THE CAUSES *of* THE PRESENT DEPRESSION *and* POSSIBLE REMEDIES

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The Finance Committee of the United States Senate has been directed to study and analyze the causes of the present depression and possible legislative remedies. At its invitation Mr. Aldrich appeared before the Committee at Washington, D. C. on Wednesday, February 22, 1933, and made the statement which is published herein.

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MR. CHAIRMAN:

I am glad to appear before you in response to your invitation, not because I have any panacea to present, but because I think it eminently desirable that there should be frank interchange of opinion between those who are charged with responsibility for government and those who are charged with responsibility for finance and for other phases of the economic life of the country. It is in some ways unfortunate that the political capital and the financial capital of the country should be separated. Misunderstandings between the financial community and the Congress have created many needless difficulties. I feel sure that many of these misunderstandings would pass away and better coöperation would exist if we knew one another better personally, and had the opportunity of talking more frequently and frankly with one another.

I understand that you wish me to present my views as to proper remedies for the present economic trouble. In order to do this it is necessary that I should first undertake to diagnose the situation, and I will ask you to bear with me therefore while I present something of the history of the events which led up to the existing situation. This will introduce the presentation of the remedies which I shall venture to propose.

CAUSES

The present depression has, of course, many features of preceding depressions. Any period of intense financial and business activity develops stresses and strains and maladjustments which compel liquidation and reaction. But the unprecedented severity—absolutely unprecedented as far back as good statistical records go—of the present depression, and the slowness with which the automatic restorative forces have worked, must be found in certain unprecedented circumstances which have preceded it. These are, I believe, as follows:

> (1) *Shift from Debtor to Creditor Position of U. S.*
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> The immense shift produced by the war in international debtor and creditor relations, and, very especially, the great shift of the United States from a debtor to a creditor nation.

Before the war we owed Europe a great deal of money, represented largely by American stocks and bonds held abroad. During the war we re-purchased most of these and we bought a great many European securities. Finally, following our entrance into the war in 1917, our own government advanced roughly ten billion dollars to our European allies.

Before the war we paid interest and amortization on our debt to Europe by sending out an excess of exports over imports. In general the normal thing for debtor countries is to have an excess of exports over imports, and for creditor countries to have an excess of imports over exports, or a so-called "unfavorable" balance of trade. England before the war regularly received about a billion dollars more imports than she sent out in exports, the difference being covered by her interest on foreign investments, her shipping services, banking services, and other items. France regularly received about half a billion dollars more a year than she sent out in goods. Germany, the Netherlands and Switzerland all had import surpluses or unfavorable balances of trade, because the rest of the world, debtor to them, paid them in goods. The logical expectation following the war was that countries formerly creditor and now debtor would send out an excess of exports, and that countries formerly debtor and now creditor would receive an excess of imports.

(2) *Inter-governmental Debts*

One of the worst legacies of the war was the existence of the inter-governmental debts, and especially the reparations. These debts involve both a budgetary problem and a transfer problem.

The budgetary problem is the problem of raising the money that has to be paid to the foreign government through taxation or other means in the debtor country, and in the currency of the debtor country. As all the principal debtor countries, very especially Germany, had exceedingly high taxes anyhow, taxes running far beyond anything we have experienced in the United States, the additional pressure on their budgets of raising the money for inter-governmental payments was very severe. This was softened for England, and eliminated for France, so long as Germany paid reparations. In the case of Germany herself, however, the pressure was so great as really to be endurable only in times of very active business, and it was a major contributing factor to the fiscal deficit which was so embarrassing to Germany in late 1928, in 1929 and in subsequent years. The existence of the huge reparation debt, moreover, greatly lessened the credit of the German government, so that it was unable to make much use of the resource which a great government usually can use in times of depression, of borrowing to fill in the gap between its revenues and its expenditures.

The other problem involved in inter-governmental debt payments, as in all international payments, is the transfer problem—the problem of exchanging the domestic currency for the foreign currency in which the debt payments have to be made. A debtor country can make payments in the currency of the creditor country to the extent that it can send out a surplus of exports over imports, or can entertain foreign tourists or can perform shipping services, etc., or to the extent that it can borrow foreign currencies, the latter being of course not a real solution but merely a deferment of the problem.

If there had been adequate freedom of movement of goods from country to country, the debtor countries could have solved this transfer problem by sending out goods. But the existence of the reparations and other inter-governmental debts was a great factor contributing to international fears regarding the movement of goods, and intensified the widespread policy of tariffs and other trade restrictions which the world has been engaging in on an increasing scale since the war. During the period when bank credit was expanding rapidly and foreign loans were placed easily, transfers were made without difficulty. But when there came a sudden cessation of foreign loans and debtor countries were suddenly called upon to pay, the problem of transition was a grave one. Germany herself did make the transition in 1929, and began to send out more goods than she took in, and some other countries made heroic efforts along these lines. But almost immediately a movement began to stop this by further trade restrictions and when we ourselves raised our tariffs still higher in 1930 there came a very general and widespread intensification of trade restrictions throughout the world. Tariffs are not the only, or even the worst, trade barriers. Quotas, vexatious inspections, exchange controls, and many other trade barriers can be even more restrictive. The payment of inter-governmental debts became increasingly difficult, although they were continued down into the summer of 1931.

(3) *High Protective Tariffs*

Our own high protective tariff policy inaugurated in 1922, preceded by some increases in 1921, prevented our foreign debtors from sending us goods in adequate amount to pay interest and amortization on their debts and at the same time buy our exports in accustomed amount. This tariff policy would promptly have checked our export trade but for the extraordinary financial development next listed.

(4) *Cheap Money and Bank Expansion*

> The gigantic and unprecedented expansion of commercial bank credit in the United States from the middle of 1922 to early 1928, amounting to 14½ billion dollars in loans and investments and 13½ billion dollars in deposits, accompanied by great expansion of bank credit in many parts of the world.

This expansion was due (a) to gold coming to us from other countries which were off the gold standard, and (b) to cheap money policies of the Federal Reserve Banks, both of which operated to create excess reserves in the member banks, with the resultant multiple expansion of member bank credit.

Perspective on the figures for expansion given above is gained by recalling that the expansion of bank credit required to win the war, from early 1917 to the end of 1918, was only five billions, eight hundred millions in deposits and seven billions in loans and investments.

The vastly greater expansion in the period from 1922 to 1928 was not needed by commerce and was not used by commerce, and went into (1) real estate mortgage loans in banks, (2) instalment finance paper in banks, (3) stock and bond collateral loans in banks, including loans against foreign stocks and bonds, and (4) bond purchases by banks, including foreign bonds. The consequences of this great expansion of credit, used in these ways, were, of course, excess construction, including road building, real estate speculation on a great scale, over-expansion of instalment buying, and an immense over-issue of securities including many ill-considered securities, but including also many others which would have been good if the total over-issue had not been so great, the rapid multiplication of bond houses, investment trusts and other financial machinery and a progressive deterioration in the *quality* of bank credit. The 25,000 banks of the country were not in a position to prevent this expansion and their managements were led inevitably into many mistakes in policy because of it. The control of the expansion was in the hands of the Federal Reserve System.

Bank Expansion, Foreign Loans and Export Trade

One very important incident of this expansion was the masking of the difficulties of international debt payments, including interallied debts and reparations, and the maintenance of our export trade despite trade barriers. This was particularly true following the Dawes Plan in 1924. The Dawes Plan was accompanied by an immense government security buying programme on the part of the Federal Reserve Banks. Following this came a tremendous volume of foreign loans which offset the influence of the high protective tariffs upon our export trade. We were able to get out, especially following the summer of 1924, a great volume of farm products and raw materials at good prices which restored, in a precarious fashion, the balance between agricultural and raw material production on the one hand, and manufacturing on the other hand, giving us active business while the foreign loans went on.

The following table exhibits the relationship between American exports and foreign loans, and agricultural prices.

AMERICAN EXPORTS, IMPORTS, FOREIGN LOANS AND AGRICULTURAL PRICES

(In millions of dollars)

	Exports	Imports	Excess of Exports	New Foreign Security Issues	Index of Agricultural Prices at the Farm. Yearly Average 1910-14 = 100*
1922	3,832	3,113	719	630	124
1923	4,168	3,792	376	267	135
1924	4,591	3,610	981	1,047	134
1925	4,910	4,227	683	1,078	147
1926	4,808	4,431	377	1,145	136
1927	4,865	4,185	680	1,562	131
1928	5,128	4,091	1,037	1,319	139
1929	5,241	4,399	842	759	138
1930	3,843	3,061	782	1,010	117
1931	2,424	2,091	333	255	80
1932	1,618	1,323	295	26	57

*Year Book of Agriculture, 1932, p. 902. Crops and Markets, January, 1933, p. 31.

(5) *The Three Main Causes of the Depression*

In these three factors, then, (a) inter-governmental debts, (b) high protective tariffs and other trade barriers, increasing in severity throughout the commercial world, including high protective tariffs on the part of our own great country, which had suddenly become creditor on a great scale, and (c) six years of cheap money and rapid bank expansion, we have the main explanation of the unprecedented financial boom, the unprecedented financial break and the unprecedented severity of the depression.

(6) *Artificial Price Maintenance*

An important secondary factor was growing interference with natural competitive markets in the period preceding 1929, partly governmental and partly by private organizations. The efforts to valorize wheat by holding movements proceeded on a great scale from 1926 to 1929. Through the activities of the Canadian grain pool and holding movements under government auspices in Hungary and elsewhere, the world's visible supply of wheat was nearly doubled between the summer of 1926 and the summer of 1929. In the autumn of 1929 our own Farm Board stepped in. The net effect of these efforts to maintain the price of wheat was merely to defer the facing of facts. Production held up more than it would otherwise have held up, consumption was checked, and surplus was accumulated. A similar policy, with a similar result, appeared in the case of copper, though the business interests responsible for the policy were quicker to recognize their mistake and quicker to change their policy than was our government in the case of wheat.

(7) *Cheap Money in U. S. and in England*

The cheap money policy of the United States was part of a policy of coöperation between the Bank of England and the Federal Reserve Bank of New York. The British believed that cheap money and expansion of bank credit were all that were necessary to get good business going again, and that it could be used as a substitute for industrial readjustments, including the scaling down of prices and costs. Without the strength in gold which we had in the United States, they tried to force the policy through anyhow. They failed to get good business by this policy, but they did succeed in getting credit so over-expanded that when the acute pressure came in the summer of 1931 they found themselves in a frozen position and without adequate gold reserves, and abandoned the gold standard.

The last chance the world had to call a halt on the over-expansion of credit and on speculation based on the over-expansion of credit without an unmanageable reaction was in 1927. I am informed that the Bank of France and the Reichsbank in Germany did try to tighten up then, Paris warning London that it was having to buy too much sterling, that easy money in London was financing speculation in the French franc and that the Bank of France, though reluctant to pull gold out of the London money market, would have to convert sterling into gold unless the process stopped.

The conference of the governors of the central banks held in New York in the summer of 1927 had a very momentous decision to make. Represented there were the Bank of England, the Bank of France, the German Reichsbank and the Federal Reserve Bank of New York. The representatives of the Reichsbank and of the Bank of France are understood not to have made any commitment regarding policy at this conference except a promise to communicate their intentions with respect to taking gold from London and New York in the future. They left the country before the governor of the Bank of England did. Following this conference there came in the early autumn of 1927, a renewal and an intensification of the cheap money policy of the Federal Reserve System. The rediscount rate was first reduced by the Kansas City Federal Reserve Bank, followed shortly by most of the others. Several hundred millions of government securities were purchased by the Federal Reserve System. Bank expansion moved rapidly, and almost all of it went into the securities market, either in the form of bank investments in bonds or in the form of collateral loans against securities. Shortly following this began a very intense speculation in securities, with rising security prices which ran through 1928 and into the late autumn of 1929.

(8) *Gold Exchange Standard*

Beginning in the middle of 1926, there came an extraordinary development in the substitution of balances in foreign banks, for actual gold in the central banks, as reserve money—the so-called "gold exchange standard," as distinguished from the strict gold standard. In the two years that followed this went very far. In particular, dollars borrowed in the United States through the flotation of bonds were used by foreign central banks as a substitute for gold, and funds borrowed in London in the form of sterling balances in British banks were similarly used as the reserves of Continental banks. This permitted the credit expansion at home and abroad to go much further than if each bank had carried its own gold. It created a very dangerous situation, the extent of which we realized in the Winter of 1931 and the Spring of 1932.

The Liquidation of the Gold Exchange Standard

Events began to move very rapidly in 1931. First, Austria was pulled down. Then Germany, though repaying gigantic sums to her creditors, was finally obliged to ask for moratorium and Standstill, and then the run on England's gold reserve began. The gold exchange standard on a great scale is only a fair weather proposition. When doubt arises regarding the goodness of balances in foreign markets, and different countries seek to convert their balances into gold and bring them home, a very difficult situation is created. England and Germany were unable to meet this situation. We ourselves were so strong in gold that we did meet it. But the liquidation in 1931 and 1932 of the gold exchange standard, which had been built up by the over-expansion in 1926–28, was one of the big factors in intensifying the present depression and making it as severe as it is. We must never let international short term credit relations get over-extended to this extent in the future.

International Coöperation of Central Banks

This leads me to an observation regarding proposals that there be international central bank coöperation designed to regulate commodity prices or designed to keep cheap money throughout the world in ordinary times, with a view to making world prosperity. The experience of recent years surely justifies grave reservations on this point. Our effort to coöperate with England from 1924 on, and especially in 1927, was very largely responsible for the excess of cheap money which has made us so much trouble. Incidentally, it created a world situation which meant a breakdown of central bank coöperation in 1931 and 1932, when the central banks of the Continent tried, unsuccessfully, to withdraw their balances from the Bank of England, and did successfully withdraw their balances from us. I firmly believe that the best policy is for each central bank, including the Federal Reserve Banks, to look after its own money market in ordinary times and to reserve international coöperation for special limited purposes, and for times of emergency.

This was the rule in pre-war days, and it was a good rule. Any country, in pre-war days, which was expanding credit too rapidly, was very likely to find its expansion checked as other money markets pursuing a more prudent policy began to take some gold away from it. Booms did not go so far, and set-backs were not so violent.

(9) *Fear Regarding Standard of Value*

The international scare in the Autumn of 1931 and the Spring of 1932 regarding the standard of value itself, the fear lest we and other countries should abandon the gold standard, precipitated the severest of all the troubles. No other fear is so terrible as this. The countries of Europe which during and following the war had such cruel experiences with depreciating and fluctuating currency, reacted to it in an extreme way. Our own people very generally trusted the American dollar, in view of our unbroken record since the end of 1878 in keeping the dollar good as gold, but even they could not escape the pall of fear which pulled down the volume of business in this country by almost one third from the middle of 1931 to the middle of 1932, which brought the greatest percentage decline of all in security values, and which pulled railroad traffic down from the levels at which the railroads' credit was good to levels at which the railroads' credit was gravely shaken, and which intensified the problem of unemployment to an appalling degree. I shall refer again to this point in discussing "inflation" as a possible remedy for the present trouble.

(10) *Broken Equilibrium*

Business life goes on well when different kinds of production are in good balance, different types of goods being produced in right proportions so that the sale of one kind of commodity produces income which can be used to purchase other commodities, so that goods can clear the markets of one another. The gravest effect of the breakdown of international trade, in the United States as in many other countries, is to throw out of balance the different kinds of production. At the present time nearly every country is geared up to do more export business than it can do under existing conditions, and has an undue percentage of its labor resources directed toward foreign markets. Every country is faced with the necessity of a radical shift in its activities, reducing its activities for export and increasing its activities for internal consumption, unless the trade barriers can be reduced and the foreign markets restored.

In the United States, this means especially that agriculture and other raw material production is greatly overexpanded in relation to manufacturing, which has meant so great a break in the prices of agricultural and raw material commodities that the producers of these things cannot buy even the relatively scant present output of the factories at prevailing prices. The balance among industries must be restored, and the only quick and sure way to do this is to restore the export market.

Equilibrium and Foreign Trade

The importance of foreign trade in our economic life has been questioned on the basis of certain estimates by the Department of Commerce, which made foreign trade 9.9 per cent. of the production of movable goods in 1927, and 9.8 per cent. in 1929.

I must say first, that these figures of the Department of Commerce do not seem to me quite correct. In figuring the total of movable goods they have taken account of agricultural products, mining products, and value added by manufacture, which is right. Then they have added to the totals, railway freight receipts, which I think is wrong when we are seeking a total to compare with exports. If we are going to consider freight receipts at all they should be divided between export business and domestic business and allowance should be made for the longer haul in the export trade. Further, the Department should consider shipping and other items. But I think the simplest and best way is to consider merely goods produced and goods exported. When this is done the percentages rise somewhat, standing at 11.2 per cent. in 1925, 11 per cent. in 1927, and 10.8 per cent. in 1929. Herewith are the Department of Commerce figures with the freight receipts eliminated:

PRODUCTION OF MOVABLE GOODS AND PROPORTION EXPORTED

(Freight Receipts Eliminated)

(Millions of dollars)

Year	Agricultural Products	Manufactures	Mining	Total	Exports United States Merchandise	Per cent. of Total
1899	3,355	4,831	600	8,786	1,253	14.3
1904	4,262	6,179	850	11,291	1,426	12.6
1909	6,472	8,385	1,238	16,095	1,701	10.6
1914	8,165	9,710	1,450	19,325	2,071	10.7
1919	17,677	24,809	3,158	45,644	7,750	16.9
1921	10,268	18,332	2,900	31,505	4,379	13.9
1923	12,382	25,850	4,300	42,332	4,091	9.6
1925	11,968	26,778	4,100	42,851	4,816	11.2
1927	11,616	27,585	4,000	43,201	4,759	11.0
1929	11,911	31,885	4,100	47,896	5,157	10.8

Source: Foreign Trade of the United States, Department of Commerce, 1931, page 11.

But I do not rest the argument on this tabulation. Eleven per cent. of our total business is a big percentage, but the percentage of many highly important individual products is enormously greater. The following table shows the percentage of various important exports exported in 1929:

Cotton	55 per cent.
Tobacco	41 "
Lard	33 "
Wheat	18 "
Copper	36 "
Kerosene	35 "
Lubricating Oils	31 "
Gasoline	14 "
Typewriters	40 "
Printing machinery	29 "
Sewing machines	28 "
Agricultural machinery	23 "
Locomotives	21 "
Passenger automobiles	14 "

(Source, Moulton & Pasvolsky's "War Debts and World Prosperity," page 409.)

Not even these percentages, however, tell the whole story. For important great areas, the dependence on foreign markets is even greater. Bright tobacco in Virginia, and cotton in Texas, are cases in point. You can prostrate a whole State when the foreign market for its principal crop is cut off. No percentages can take adequate account of the organic interdependence of foreign and domestic business.

REMEDIES

I think that the foregoing analysis of the major causes of the present situation will justify my proposals as to remedies. Some of them I shall list briefly.

1. Prompt settlement of the inter-allied debts.
2. Prompt reciprocal reduction of tariffs and the moderation of other trade barriers.

These two things are basic to the restoration of our export trade, which, in turn, is basic to the restoration of balance in our own economic life, so that our farmers and other producers of raw materials, receiving good prices for their products, may be able to buy the products of our factories in adequate volume, restoring activity and employment in the cities and restoring an adequate volume of traffic for the railroads.

Interim Measures

3. While these basic measures for restoration of normal activity are being put through, I would continue a policy of emergency credit relief, making use of the Reconstruction Finance Corporation. We must face the fact, however, that not all of the existing fabric of capital debt can be maintained in full.

There are important cases where the capital structure is top-heavy, and where it is desirable to scale it down to conform to the existing facts. The Reconstruction Finance Corporation should not be called upon to validate capital structures which cannot be maintained even when we get a moderate business revival. Instead, we should scale down fixed charges in a good many important cases. It is good credit policy to tide over in emergencies solvent institutions whose total assets exceed their total liabilities, but it is not good policy to undertake to validate the really inadequate assets of insolvent institutions. To facilitate reorganizations, the new bankruptcy legislation—that relating to corporations as well as that relating to individuals—should be enacted as soon as possible.

4. I would extend emergency credit relief to the farm mortgage situation, and also to certain city mortgage situations when, in the judgment of the Reconstruction Finance Corporation, a general financial interest is involved. In connection with farm mortgage relief, I would make every effort to deal with intelligent discrimination in individual cases, seeking to bring debtors and creditors into agreement with one another, seeking to limit the government's financial commitments to what is necessary to persuade creditors to make the necessary adjustments, but still doing the thing in a big enough way to make sure that an honest and competent farmer does not lose his farm. It is to the interest of the country and to the interest of the creditors, by and large, that that farmer who with his family knows the farm, knows its potentialities, knows local markets and has the home lover's interest in the farm, should be able to stay upon it and control it.

Differential Treatment of Debtors

I think we ought to avoid sweeping legislation making a general rule for every farmer. There are some farm mortgages which are perfectly good, where the farm debtor is able to pay interest and amortization, and where he needs no relief. There is no reason why the contract here should be altered. There are other cases where the farmer needs a great deal of relief. The same thing is true in connection with city mortgages and other debts. Such relief as is given should be given to embarrassed debtors and not to debtors as a class. We must protect the commercial morality of the country in the interest of the future giving and taking of credit. We must seek to be fair to creditors as well as to debtors. If we establish a precedent of allowing men who are perfectly able to pay their debts to escape from them in part, merely because other men are unable to pay their debts in full, we shall strike a severe blow at the fabric of confidence in the future.

My view is that we shall get out of this depression by removing its causes. The chief of these is a broken equilibrium, growing out of strangled international trade. This has made raw materials and farm products pile up unsold in the United States, even though offered at very low prices, and has led to an immense contraction in the volume of manufactured goods, and in manufacturing activity, though the prices of these things have not fallen nearly as much as have farm prices and raw material prices.

I would ease off the situation by giving emergency credit to prevent further forced liquidation of good assets at depression levels. And I would emphasize the necessity of undeviating adherence to sound money and sound public finance as vitally important to alleviate the fears which have arisen with respect to our currency and our government credit.

I am aware that there is another view, or set of views, advanced by men who think that the trouble with the world is simply a shortage of money and credit, and who propose to bring about a revival of business by what they call "inflation."

"Inflation" Has Many Meanings

The word "inflation" is a very unsatisfactory word. It covers a wide variety of meanings, and I believe it best to distinguish among some of these and to talk about concrete proposals. Among the possible meanings are the following:

(1) The issue of irredeemable paper money.

(2) The debasement of the standard of the currency—
- (a) by reducing the gold content.
- (b) by introducing bimetallism with silver.

(3) Going off the gold standard by suspending gold payments, which gives you practically the same situation as (one)—namely, the issue of irredeemable paper money.

(4) Some men would call a great increase in gold production in the world leading to an increase in gold throughout the world "inflation."

(5) Some have called the concentration of gold in a single country "inflation." Thus Professor Fisher referred to the gold which we obtained during the war as causing "gold inflation."

(6) Some would call any expansion of bank credit "inflation."

Cassel and Keynes

(7) Some would limit the word "inflation" to those changes in the currency and credit situation *which raise* commodity *prices*. This, for example, was Professor Cassel's view, and he denied pointedly that there was any "inflation" from 1922 to 1928 because commodity prices did not rise. The fact that credit expanded enormously and that we were having great speculative excesses and great price rises in real estate and in the stock market meant nothing at all to him, and he demanded even more credit when commodity prices softened a little. Mr. J. M. Keynes, in his recent treatise on money (Volume II, page 190) says with respect to the years 1926-29:

"Anyone who looked only at the index of prices would see no reason to suspect any material degree of inflation; whilst anyone who looked only at the total volume of bank credit and the prices of common stocks would have been convinced of the presence of an inflation actual or impending. *For my own part, I took the view at the time that there was no inflation in the sense in which I use this term.* Looking back in the light of fuller statistical information than was then available, I believe that whilst there was probably no material inflation up to the end of 1927, a genuine profit inflation developed some time between that date and the Summer of 1929."

This confession of error on Mr. Keynes' part comes too late to do anybody any good. He was one of the men who were urging cheap money through the whole of the period from 1922 on, and he continued to do it after the stock market broke in 1929.

Quality and Quantity

One very important distinction must be drawn in connection with these various ideas: (1) that of an impairment of the *quality* of the currency itself, and the other that of mere *quantitative* increase either of money or of credit.

But then a further point comes up at once, that an increase in quantity, if it goes far enough, will impair quality. If paper money, redeemable in gold, is issued in such quantity as to raise doubt about the adequacy of the gold reserves on the part of the issuing authority, runs can be started which will either force a great contraction of the quantity, or force suspension of gold payments and damage the quality.

Similarly, an over-expansion of bank credit impairs the quality of credit. We saw this on a great scale, running progressively from 1922 into 1929, bank credit expanding in excess of commercial needs went into capital uses, speculative uses, and consumption loans, taking the form of real estate mortgages, instalment finance paper, stock and bond collateral loans and bank investments in bonds.

Moderate amounts of any of these would have been all right, but the total was so great that there came impairment of quality, and the capital values of securities and real estate which underlay the credit became top-heavy and broke violently. Then there came loss of confidence in the assets of many banks, followed by a loss of confidence in their liabilities—namely, their deposits, which led to runs on banks, which took reserve money out of them and which forced even strong, solvent banks to contract credit. We thus ran through the scale whereby "expansion" or "inflation" of bank credit forced liquidation or "deflation" of bank credit.

When there is sufficient loss of confidence in the quality of credit, this can generate doubt also as to the goodness of the currency itself, and we saw this on a great scale in 1931–32. Foreign fears regarding the goodness of the American dollar led to withdrawals of hundreds of millions of dollars in gold from us and further quantitative contraction in bank credit in the United States, even though the dollar itself stood sound and strong.

Paper Money

Whatever else we may have in the matter of currency and credit policy, we must at all hazards protect the *quality* both of our currency and of our credit.

Paper money is, after all, a credit instrument—a promissory note. I know of no case where a government has actually issued such paper with an announced intention of never redeeming it. The value of irredeemable paper money rises and falls with the prospect of redemption. There is no mathematical rule relating quantity of issue to the extent of depreciation. Unpredictable events may cause the value to slump or recover violently—as the Battle of Gettysburg, which caused a great rise in the value of the Greenbacks in three days. These fluctuations are disturbing to all business, and only a few reckless speculators gain.

The issue of new paper money currency is futile. If it is redeemable and confidence in the gold standard remains unshaken, the paper will not stay in circulation but will merely pile up in banks. If confidence, however, is shaken, the effect is either forced liquidation, or else the abandonment of the gold standard. In the latter case, you cannot multiply quantity fast enough to keep up with depreciation.

The gold value of the *trillions* in circulation in Central Europe in 1921 was a fraction of the value of the *billions* in circulation in 1913.

Debtors and Depreciation

Debtors are supposed to gain by currency depreciation. But Germany, 85% of whose mortgage debt was wiped out by the disappearance of the mark, showed no gains as a result. Following stabilization, it was compelled to pay such fantastic rates of interest for all new credit that its debt burden was soon very heavy again.

Debasing the Gold Content of the Dollar

With respect to the *quality* of credit and the efficiency of credit in accomplishing economic purposes, it is clear, of course, that there must be *confidence*. But confidence is not a vague general thing. It is a specific thing. Confidence in bank deposits means confidence that the bank will be able to pay cash on demand. Confidence in the currency means confidence that the government or bank of issue will pay gold on demand, and the full amount of gold specified.

Two factors are involved in both these things: (1) belief in the ability to pay and (2) belief in the intention and good will of the bank or government. The latter is of absolutely vital importance.

Good Faith the Foundation of Credit

The preservation of good faith, the keeping of contracts, even though they hurt, are absolutely vital. An honest man can go bankrupt and retain his reputation, if he has clearly done the best that he can and protected his creditors to the extent of his ability. Such a bankrupt can come back again and receive credit again in the future. But the man who has turned sharp corners, who has evaded obligations, whose word is not accepted because he has broken his word, must for the future either pay cash or offer excellent collateral with a big margin.

The proposal that our government should *deliberately debase the dollar by reducing its gold content*, if carried out, would shock credit throughout the world for a prolonged period.

The Good Faith of the American Government

The shock to confidence, at home and abroad, of a deliberate breach of faith of the United States Government with respect to the gold standard of the present standard of value (meaning the present standard of weight and fineness) would be something we could not get over in years. Our government has given its solemn promise on every Liberty bond to pay gold coin of the United States of the present standard of value. The same promise is on the Federal Reserve notes and the laws relating to them. The law defines the standard of value as 23.22 grains of fine gold, or 25.8 grains of standard gold nine-tenths fine. The same promise is printed on virtually all our privately issued bonds and State and municipal bonds, and in a multitude of mortgages. We are bound by every promise.

These gold clauses in the government bonds were put there because of the fears which had risen in investors' minds growing out of our Greenback period and growing out of the silver agitation of the '90s. They were put there to assure our investors that, even if the government should ever get into such a position that it could not redeem its paper money, it would still pay interest and principal on its public debt in gold, which the country did even in the years 1861–79. It could not redeem its Greenbacks in gold, but it could pay interest and principal on the public debt in gold and it did so. For the greatest government in the world, without compulsion, deliberately to break these solemn promises would be an incredible shock to good faith everywhere. Excuse can be made for embarrassed countries like England for going off the gold standard that they couldn't help it, but no excuse could be made if we did it deliberately.

Destroying Confidence Wrecks Buying Power

The result of an action of this kind on our part, from the standpoint of the volume of credit and revival of gold prices throughout the world in the future, would be demoralizing in the extreme. The actual quantity of circulating money in the world constitutes a very small part of the world's buying power. The great bulk of it is credit. If we should do this thing, creditors, investors and lenders everywhere would for years to come be timid and apprehensive. The experience of the French people with the depreciation of their own currency has already put them in this frame of mind. France with all her gold has done very little in the way of investing since the *de facto* stabilization in the winter of 1926–27, and when she has put out her cash she has done it for the most part on short term, constantly watching, frequently calling it back. The French people are continually apprehensive regarding currency. In the winter of 1931–32 they were hoarding gold. They could not get gold in small amounts from the Bank of France. The Bank pays out only large gold bars, and the French people were consequently paying a premium over the French franc for American gold coin, and were paying a premium on small slices cut from gold bars. If we should deliberately debase our currency, as an act of choice, we should make general this kind of fear. Instead of getting easy and automatic expansion of credit in the near future, we should have a world much more reduced to a cash basis than it is even today.

Effect on Prices of Debasing Dollar

This consideration should make it clear why those who would expect a doubling of commodity prices to follow a cutting in half of the gold dollar would be radically disappointed. The weight of purchasing now carried by gold and credit together would, in that case, be thrown back to a disproportionate extent on gold alone, and the value of gold would consequently undergo a real rise. Prices in terms of gold would fall. Prices in terms of the new 50 per cent. dollar might rise a little, but not at all in proportion to the cut in its gold weight, and not *certainly* at all.

The prestige and the reputation for financial integrity of the American government, of the United States Treasury, and of the Federal Reserve Banks, are two of the biggest capital values in the world and two of the most essential features of world financial organization. Wantonly to destroy them, quite apart from the question of morality, would be an act of economic destruction of fearful magnitude.

The worst of our whole trouble came from the end of September, 1931, into the middle of June, 1932. England's abandonment of the gold standard caused a great scare regarding the standard of value itself. Creditors and investors everywhere called loans, refused new credits and sold investments. In two immense waves, foreigners pulled hundreds of millions of dollars out of the United States. Fear and hysteria drove the New York Times index of production down from 75 to 52 within twelve months. With a demonstration in the middle of June, 1932 that we could meet the foreign drain of gold, and with the magnificent vote of the United States Senate on June 17 against the soldiers' bonus bill, an immense sigh of relief went up. Securities rallied, and then business had its first real upward move in three years. Whatever else we do, we must not invite a repetition of this panic regarding the standard of value itself.

Debasement Could Not Solve Farm Problem

I want to say one further thing with respect to those who would advocate cutting the gold content of the dollar as a means of raising the farmer's prices. Quite apart from the moral and financial objections which seem to me so vital, I would observe that the plan would not do the farmer anything like enough good, even if it worked out perfectly. Suppose that the dollar were cut in two and suppose that all commodity prices should double. The farmer could then see his fat hogs rise from 3¼ cents a pound to 6½ cents a pound; but at the same time the prices of everything he buys are doubled. This does not help the farmer much. I would like to see the farmer get nine cents or ten cents for his hogs, and I want the price of his cotton doubled or more than doubled, *without* a rise in the prices of the manufactured goods which he buys. The manufacturer does not need higher prices —what he needs is volume—but the farmer must have radically higher prices. We must get the balance restored between the manufacturer and the farmer. This means that the farmer must get his export market again. I would strike at the export trade—not at the currency.

Silver Inflation

Testimony before your committee, and the cross examinations, have raised questions regarding the possibility of using silver, either under a bimetallic system or in some other way, and I want to make some observations regarding that. First, let me say that, in my opinion, the suggestion that our foreign trade has been primarily damaged by a decline in the price of silver seems to me to have no merit. Our trade with the one great silver country, China, has kept up a great deal better than our trade with the world as a whole, as shown by the following figures:

U. S. EXPORTS, 11 MONTHS ENDING NOVEMBER

	Total	Index	To China	Index
1929	$4,814,444,000	100	$114,437,000	100
1930	3,568,494,000	74.1	82,157,000	71.8
1931	2,240,219,000	46.5	84,193,000	73.6
1932	1,481,750,000	30.8	52,165,000	45.6

Silver bimetallism at 16 to 1, or any other ratio than the commercial ratio, would mean the debasement of the currency and the abandonment of the gold standard, but the adoption of bimetallism at the current ratio would still involve breach of contract under the gold standard and undermine confidence and good faith, and, moreover, would accomplish none of the purposes that the silver people have in mind, because what they want to do is to raise the price of silver.

I see no reason to go any further with silver than is proposed by the economic experts who prepared the agenda for the coming World Economic Conference. They rule out the use of silver, even in moderate amounts, as part of the reserves in central banks, saying that silver is unsuitable for such use because there is no fixed price at which it would be received by other central banks in the settlement of balances on international account. They make a few minor concessions to the notion that certain countries might withdraw very small denominations of bank notes and substitute silver subsidiary coins for them, and that some other countries might enlarge the use of subsidiary silver coinage. But they accept none of the main proposals made by the silver advocates, and I think they are right. I recommend their view to your committee, and I submit for your records what appears to be a verbatim account of their recommendations, as prepared at Geneva, taken from the New York Herald Tribune of February 9, 1933:

"After keeping relatively stable from 1921 to 1929, the price of silver in gold currencies fell abruptly by more than one-half in less than three years. There is no doubt that this sudden decline must, in the main, be attributed to the same causes as have acted on the general level of prices, and may thus be said to illustrate in a particular case the incidence of the world depression. Some special factors can, however, be found which have accentuated the downward trend, and these were to some extent already operating before the depression set in. Such factors are the demonitization of silver, the reduction of the silver content of token coins, and also the disposal of surplus stocks.

We have considered a series of proposals which have been discussed in recent years with a view to raising the price of silver, and we wish, in this connection, to make the following observations:

(I) It has been suggested that some form of bimetallism should be introduced.

We would point out that a bimetallic standard, which presupposes a fixed relation between the value of gold and that of silver, could be safely introduced only if the most important countries of the world agreed to such a measure. As the only international monetary standard which is at present likely to command universal acceptance is the gold standard, the idea of introducing bimetallism must be regarded as impracticable.

(II) It has been proposed that banks of issue should be allowed to hold increased quantities of silver in their legal reserves.

On the assumption that no form of bimetallism will prove acceptable, silver is unsuitable for extensive inclusion in the metallic reserves of a central bank, there being no fixed price at which it would be received by other central banks in the settlement of balances on the international account.

(III) It has also been suggested that governmental action should be taken for the purpose of improving the price of silver.

We would, in this connection, refer to the suggestion made in a previous part of this report, to the effect that, in countries where banknotes of small denominations are in circulation, these small notes might be withdrawn and replaced within proper limits by subsidiary coins, and we think that the conference should, in this connection, examine to what extent the use of silver in subsidiary coinage could be enlarged. Whatever sales of government stocks of silver may be deemed desirable it is important to conduct these in such a manner as to avoid any unnecessary disturbance of the market.

The conference should also consider whether, and if so by what methods, the marketing of the metal by producers and currency authorities is susceptible of improvement. The question of developing new and enlarged industrial uses for silver is, in our judgment, also worthy of careful consideration.

From the point of view of commercial relations with silver-using countries, particularly China, trade interests would best be served, not by a rise in the price of silver, as such, but by a rise in the general level of commodity prices. Any action which would tend to raise that level and in due course achieve its stabilization may be expected to have a favorable effect on the price of silver, and would, on general grounds, be welcome."

"Inflation" by Government Borrowing

Among the many meanings of "inflation" is one that relates to public finance, and here there are many proposals, ranging from moderate notions of necessary government borrowing, which I should favor, to extravagant notions regarding government borrowing which would be dangerous in the extreme. Excessive borrowing by the government can, of course, impair first the credit of the government, and then, ultimately, as the government leans on the Federal Reserve Banks too heavily, threaten the currency.

Sound Public Finance

We must have sound public finance. This means: (a) reduced expenditures and increased Federal taxation. I personally do not like a sales tax applied at a uniform rate to all manufactures. A very moderate tax would bear very heavily on some lines where demand is highly elastic, and a heavy tax would not make much difference in certain lines where demand is very inelastic. Necessities could stand much heavier percentage taxes than can articles which people can easily do without. Taxes could be put on tea and coffee and on such things as spices, of which small amounts are used in the individual's daily consumption, at much higher rates than on articles which make up a substantial part of the day's consumption. I do not pretend to have worked this out with any detail, but I do believe that a series of special sales taxes at different rates, classifying commodities with reference to elasticity of demand, would be less burdensome by far than one uniform flat rate. Of course, taxes should not be pyramided; they should strike production only in one stage and not in successive sales.

I am very hopeful, too, quite apart from reasons of taxation, that you will soon be getting a good revenue from beer and from wines.

Let me add that more moderate tariffs, which will let goods in instead of keeping them out, will be of real help to this problem of raising the government's revenues. In pre-war days the tariff was in fact our main source of Federal revenue, down to the time when the income tax came in.

But, in addition, expenses must be cut drastically. The discussion which has already taken place at these hearings has indicated possibilities in connection with the government's outlay to veterans who have no disabilities connected with service in the war, and the possibility of cutting that item very drastically is one which we cannot afford, for political reasons, to ignore. It is my understanding that very great reductions of expenditure can result from reorganization and consolidation of government bureaus, and from the elimination of overlapping functions. The political difficulties of this are, of course, recognized, but, in a great fiscal difficulty, political difficulties must be overcome.

I think, too, that the reduction in prices which has taken place ought to make it possible for us to cut almost every item of government expense except the fixed interest on public debt, and even there something can be done by refunding.

What "Balancing the Budget" Means

The budget ought to be balanced, in the sense that all ordinary expenses are covered by current taxes, and that the borrowings for special and non-recurrent purposes should be covered by additional taxes to the extent of current interest.

The orthodox canons of sound public finance would require, under anything like ordinary conditions, further taxes to cover current sinking fund on all new borrowings and also on existing debt. I have not consulted other bankers with respect to this point, but my personal view would be that, in a time of great depression such as the present, it is legitimate to borrow for contractual sinking fund requirements and to eliminate this item from the budget proper. Taxes which under existing conditions are adequate to balance the budget in the sense above described would, with any considerable improvement in business, be very much more than adequate for sinking fund requirements. My personal view is that we need not count in the deficit any expenditure which does not actually increase public debt.

If the Congress and the Treasury give definite and convincing evidence of their intention of dealing with this problem with full responsibility, they will strengthen the credit of the government and, in my opinion, the government bond market will take what bonds are really necessary for the meeting of this emergency. If, on the other hand, there is an evasion or failure to grapple with the problem earnestly and courageously, or light-hearted adoption of a borrowing programme without consideration of this point, the government will speedily find its securities sinking in the market and the market wholly unreceptive to new issues except at very high rates. The credit of the government is basic to every other credit, and we must protect it unflinchingly.

Government borrowing is necessary for emergency credit relief and for loans to the States to give direct unemployment relief. I recognize and would emphasize the responsibility of the whole country to the suffering millions who, through no fault of their own, are victims of this great depression.

But we must not overstrain the finances of the government and we must not jeopardize the credit of the government by proposals of a great government-borrowing programme for new public works on the theory that this will start a business revival. The government's credit cannot stand a great deal of that in addition to its necessary borrowing.

Further, we do not need government borrowing for new public works to start a business revival. If we move promptly to restore our export market for farm products and raw materials, we shall get a business revival quickly, and such government borrowing will be unnecessary. If, on the other hand, we use government borrowing as a substitute for the restoration of the export market, in the hope that we can force a revival of business merely by spending borrowed money in a country whose industries are badly unbalanced, the borrowing and the spending will be ineffective.

"Inflation" by Forced Expansion of Bank Credit

I should avoid further artificial efforts to force an expansion of bank credit. It was forced expansion of bank credit from 1922 into 1928 that was responsible for a great part of the present trouble. The renewal of government security purchases by the Federal Reserve Banks following the break in 1929, and especially in early 1930, was responsible for the false stock market boom in early 1930, and the renewal of excessive security issues which complicated very much the difficulties in the period that followed.

I strongly sympathized with the Glass-Steagall Bill, and with the government security purchases of the Federal Reserve Banks in the panic of the Spring of 1932, especially when the foreign run on our gold was on, as a means of preventing further forced liquidation. But heavy excess reserves, in the absence of confidence, will not force bank expansion. On the other hand, in times when confidence is normal and when borrowers (especially speculators) are ready to borrow at low rates, and when banks trust the security offered, excess reserves of 50 to 100 million dollars mean cheap money and rapid bank expansion. Excess reserves of 500 or 600 million dollars, in a period of reviving confidence, would be exceedingly dangerous.

The volume of bank credit in the country does not depend alone on the volume of bank reserves. It depends also on the temper of the business community, which is governed by the prospects of business, and on the movements of goods and on the prices at which goods move. Given the restoration of the export trade and revival of agricultural and raw material prices, credit will expand rapidly. There is no use trying further to force it from the other end by an artificial increase in bank reserves.

Nor is there any use in trying to increase the volume of currency in circulation by paying out more paper money. If the paper money is redeemable and confidence in the gold standard is not shaken by this, it will not stay in circulation but will merely pile up in banks. If the paper money is issued in such amount as to shake confidence in the gold standard, the effect would be forced liquidation and tightened credit.

State and Municipal Taxes and Expenditure

The Federal Government, even though reducing expenses sharply, will still need to have increased taxes in view of the present low returns from taxes and in view of the necessity of providing for interest for additional borrowing. The States and local governments, on the other hand, in many cases can reduce taxes, and this is particularly true of rural local governments, where the tax burden has grown so enormously in recent years, and where the farmer pays the bulk of his taxes. I am told of one farm in an upstate New York county where taxes in the last year have been reduced from $380 to $200, due to vigorous action by the county commissioners, who have cut salaries and sharply reduced the county expenses.

Our local government has been a haphazard growth rather than a businesslike adaptation of government to needs. Areas in many cases are altogether too small. They were set in horse and buggy days. There are many places where groups of small counties could be combined into one county, with the elimination of several sets of officers. There are many unnecessary road districts and school districts, each with independent sets of officers. There are immense possibilities for curtailing expenses in the cities. Even with the additional burden of direct unemployment relief which is thrown so heavily upon local government by this great depression, I am satisfied that the possibilities of saving are so enormous in the general field of local government that the total of the taxes can be radically cut. Much is being done in many States looking toward this development, and the Federal Government might very well use some of its existing instrumentalities for the study of what is going on, giving publicity to it, and acting as a clearing house for information regarding it.

International Goodwill

We should move as rapidly as possible and contribute as much as we can toward bringing about peaceful relations throughout the world, so that nations will be willing to go in for a thorough-going lightening of the burden of armament. I do not think that we shall contribute to this by peremptory demands that other nations disarm, because such demands may even intensify the fears that have led to the excessive armament. In general, it is far more fear than lust for dominion that accounts for excessive armament.

Tying Together Various Remedies

In connection with the programme which I have outlined, the desirable thing seems to me to be to accomplish all of the parts as rapidly as possible. When it comes to doing one thing conditioned upon some country doing another, I would be thoroughly opportunistic, bringing them together if it facilitates the transaction, and separating them if the effort to tie them together creates difficulties. In connection with tariff revision, I think that there is a great advantage in tying our reductions and the reductions of other countries together by reciprocal tariff agreements. I believe that public opinion on both sides of the water will be much readier to move in this way.

I think it might be difficult to tie together the settlement of inter-allied debts with a disarmament programme. Disarmament will be much easier to achieve when business recovery is already under way and when nations with a new economic hope are forgetting their fears and hatreds. It is noteworthy, for example, that, as between France and Germany, the era of good feeling was also the era of business prosperity, from 1924–25 down toward the end of 1928.

When it comes to international negotiations, it must be remembered that public opinion in every country is sensitive, that there are many points of national pride involved, that no country will accept dictation from any other country, and that public opinion in every country needs to be educated to make the necessary concessions to national pride in other countries.