Form F. R. 131

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date April 18, 1939.

To Chairman Eccles

Subject: Cotton Problem

F Lauchlin Currie

LBC

You may possibly be interested in the attached memorandum on the cotton problem, which was prepared at my request by Mr. Sweezy.

Form F. R. 131

BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

Date April 14, 1939

To Mr. Currie

Subject: The Cotton Situation

From Alan R. Sweezy

BACKGROUND

The cotton surplus presents a more serious problem at the present time than ever before. At the same time, cotton prices have fallen so as to endanger seriously the income of the Cotton Belt. The following table shows clearly how the present surplus came into existence.

(Millions)

Crop Year	Production	Domestic Consumption	Exports	Govt.* Stocks	Acreage
Aver. (1922-23 through 1928-29)	13.8	6.3	7.6	--	40
1931-32	16.9	4.7	8.7	3.4	38.7
32-33	13.0	6.0	8.4	3.6	35.9
33-34	12.7	5.6	7.5	4.0	29.4
34-35	9.6	5.2	4.8	5.5	26.9
35-36	10.5	6.2	6.0	5.1	27.6
36-37	12.4	7.8	5.4	3.0	30.0
37-38	18.4	5.6	5.6	6.5	34.0
38-39	11.9	p6.5	p3.0	11.0	25.3

*January 1
p Preliminary

1. The greater part of the responsibility must be assigned to the"magnificent" crop of 1937. The 18-1/2 million bales produced in that year is the largest crop on record. As compared with the four preceding years in which the control program had been in operation,this record crop can be attributed partly to increased acreage and partly to an extraordinarily high yield. The acreage in 1937, largely because of the weakening of production control following the Supreme Court decision a year earlier, was, roughly, 25 percent higher than the average of 1933-35. The crop, however, was over 50 percent larger, showing that the ideal weather conditions in 1937 played an even more important role than the expanded acreage.

2. American exports in the current crop year, 1938-39, are the lowest on record. Throughout the period of production control, exports were approximately one-third lower than they had been before that. The 1938-39 rate is little more than half this reduced amount.

The excess supply resulting from the tremendous 1937 crop and the decline in exports has been moving into Government-financed stocks. On January 1, 1939, the Government held approximately 11 million bales, which is about equal to a normal year's production.

The figures on domestic consumption also bring out the fact that the present surplus is not due to a decline in the domestic use of cotton. The amount consumed in 1936-37 was, in fact, the largest ever--7.8 million bales, as compared with an average of 6.3 million in the prosperity period from 1923 to 1929. Even in the years 1934 and 1935, when the restriction program was operating with a relatively low level of national income, domestic consumption was not much below the average for the Twenties.

If exports could be restored to the 1934-37 average, we could with the present level of domestic consumption just about hold our own, provided, of course, that acreage restriction were continued as at present and the yield remained "normal". With exports at this year's level, current production would result in the addition of 2 to 3 million bales a year to the existing surplus.

PROGRAM

Any program adequate to deal with the situation must contain the following elements: (1) continued production control, (2) some way of increasing exports, (3) protection of cotton farmers' income.

Current controversy centers on a means that should be adopted to achieve the second and third objectives; i.e., increase in exports and protection of farmers' income. Effective techniques for production control have already been developed and there can be no serious question but that production control must be continued. In achieving (2) and (3), it is important, however, not to resort to further acreage reduction, since that would intensify the surplus labor problem of the South. (That is, there is no good in reducing excess cotton by increasing excess labor.)

Broadly speaking, there are two lines of approach to the problem of achieving the above-mentioned objectives:

1. Maintain domestic prices by a continuance of the present loan program (or some other price-pegging device) and subsidize exports so as to increase the American share in world markets.

2. Let both domestic and foreign prices fall sufficiently to move a more satisfactory amount of American cotton into consumption and make up the difference by adjustment payments to the farmers. Increased consumption would be primarily in foreign countries, but with a lower price there would probably be some increase in this country as well.

Of these two ways of tackling the problem, the second offers distinct advantages. It would avoid the appearance of dumping, which inevitably would go with the first, and would have the highly desirable effect of giving American as well as foreign consumers the advantage of the lower price. From a more technical point of view, it would also seem to be preferable.

The subsidization of exports would necessitate the imposition of a tariff to keep the subsidized cotton from being brought back into the country and would also probably necessitate a subsidy to American producers of cotton goods in order to enable them to hold their place in the world market. As contrasted with this cumbersome setup, the alternative approach would preserve a unified world market and would obviate the necessity for special duties or bonus of any kind.

It is interesting to note that the price-adjustment or parity-payment method seems to be favored by Secretary Wallace himself.

> "With regard to cotton, Mr. Wallace admitted that the loan programs have, while maintaining domestic prices, caused exports this year to fall off 'alarmingly' with the indication that they will be little more than half what they were in previous years.
>
> "'If the cotton loan is to be continued, and I think we should frankly face the fact that its discontinuance would probably permit the price of cotton to fall by 2c or 3c a pound, then some means

must be found to move the cotton into export,' he continued.

"He said continuance of the loan on the present basis would be almost certain to reduce our exports to a still lower level probably below 3,000,000 bales, necessitating a reduction in acreage from 27,000,000 acres to 20,000,000.

"The Secretary warned, however, that if cotton is kept out of the loan, then 'probably $200,000,000 a year or more' will be needed in addition to present conservation and parity payments to maintain even the present low level of income in the South. He added that this would not be so difficult if the original Triple A system of financing payment from a tax on domestically consumed cotton could be resumed."

The chief argument advanced against the parity-payment method of moving larger quantities of American cotton into both foreign and domestic consumption is that it would cost more than the export subsidy plan. This is clearly based on a very narrow definition of cost. If American consumers are forced to pay a higher price than foreign consumers in order to maintain farmers' income, the cost to the American public is obviously just as great as if the same amount of money were paid out of the Federal treasury. The cost would be exactly the same if the parity payments were financed, as Secretary Wallace proposes, through a processing tax. It would be far less in real terms, however, if the general funds of the Treasury were used instead of a processing tax. From the point of view of increasing the purchasing power of consumers in general, as well as of the farmers, the latter method is clearly the most desirable. In fact, the use of processing taxes would largely nullify the benefit that could be obtained by the parity-payment method of dealing with the problem. Payment of benefits out of the general fund would mean, of course, that the money would be borrowed until the revision of the existing tax system of a sort that would increase revenue without burdening consumption could be carried through.

CAUSE OF THE DECLINE IN EXPORTS

Through the production control and loan programs, the United States has, in effect, been holding a price umbrella for the rest of the world. By curtailing acreage in this country and by offering to absorb supplies in the loan program at attractive prices, we have been giving foreign producers a chance to expand their output and their sales without bringing prices to a ruinously low level. As American cotton has gone into the loan, foreign sales in the world market have increased. This point comes out clearly in an examination of production and carry-over figures for American and foreign cotton.

Before the depression began, the world carry-over of American cotton was normally around 40 percent of the annual production of American cotton. The ratio of carry-over to production in the case of foreign cotton fluctuated around 50 percent. Since 1930, the situation has changed drastically. The ratio of foreign carry-over to production has remained about the same, i.e., 50 percent, but the American ratio has increased sharply. Including loan stocks, total American carry-over at the end of the 1937-38 season was 74 percent of production. If the carry-over of American cotton at the end of the 1938-39 season is 14.5 million bales, as it probably will be, it will be 122 percent of production. Thus, while American stocks have been piling up to a tremendous amount, foreign produced cotton has been moving into consumption at almost the same rate as it did before the depression and the American control program began.

It is impossible to say just how much of the world market loss in the last couple of years could be regained for American cotton by a policy of unpegging the world price. Undoubtedly some of it is lost beyond repair within the limits of any decline in prices this country would be willing to see. The most drastic decline in imports of American cotton has been in Germany, which formerly took an average of a million and a half bales a year but which in 1938 imported only 200,000 bales. Meanwhile, German imports of Brazilian cotton have increased from practically nothing to 375,000 bales. In addition, increasing use of rayon has brought about a marked decline in the total consumption of cotton in Germany. There seems to be no reason, however, why exports to England and other countries where there are no special restrictions on American cotton should not recover at least to their mid-Thirties level.