BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

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ADDRESS OF
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THE THEORY AND PROGRESS OF THE RECOVERY PROGRAM

The Problem in 1933

As one who has followed with keen interest the comprehensive program adopted three years ago to bring about recovery, I should like to attempt to explain my understanding of developments since it was adopted, and how, in my view, it may achieve and maintain the complete restoration which we all desire.

Let me first direct your attention to the conditions prevailing in 1932 and early 1933, and to that most fundamental of all economic data, the national income. The national income, which was estimated at more than $80 billions in 1929, had shrunk to half that amount by 1932. The annual buying power and debt-paying capacity of the community, therefore, had been reduced by more than $40 billions. The problem of recovery was to raise that national income to above its 1929 level, which could only be brought about by the government undertaking activities and expenditures which private enterprise was not in a position to undertake. How could it be accomplished?

Leaving aside plans which involved fundamental and far-reaching changes in our whole economic organization, the solutions offered to the country in 1933 were of two main types. On the one hand there were those who contended that all that was needed was the restoration of confidence. They insisted that it was essential to balance the budget; that the gold standard must be retained at all costs; that no legislation disturbing to business should be enacted. On the other hand there were those who, like myself, felt that recovery in the present situation could only be achieved by bold and aggressive intervention by the government, largely through underpinning the entire private credit structure which had collapsed, and undertaking to restore purchasing power through relief, public expenditures and other measures.

I think the hope of success by the former method rested on faith rather than logic. After all, a budgetary surplus did not prevent the downturn in 1929; a balanced budget in 1930 did not prevent an acceleration of the decline. Not only were we on the gold standard in those years, but gold was flowing in steadily. Efforts to balance the budget in 1931 and 1932, maintenance of the gold standard, and the absence of reform legislation, did not prevent us from descending to lower and yet lower economic depths. What reason was there for thinking that factors which failed to prevent or check the downturn would in themselves lead to an upturn?

The Question of Confidence

Looking at this question of confidence a little more closely, let us try to see exactly what conditions are necessary for its establishment. With the national buying power cut in half the demand for goods of all kinds was reduced accordingly. Industry as a whole possessed more than enough equipment to satisfy the current demand. What does confidence mean in conditions such as these? Does it not mean confidence that increased expenditure on plant, equipment and inventory will be profitable? What business man would have added to his plant, when he already possessed a great amount of excess capacity, merely because he read that the budget had been balanced? It is difficult to understand why people would be expected to invest money in new enterprise when existing investments were becoming less profitable every day. It should not require any great insight to understand that a reduction of government expenditures while everybody else as a matter of self-protection was being forced to reduce expenditures, could only accentuate the processes of deflation by reducing buying power. An increase in tax rates at such a time would have had a deflationary effect to the extent that they reduced expenditures that otherwise would be made, and would consequently have yielded little, if any, additional revenue.

A belief that industry would have voluntarily entered upon capital expenditures in 1933 if the government had restricted its expenditures and raised taxes is unrealistic to the highest degree. It displays an utter miscomprehension of the considerations that influence a business man in planning expenditures. There must be reason to believe that capital expenditures can be profitably made before they are undertaken. This profitable outlook existed at the bottom of the depression in but few industries, such as brewing, distilling and gold mining. In these industries plant expenditures actually occurred and an abundance of capital was readily available. Why? Because there was confidence, that is, an expectation that funds could be profitably invested in these industries, which had been renewed by repeal of prohibition and the premium on gold.

What was the opportunity generally throughout the country for profitable investment in new enterprise? Throughout industry there was excess capacity in relation to consumer buying power, nor was there any inducement for residential construction so long as it was cheaper to rent or buy than it was to build.

The Theory of the Recovery Program

Obviously, what was needed to absorb excess capacity generally was an increased demand arising from increased consumer buying power. And here, it seems to me, is the crux of the matter. Increased demand could come about only as a result of increased incomes; and increased incomes depended upon increased disbursements by industry or by government or by both. As far as industry was concerned, it was being forced, in self-preservation, to reduce wages and expenditures of all kinds, thus rapidly increasing the number of unemployed, further shrinking consumer buying power and accelerating the deflationary forces which threatened complete collapse of the entire credit structure.

The only alternative, under the circumstances, was intervention by government. Only in this way was it possible to arrest the forces of deflation by bringing about an increase in incomes and hence an increase in the demand for goods and services of all kinds, through increasing disbursements financed initially by borrowings rather than by taxes. Those of us who advocated this course believed than an increase in incomes brought about in this way would lead to an increase in the demand for goods. Industry would pay out more in wages and materials in making these goods. These payments would result in further increased demands until finally the stage would be reached when here and there individual business men would see some point in taking up deferred maintenance, in adding to plant or venturing to establish a new type of service or industry. Here and there it would become profitable to build new houses as the demand for houses, and consequently rents, rose. As this process proceeded, we anticipated that tax revenues would increase as incomes increased, and the gap between expenditures and receipts would gradually close. A little later the whole burden of the recovery movement could rest on increasing business and individual expenditures and the Federal Government could not only balance the budget, but could begin to retire the debt built up in the depression. The expenditures of the Federal Government can be fully justified solely on humanitarian grounds--on the urgent necessity of relieving the home owners and the farmers, who were about to lose their homes and their farms, and aiding the great army of unemployed who were destitute and helpless through no fault of their own. However, I feel that the expenditures are fully justified as a means of achieving business recovery.

Has the Program Been Successful to Date?

Has the economic philosophy of the past three years which I have attempted to outline fulfilled reasonable expectations?

The answer is to be found by looking without bias at the results to date. On the debit side we should put the gross increase in the Federal debt from $20,935,000,000 on February 28, 1933, to $31,459,000,000 on March 31, 1936, and the continuing large number of unemployed, many of whom are dependent on relief. Neither of these adverse factors is as unfavorable as most of the business and financial community have been led to believe. Against the increase in the debt must be offset the increase in the Treasury's cash balance from $221,000,000 to $2,866,000,000 in the same period (exclusive of the Stabilization Fund), and an increase in the recoverable assets of Government agencies from an estimated $2,400,000,000 to $4,300,000,000, largely in the Reconstruction Finance Corporation which was used very largely to support directly the banking and private credit structure. So that this leaves a net increase in the national debt of $5,979,000,000, which is less than a month's national income in 1928-1929. The annual interest charge on the Federal debt as computed at the end of March, 1936, increased by only 8 percent over the end of March, 1933. This may be compared with an increase in the gross debt of 50 percent in the same period. The total carrying charges amount to a little over 1 percent of our current national income, not, I think you will admit, an excessive burden.

In considering the continuing heavy volume of unemployment, it should be remembered that there were 2,000,000 to 2,500,000 of unemployed prior to the depression, and that the number of people seeking work has increased since then by 3,500,000 to 4,000,000, due to the increase in the number of those reaching employment age. The lack of employment in many cases of the principal breadwinner of the family is also responsible for other members of the family, who would not ordinarily be employed, seeking employment. More important than these considerations, however, is the fact that millions of workers who were formerly working only one or two days a week and yet were listed as employed are now working four and five. The increase in man hours worked, in other words, has been much greater than the increase in the number of men working. The introduction of labor-saving machinery has doubtless also played its part. I am not saying that the employment situation is at all satisfactory. I am merely saying that the progress has been far more substantial than appears at first sight. Because of the various factors I have just mentioned, the burden of relief has not diminished correspondingly with the increase in employment. As recovery proceeds, we can, of course, expect relief expenditures to diminish.

Income, Production and Restoration of Money Supply

On the favorable side of the recovery program to date, I would stress particularly the rise in the national income and production, the restoration of the supply of money, increasing tax revenues, and the rise in building activity.

Although current direct estimates are not available, it would appear from other evidence that the national income is running currently about 60 billions a year as contrasted with approximately 40 billions in 1932. The index of production has risen from 58 percent to 94 percent of its 1923-25 level. The supply of deposits of all commercial banks rose from $27,000,000,000 on June 30, 1933, to $37,000,000,000 on December 31, 1935, or about the pre-depression level, so that the contraction in the money supply which occurred as a result of deflation has been largely offset. This replenishing of bank deposits is chiefly attributable to the increase in bank holdings of government securities and to the inflow of gold. It is directly attributable, in other words, to the relief and recovery expenditures of the government and indirectly attributable to the revaluation of gold, which was a necessary condition for the reversal of the international flow of capital. In the absence of government borrowing and the revaluation of gold no progress would have been made toward a restoration of the community's supply of purchasing power, since private loans and investments of banks continued to decline until 1935. It is encouraging to note that recovery is bringing about some increase in the demand for an extension of private credit by the banking system.

Progress Toward a Balanced Budget

Turning to government revenues, the trend is most reassuring. In the calendar year 1932 they amounted to $1,880,000,000. In 1935, despite the non-payment of part of the processing taxes, they amounted to $3,857,000,000, an increase of nearly $2 billions. With bonus payments met and a revision in taxes enacted, this favorable trend should be accelerated so that we would have every reason to expect a balanced budget within a reasonable period. Balancing the budget through increasing taxes or decreasing expenditures, or both, as the national income is restored, is an absolutely indispensable element in the eventual and complete success of a program of recovery requiring government intervention which entails large deficit-financing.

Orderly Character of the Recovery Movement

Finally, I would stress the increasing activity in the heavy industries and in building construction. During 1934 and 1935 it was constantly said that the deficit-financing experiment had been a failure because heavy industry and building construction had not picked up substantially. Such criticism displayed a misconception of the necessary sequence of events. First, the process of forced liquidation, caused by deflation, had to be stemmed. Second, the demand for consumer goods had to be greatly increased before there could possibly be any inducement for corporations or individuals to add to productive capital facilities to provide more goods and services. Third, long-term interest rates had to be brought down to encourage and make profitable the use of capital for new enterprise, and to adjust, through refunding, a substantial portion of the existing debt structure on a supportable basis.

In the real estate field liquidation had to be stopped and rents had to rise, this together, with lowered interest rates, bringing about a reopening of the mortgage market. All of these necessary steps took time. They could not have been accomplished in a much shorter space of time considering the depth of the depression and the immensity of the problems thus created. For more than a year the improvement of underlying conditions has become increasingly steady and orderly in character. The ground has been well prepared. The national income has been increased by some 50 percent. Industry and finance have been enabled by the recovery program to improve greatly their financial position through increased earnings, adjustment and reduction of debts and refunding on more favorable terms. Favorable long-term interest rates are available for financing in practically every field of activity. Rents have risen, hence real estate values have increased, making it again profitable to increase building construction. Excess capacity in nearly every field of production is rapidly diminishing. The index of commodity prices has remained steady for more than a year.

The Present Phase of the Recovery Movement

The present phase of the recovery movement is a most important one. Will the disbursements of private business and individuals increase sufficiently to warrant a lessening of the government's contribution to the growth in the national income? It is encouraging to note that activity in the housing field is rapidly increasing; capital financing is gradually being undertaken for new enterprise; an expansion of private credit on the part of the banking system is in evidence; activity in the machine tool, industrial equipment and heavy industries reflects substantial improvement.

Barring unforeseen contingencies, the present improvement should continue. The outlook at the moment is very encouraging.

Conclusion

The Federal Government cannot and should not decrease its expenditures on recovery faster than private industry is able profitably to take over the load. To do so would reduce consumer buying power and thus retard, if not reverse, the progress of recovery.

The flow of money must be maintained and increased in an expanding economy. If private capital fails to maintain and expand the flow, and widespread unemployment exists or develops, government must act as a compensatory factor.

Purchasing power can only be maintained by private business as a whole disbursing its income, or insofar as it fails to do so, by government expenditure either on the basis of deficit-financing, or by taxing in such a way as to insure the flow of funds that individuals and corporations otherwise would accumulate and maintain in idle balances, so that socially beneficial work will be provided for those who are able and willing to work but for whom private enterprise fails to provide.

I am sure that we will all agree that our objective should be the maintenance of long-term prosperity and the avoidance of the twin evils of inflation and deflation. The attainment of this objective depends not only upon the effective coordination of monetary and fiscal policies, but also upon an enlightened body of public opinion.