last quarter of 1937.

Customers' debit balances with stock exchange firms declined during January by about $25,000,000 and at the end of the month were about $960,000,000 as compared to the peak last year of $1,560,000,000. A further decline is indicated for February. The current level of these balances and of brokers' loans is lower than at any time since 1933.

Capital issues

During January and February, corporate security issues offered for new capital purposes totaled about a third as much as in the corresponding months of 1937. Activity in the new capital market is more closely related to the volume of productive activity than to security prices. When the volume of output falls so low that available capacity appears ample to supply the market demand, previous plans for expansion are likely to be postponed, regardless of the cost of obtaining new funds. While isolated plans for corporate capital expansion during 1938 have continued to receive wide publicity, the aggregate volume involved in such plans appears to be far below the level of a year ago.