

Before the	::	November 16, 1917.	2 P.M.
INTERSTATE COMMERCE COMMISSION	::		
	::		
Docket 4590	::	Testimony of	
No. 57 Ex Parte	::	HON. PAUL M. WARBURG	
.....	::	Vice-Governor,	
	::	Federal Reserve Board.	

You have done me the honor of inviting me to testify before you for the purpose, I understand, of giving some facts as to how the general banking situation affects the financing of the railroads, and I believe you wish me to dwell upon this phase of the problem in its bearing upon the question before you of the petition of the railroads to be granted a fifteen per cent increase of the rates charged by them.

Owing to the very short notice that you have given me, it has, of course, been quite impossible for me to familiarize myself with the more technical railroad questions involved in this case or to collect any statistical material. I am glad to comply with your request to discuss this question from the purely financial point of view, but, at the same time, I am frank to admit that I do it only with great hesitation. Your honorable body is so fully conversant with the entire situation and has given it such close study that I feel that there is very little that I can add to the discussion of a subject that has been before you for about ten years. There are, however, certain extraordinary conditions which must enter at this time into your deliberations - conditions which have created a most unprecedented and anomalous situation in the financial market. It is, I understand, your wish that I should speak to you about this phase of the problem, and I am only too glad to present to you my thoughts for what they may be worth - emphasizing, however, that, of

course, they represent only my own personal views.

A discussion of the subject necessarily involves at this time a consideration not merely of the railroads but also of the people as individuals and the Government as a whole, for the interests of each of these elements, interdependent even in normal times, are still more closely woven together in view of the common cause of all - the successful prosecution of the war.

When the country turns from peaceful occupations to the business of war a drastic upheaval in the entire economic structure of the country must necessarily result, and inasmuch as it is clear that the combined strength of the nation is essential to victory, every project, every industry, that contributes towards this end must be encouraged in every possible way; whereas, what is not necessary for the common cause must, for the present at least, stand aside. The railroads are clearly one of the most necessary factors in this respect and they must be placed and maintained in such a condition as will best enable them to render in the most efficient degree the services for which they are designed. It is not necessary to elaborate this point; it is sufficient to consider the disastrous effect that the deterioration of the railroads has had upon the military efficiency of some of the European belligerent countries.

What, then, is the carriers' present condition? Like any other corporation or individual, or even the Government itself, railroads suffer at this time from the fact that the dollar which they now earn has diminished very materially in purchasing power so that, even if they were earning the same amount in dol-

(3)

lars as prior to the war, these earnings would not buy anything like the same amount of materials or the same amount of labor. It is interesting in this respect to note that their condition is parallel to that of all the belligerent governments which, owing to increasing prices, in order to produce the same purchasing power as heretofore, are forced to place upon the market larger and larger loans.

A comparison of the index figures for the years 1914 and 1917 would show that wholesale prices of commodities have increased, roughly, by 100% since the beginning of the war, and, therefore, the same number of dollars netted by a railroad can produce only a smaller amount of improvements than it produced in pre-war times. It follows that in order to secure these improvements, or even the necessary upkeep, a much larger amount of money must be procured. That money can be obtained in two ways only: by the flotation of additional securities or by an increase in revenue.

I believe I am safe in saying that the vast majority of the railroads are nowadays old established concerns which long since have sold their first mortgage bonds and have generally given comprehensive liens on their tangible properties so that, in financing today, they offer as the basis for new securities the general equity in the property; that means it is their earning power that today constitutes the chief basis of their credit. When net earnings dwindle, as they have, or when doubt arises in the public mind as to the ability of the railroads to be permitted to earn a generous return in the future, the entire credit struc-

ture of the railroads suffers. Securities can then be sold only on a higher interest basis. The higher interest charge, in turn, causes a corresponding reduction in net earnings, which again, in turn, operates further to destroy public confidence. And so one destroys the other!

Moreover, it must be borne in mind that the purchasing power of the dollar having been reduced to about 50% of its pre-war value, the interest received from his railroad obligations and the dividends received from his stock to the investor are worth only approximately one half as much as they were before the war, and the return from his investment is further reduced by taxation which absorbs a more or less substantial portion of what the railroad pays him. These are factors which make for the depreciation of railroad securities and it will have the further effect of forcing railroad companies in general to pay higher rates of interest and higher dividends in order to attract the investor's money.

The investor's present attitude toward railroad securities is, as just described, one of serious doubt as to the future. He does not and cannot know what will be the requirements of the Government; or what will be the labor situation: whether adequate labor will be available and if so at what price, and he naturally asks himself the same question as to the materials for the upkeep of the railroads: will they be available and at what price. On the other hand, he questions himself as to the attitude of the Interstate Commerce Commission: will it permit an increase in the rates charged by the railroads sufficient to offset these abnormal conditions?

It is natural that such an attitude of doubt affects seriously both the marketability and the market value of railroad securities. But this doubt alone has not produced the present shrinkage in their value. Other important factors play a part. One is the unprecedented amount of Government securities which has been placed upon the market and which must continue to be offered as long as the war lasts. It is natural that Government financing undertaken upon so gigantic a scale cannot occur without affecting security values both directly and indirectly. Another factor is that the patriotic investor, under present circumstances, justly has a strong desire to make all his savings available for the direct use of the Government, and he wishes, therefore, to buy Government securities, regardless of how tempting may be the securities of private corporations. There is, in addition, the endless stream of American railroad securities, heretofore held in Europe, flowing back into our country and seeking investment here ever since the beginning of the war in 1914. Under all these circumstances, it is at present becoming increasingly difficult for railroads to sell their securities on reasonable terms, whether to provide for the renewal of such of their obligations as may be approaching maturity or whether for necessary improvements. As a matter of fact, the sale of securities has become practically impossible for most of them.

Inasmuch, therefore, as the present condition of the securities market is practically prohibitive as far as the carriers are concerned, it is of paramount importance that the railroads, as far as possible, should be enabled to pay out of current revenues for all improvements that are necessary to keep their prop-

(6)

erty in at least the same condition of efficiency as obtained at the outbreak of the war. They should have ample revenue, not only because of these reasons, but also because of the fact, as stated before, that their earning power is the measure of their credit. If their credit is sustained it will tend to eliminate at least the lack of confidence, the doubt on the part of the investor, and thus remove one of the most serious handicaps upon the financial operations of the railroads. Enhanced confidence is tantamount to an increase of revenue because of the fact that it decreases the interest charges which must be paid.

It may be asked whether or not the proposed increase in net earnings and the consequent greater confidence of the public will open the securities market to the railroads to a degree sufficient to enable them to finance themselves. Not entirely. It will remain difficult enough for the railroads to finance themselves even under improved conditions, and it has been suggested that it may become necessary, in some way or other, to use or create agencies of the Government for the purpose of granting some sort of relief. Without entering into the merit of such a proposition, it is evident that, even in that case, the task of such agencies would be immeasurably relieved if they were dealing with companies capable of showing substantial net earnings.

It might be asked, "Why not let the railroads stop paying dividends and use these funds for the purpose of providing the moneys necessary for their improvements?" It is patent why such a policy would be fatal. The weak railroads have no dividends

which they might suspend. The strong railroads through such suspension would destroy the continuity of their dividend records which constitutes a most valuable asset in that on the strength of these records they have secured the advantage of being able to sell some of their obligations as investments for savings banks. Furthermore, such a policy would completely wreck railroad credit and would seriously affect the income and savings of the very public upon whom the Government must now rely for its revenues and for the flotation of its loans.

While all corporations, industrials and railroads, and even municipalities, when trying to raise money in the security market, are meeting with some of the obstacles encountered by the railroads i. e. the general conditions created by the over-shadowing financial operations of the Government, there is no doubt that no other class of borrowers is as much affected as are the railroads. The municipalities still have the advantage of making their issues attractive by freeing them from onerous taxes, and such industries as are not affected by price fixing by the Government are not hampered in shifting to the consumer the additional burdens arising out of changed conditions. The railroads, however, and certain public utilities, while forced to pay increased wages and increased prices for materials, are dependent upon the action of Government agencies in adjusting the rates which they may charge for their services. From all the information available to me,

(8)

the index price of railroad stocks has gone down about 20% since the beginning of the war in 1914 down to the present time, while the index price of industrial stocks has undergone but little change. The capitalization of all the railroads in the United States has been stated at \$8,750,000,000 of stock and about \$11,000,000,000 of funded debt. If we should figure that the value of railroad bonds has decreased by about 10% and that of railroad stock by about 20%, we would find that the shrinkage in railroad values since the beginning of the war, on that basis, would amount to about \$2,800,000,000.

This leads me to a discussion of another side of this question - the interest of the Government.

The successful placing of the Government loans to be issued from time to time, and running into billions, is predicated upon the strength of the general banking situation and the public's confidence in that strength. It has been estimated that national banks, State banks, trust companies and savings banks together own about two billion dollars of railroad securities. In addition to that, these securities form a large percentage of the collateral for their loans. A drastic shrinkage in value of railroad securities, therefore, is naturally a matter of serious concern to all of these institutions and might materially impair their vigor and freedom of action in cooperating with the Government's financial program and, if permitted to go too far, it may throw an additional burden upon the Government. It is my sincere



(9)

conviction that one of the main objects of the Government - the successful prosecution of the war - will be considerably helped if greater strength is given to the railroads and if greater confidence in them is instilled into the public mind.

For reasons which no doubt are apparent to your honors, it is difficult, in a public hearing, to express my views fully or in more than a very general way, but, in conclusion, I do not hesitate to say that present financial conditions appear to me to be such that an increase of the revenues of the railroads seems an urgent necessity for the purpose of sustaining their credit and efficiency, both of which are essential in aiding the Government and the country successfully to master the difficult tasks which are their chief concern at this time.

\* \* \*