

[Communicated to the Council
and the Members of the League.]

Official No.: **C. 227. M. 129.** 1938.II.A.[Pt.II.]
[F.1640, Pt.II.]

Geneva, July 9th, 1938.

LEAGUE OF NATIONS

FINANCIAL COMMITTEE

Report to the Council on the Work of
the Sixty-sixth Session of the Committee¹

(Geneva, July 4th-9th, 1938)

I. SOME OBSERVATIONS
ON THE GENERAL SITUATION

Series of League of Nations Publications

II. ECONOMIC AND FINANCIAL
1938. II.A. 9.

¹ The report on Bulgaria and Hungary is printed separately as document C.227.M.129.1938.II.A.[Pt.I].

SOME OBSERVATIONS ON THE GENERAL SITUATION.

1. In our last report,¹ we explained the system of the collaboration that we had established with the Economic Committee for studying the problem of exchange control and quantitative restrictions on trade.

2. From the enquiries which we have instituted, it is clear that, in many countries, such controls have already been relaxed by the independent action of Governments to a greater extent than we believe is generally appreciated. In agreement with the Economic Committee, we thought it well to entrust to a Committee composed of representatives of the Economic and the Financial Committees the task of studying the present exchange-control situation. In its report,² that Committee traces briefly the growth and gradual relaxation of these controls, and adds some observations concerning the relative efficacy of the various measures adopted with a view to liberating trade from avoidable impediments. We trust that this survey may prove of some value pending the time when circumstances may permit of a reconsideration of the general line of policy discussed at the last Assembly.

3. Since September last, however, when the Assembly laid down the general lines of work for the Economic and Financial Organisation on this and allied questions, the economic and political situation has undergone a decided change. In this connection, we have received from the Secretariat a review of the present economic situation and this we attach to our report. While we have considered the matter ourselves and have raised various questions which have led by agreement with the Secretariat to certain amendments to the memorandum, we have felt that the time at our disposal was insufficient for us properly to appraise an important technical work of this character. We must

¹ Document C.569.M.405.1937.II.A.

² Report on Exchange Control, submitted by a Committee composed of members of the Economic and the Financial Committees (document C.232.M.131.1938.II.A).

confine our observations, therefore, to certain points which appear to us of special importance.

4. From the facts given in the note and in particular from a study of the valuable series of diagrams, it will be clear that the setback in activity and trade since the spring of 1937 has been surprisingly sharp. In many instances, the retrograde movement has been as great as in the period 1928 to 1931.

It would, in our opinion, be a mistake to conclude that there is any very great analogy between the present setback and the earlier depression, either as regards its cause, the attendant circumstances or its probable duration.

The depression of 1929 to 1932 came at the close of a period during which, in general, the trend of world prices had been downward. At best, certain countries had for a few years enjoyed a relative stability of the average level of prices. The long-term downward trend culminated in a short-term movement of extreme violence in the same direction. A great agricultural depression throughout the world, due largely to causes peculiar to agriculture, happened, moreover, to coincide very nearly in point of time with the main depression.

The attendant circumstances were of a nature to intensify the depression and to aggravate its effects. The supply of gold was insufficient, or, if the total supply were regarded as sufficient, there was no surplus to overcome the difficulties caused by its maldistribution. Exchange rates were stable between all the principal countries, but that stability was threatened and eventually destroyed by the great accumulation of short-term foreign debts in the leading markets. Stock-exchange speculation had been carried to great lengths and there had been a sharp expansion of plant and fixed capital. The general economic structure was in no position to stand a great and new downward movement, and, in fact, in many countries the banking position, proving unsound when the trial came, accentuated the crisis. With all these difficulties, to which a high degree of currency instability was soon to be added, recovery, particularly in connection with international trade, proved to be a slow matter.

5. If the circumstances at the present time are compared with those mentioned, a reasonable degree of optimism may be felt. In the vast majority of countries, monetary conditions are easier,

as a result of the adoption of appropriate credit policies, assisted in some cases by currency adjustments, while the banking systems which proved unsatisfactory have been replaced by incomparably more solid structures. A considerable degree of stability between the leading currencies has been secured, while this time the impending threat of short-term foreign indebtedness has been very largely removed, partly by the liquidation of such debts, partly by the large accumulation of gold in the leading centres, and partly by the adoption of new machinery in the form of equalisation funds, which have in practice proved capable of neutralising the ill effects of even great international transfers of capital.

6. The present setback is usually attributed largely to the difficulties experienced by private industries during a period of transition. Manufacturers' stocks had been greatly expanded in the expectation of larger trade at higher prices, this process being at first encouraged by the obvious tendency towards rising costs of raw materials and rising wages. When it became apparent that the rise in costs would go so far as to defeat the expectations formed by manufacturers, a revulsion of feeling took place. The stocks which accumulated in manufacturers' hands, though they have now been much reduced, greatly complicated the situation. Fresh orders were not placed and the prices of raw materials fell abruptly. This development threatened the prosperity of countries whose exports are mainly in the form of raw materials, and these countries in turn are being led to reduce their imports of manufactured goods.

While in general this explanation must be accepted, sight must not be lost of other unfavourable factors. The situation has been rendered more difficult by the political tension and the autarkic policies of certain important nations.

7. In passing, some comment would seem appropriate on the extreme degree of variability which world prices of raw materials and foodstuffs have shown since 1928. A reasonable degree of stability in these prices is of the greatest importance to countries whose exports mainly take that form, as their economy cannot function normally in the presence of violent changes in values of the exports on which they principally rely for their supplies of foreign currencies. As events have shown, it is also of great importance that manufacturers should be able to plan their programme of production without risk of disturbance from rapid changes in

the prices of commodities they have to purchase. Whatever the merits or demerits of restriction schemes may be, it seems obvious that this problem has not yet been solved.

8. In our opinion, what is essentially required for a speedy recovery is a period during which private industry can carry on its affairs with a reasonable expectation of reasonable profits, and with a minimum of disturbance from fluctuations in costs and from fears of international complications.

That does not imply that we do not attach importance also to a continuance of policies directed to providing easy monetary conditions and to maintaining the economic welfare of the nation by methods appropriate to conditions in the particular countries concerned. On the contrary, the existence of a state of depression makes it more incumbent to pursue all such policies, as well as to encourage the movement towards practical stability of currencies and more liberal trade policies.

9. We have tended in our remarks rather to emphasise the brighter features in the present situation, but it must be borne in mind that the present situation is not in all respects better than the position in 1928. The renewed falling-away of international trade presents a serious problem to countries whose activities had been largely directed to export trade, and this in turn must react on the rest of the world, since in the long run a falling-off of export trade on the part of particular countries must lead to some reduction in imports.

It must also be obvious that the worsening of the political situation in Europe, the hostilities in Spain and the Far East, and the tremendous growth of armament expenditure, have profoundly affected the course of economic events. As a result, consumers are less willing to make purchases, manufacturers are less able to make plans for the future, and productive industry in general is depressed by heavy taxation and finds its structure distorted by armament demands. So long as the world lives in a state of continual tension and is thereby compelled to spend vast and non-reproductive sums on armaments, an interference with normal activities and a depression of the general economic well-being are inevitable consequences.

ANNEX.

NOTE BY THE SECRETARIAT ON CERTAIN ASPECTS
OF THE ECONOMIC SITUATION.

During the past twelve to fifteen months, the world economic situation has undergone a marked change. A year ago, the process of recovery had made great progress in most countries. Production had risen substantially from the low levels of the depression,

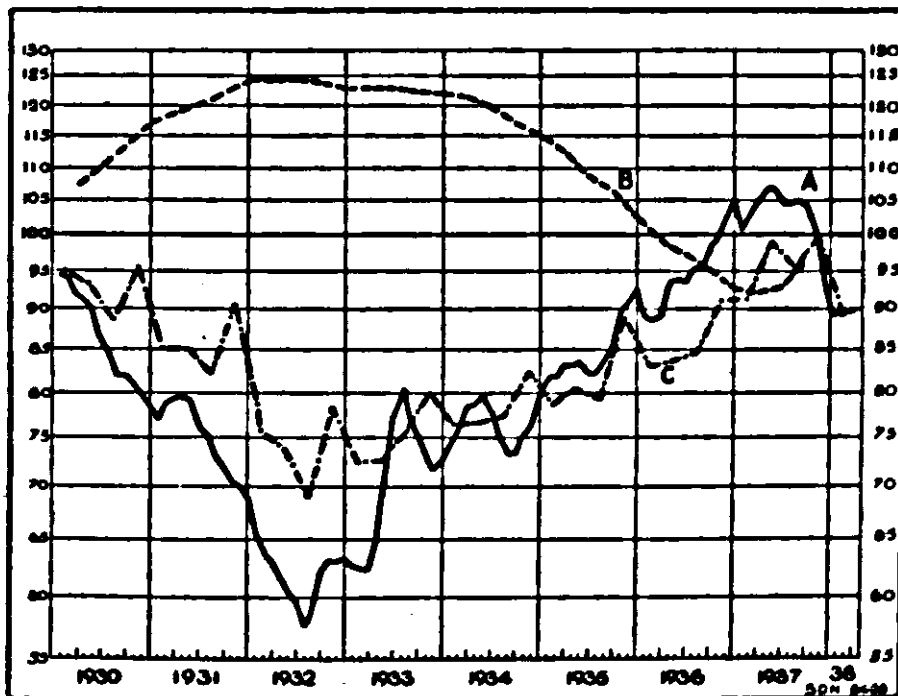
Diagram I.

WORLD INDICES OF INDUSTRIAL PRODUCTION, STOCKS OF PRIMARY COMMODITIES
AND WORLD TRADE.

- A. Industrial production.
- B. Stocks of primary commodities (adjusted for seasonal variations).
- C. Quantum of world trade.

Logarithmic scale.

1929 = 100.



unemployment had been greatly reduced, prices had been restored to more profitable levels. The world index of industrial production, calculated by the Economic Intelligence Service of the League of Nations, was nearly 10% above the 1929 level. Visible stocks of primary commodities were nearly 10% lower, and the quantum of world trade, which had fallen to less than 70% of the 1929 figures in 1932, had regained the 1929 level.

Commodity and security prices had risen considerably from the levels reached in the depression years, and domestic credit was cheap and abundant.

It is true that, in most countries, boom conditions had not been reached. But in some quarters there was concern about the signs of maladjustment developing. In some countries, wages in important industries had risen suddenly and unevenly; raw-material prices were mounting rapidly, and had induced industrialists, in some cases, to acquire stocks which subsequently proved to have been unduly high. Considerable discussion was devoted to possible methods of slowing down price-rises in the feared event of an inflationary expansion later.

By the spring of 1937, economic activity was ceasing to expand and a tendency towards recession has since spread to almost all parts of the world; by the middle of 1938, aggregate world industrial production¹ had lost all the ground gained in the preceding two years and was about 15% lower than in 1929; the quantum of world trade had again fallen to less than 90% of the 1929 level; unemployment was on the increase in most countries. Fortunately, the most recent developments seem more favourable than they have been for a number of months and it is possible that the trough through which we have been passing may prove at once shallower and shorter than was at one time anticipated. These reassuring signs are not confined to the stock exchanges, which have quite recently materially improved their tone, but are to be found, for instance, in the course of raw-material prices, which very recently seemed to be showing some recovery. This aspect of the question is examined again elsewhere in this note; it is necessary to consider first the course of events in the last fifteen months. It is not proposed, however, to attempt to trace the ramifications of the

¹ Excluding the U.S.S.R.

present recession throughout the world. This note is confined to elucidating the course of events in three countries—the United States of America, France and the United Kingdom—whose influence is widespread. That does not mean, of course, that it is suggested that the setback in economic activity is to be sought only in the events in these three countries. The worsening of the political situation in Europe, the civil strife in Spain, and the hostilities in the far East, together with the tremendous growth of armament expenditure, have had profound economic effects which it would be absurd to ignore. Consumers are less willing to make purchases, producers are less able to make plans for the future, and the standard of living is depressed by heavy consequential taxation.

The setback in business activity in the United States, which, as the greatest of the three countries concerned, may be taken first, down to the spring of 1938 is illustrated in Diagram II below. This diagram compares the course of industrial production and wholesale prices in that country since a year before the peak level of industrial production was reached in December 1936 with a period of similar length beginning a year before the peak level was reached in June 1929.

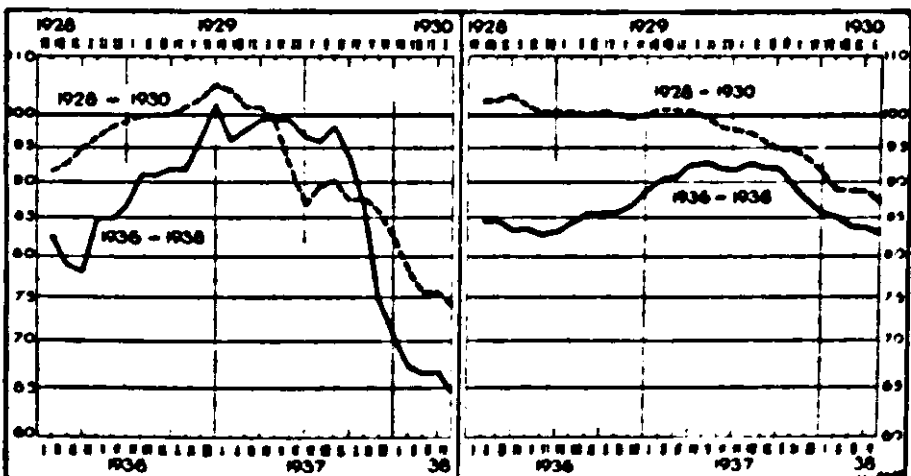
Diagram II.

INDUSTRIAL PRODUCTION AND WHOLESALE PRICES IN THE UNITED STATES.
Logarithmic scale.

1929 = 100.

Industrial production.

Wholesale prices.



It should be observed that, in this and certain other diagrams appearing in this note, the changes shown in certain economic indices in the period from 1936 to 1938 are compared with the changes in the same indices in the period of 1928 to 1930 for the sole purpose of exhibiting the magnitude of the changes. It must not be assumed that the setback in economic activity in 1936 to 1938, either in its causes or its probable future development, bears any close resemblance to the earlier depression.

In the United Kingdom, the contraction in business activity has been much less serious. Indeed, the Board of Trade index of industrial production, though lower in the first quarter of 1938 than in the last quarter of 1937, was higher in both quarters than in the corresponding quarters of the previous year. But, in spite of large rearmament expenditure, there has been some falling-off in general business activity. Diagram III below shows that the comprehensive *Economist* index of business activity fell steadily after August 1937. Many other important economic indices are down from the exceptionally high levels reached in 1936 and 1937;

Diagram III.

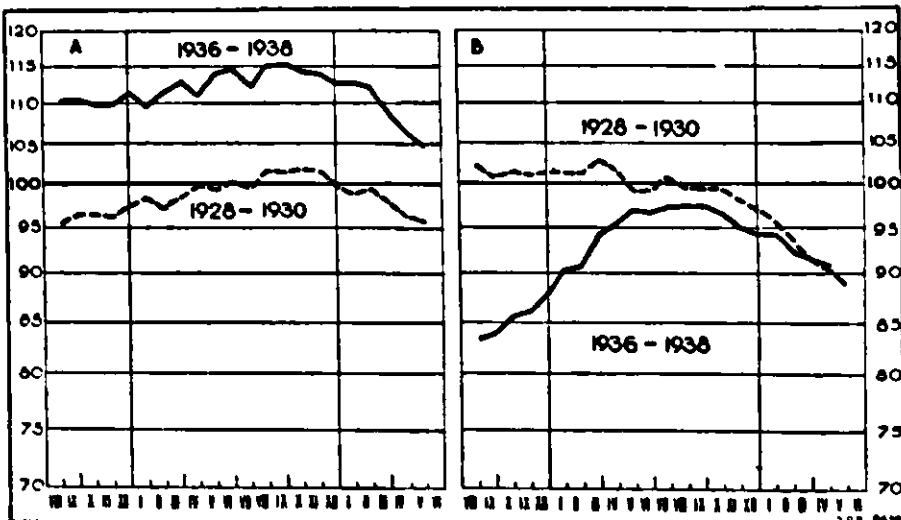
BUSINESS ACTIVITY AND WHOLESALE PRICES IN THE UNITED KINGDOM.

Logarithmic scale.

1929 = 100.

A. Business activity.

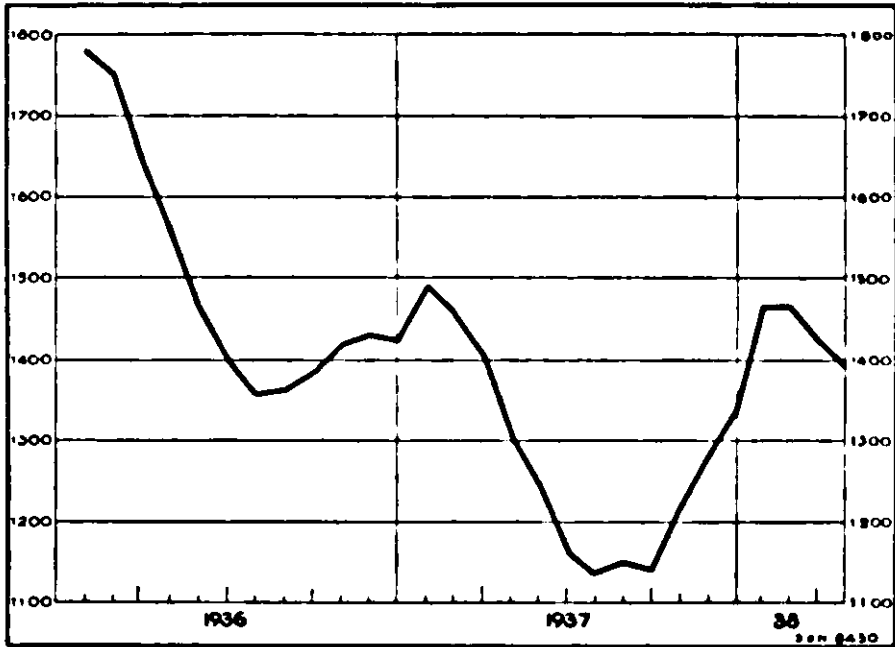
B. Wholesale prices.



this is true, for example, of building and textile output. Unemployment, including temporary stoppages, was about 300,000 higher in April 1938 than April 1937, and there was a fall of 100,000 in the numbers employed in British industry.

Diagram IV.

NUMBERS WHOLLY UNEMPLOYED IN THE UNITED KINGDOM (000's).



In France, recovery from the last depression was much less substantial than in the United Kingdom, and also less substantial than in the United States. But there, too, a fresh setback appears to have occurred after the end of last year. The general index of industrial production fell by more than 15% between December 1936 and August 1937 and, though some recovery occurred in the subsequent months, much of the ground gained was again lost in the first quarter of 1938.

The figures and the diagrams given above are confined to three countries, but in many others, especially those which are dependent upon exports, economic indices have recently tended to flatten out or to fall. Attention has been drawn in Diagram I above to the contraction of international trade. The decline in the imports of the United States, which in normal times takes a very large proportion of the world's exports of raw materials, is particularly striking.

Table 1.

FOREIGN TRADE OF THE UNITED STATES, FIRST QUARTER OF 1937 AND 1938.

First quarter	\$ (000,000's)		
	Imports	Exports	Balance
1937	784.8	701.2	— 83.6
1938	492.7	816.9	+ 324.2
Change	— 292.1	+ 115.7	+ 407.8

It should be remarked, however, that the magnitude of the imports during the first quarter of 1937 was no doubt due in part to the purchases for stocks to which allusion has already been made.

With the general contraction of world trade and fall in prices of primary products sold on world markets, the movement towards relaxation of exchange controls, particularly those of the Latin-American Republics, which occurred in 1936 and the first part of 1937, was slowed up and in certain cases even reversed.

Before examining the factors which appear to have contributed to this state of affairs, it should be emphasised that, difficult though the situation is, it would appear in many ways more resistant than in 1929. There has been no serious inflation of credit in recent years; in the major money markets of the world, banking conditions are sound, and, indeed, in the vast majority of countries the monetary and banking conditions are much easier than was the case in 1929; bond yields are low and the principal money markets continue to have abundant resources at their disposal. Moreover, there has been a wide-scale liquidation of indebtedness in all countries and short-term foreign debts have been greatly reduced. In cases in which these are not subject to standstill arrangements, the central banks and exchange funds appear to be well equipped to deal with the international transfers which take place. Owing to currency devaluation, the leading central banks find themselves with much more liberty than in 1929 to adopt any credit policy which circumstances may call for. The political situation, however, is much more unfavourable than it was then.

A special feature connected with the situation in the United States gives some basis for optimism regarding the possibility of a more speedy revival in that country than took place after 1929. The years preceding 1929 were marked by a very sharp expansion of plant and fixed capital of all sorts, which was, of course, checked

during the slump. Taking the recovery period of 1933-1936 as a whole, plant expansion does not appear to have been very great; in these years, the production of investment goods averaged 58% of the 1929 level, while the production of consumption goods averaged 87%. This fact should mean that there is a large latent demand for capital goods—for replacement and to meet obsolescence as well as for expansion—which could form the basis of an early and important recovery movement, granted favourable conditions, once surplus stocks in the hands of manufacturers or merchants have been absorbed. Consumption in recent months has in fact, it is believed, considerably outrun production, so that an appreciable absorption of stocks must already have taken place.

CAUSES OF THE RECESSION.

In an economy based on private enterprise, economic activity necessarily depends upon the prospects of profits. The prospects of profits in their turn are determined by the costs of production on the one hand and by selling prices and the volume of demand on the other, and by the expectation that nothing will occur seriously to disturb favourable relationships among these factors.

It is therefore necessary to examine the changes which have taken place in the cost factors and in the nature of demand. The most important variable cost elements are raw materials, wages and interest rates.

(a) *Rising Costs.*

It is a matter of common knowledge that the prices of raw materials rose very rapidly in the winter of 1936 and the spring of 1937. Between September 1936 and March 1937, the world price of tin rose by 46%, of lead by 68%, of zinc by 140%, and of copper by 78%; the price of wool rose by 17%, of rubber by 72% and of timber by 28%. Indices of the prices of primary products calculated by the London *Economist* for the United Kingdom and the United States show a rise of nearly 40% between the beginning of 1936 and March 1937. The sharp rise in raw-material prices was only partly due to increased consumers' demand. To a large extent, it was due (at the end of 1936 and the beginning of 1937) to speculative buying by those who were

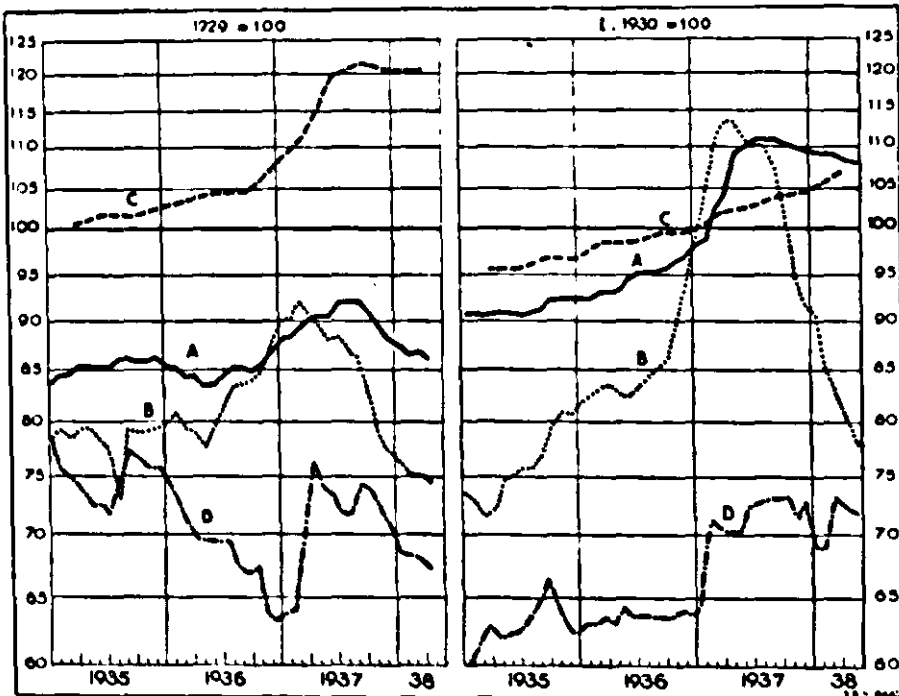
anxious to cover themselves as quickly as possible against a further rise in prices. One authority estimates the increase in United States inventories during 1936 at 2.3 billion dollars, and in 1937 at 3 billions. This writer holds the view that "inventories

Diagram V.

INDUSTRIAL COSTS AND SELLING PRICES IN THE UNITED STATES
AND THE UNITED KINGDOM.

Logarithmic scale.

- | | |
|----------------------------------|--------------------|
| A. Prices of manufactured goods. | C. Wage rates. |
| B. Raw-material prices. | D. Interest rates. |
| United States. | United Kingdom. |



were not out of line with sales at the end of 1936 and presumably were not therefore the initiating force in bringing the decline in the spring."¹ But there can be no doubt that the speculative purchases at the turn of the year drove raw-material costs beyond the level justified by the volume of current operations and prices of finished goods and thus tended to restrict the profit prospects of industrialists. Moreover, as the writer quoted states, the

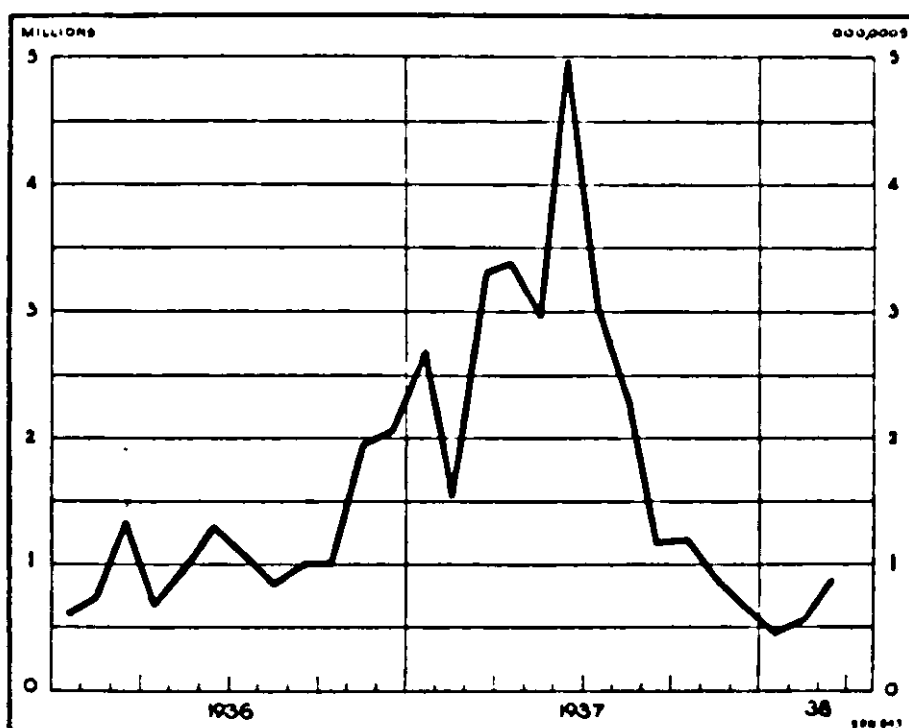
¹ *Dun's Review*, May 1938, published by Dun & Bradstreet, Inc.

accumulation of stocks " during 1937 was an important factor in deepening and prolonging the recession ".

The sudden rise in raw-material prices was accompanied by a rise in wage costs. This can be seen in Diagram V on the opposite page, which shows the monthly movements of raw-material prices, wages, interest rates and the prices of finished products in the United States and the United Kingdom since the beginning of 1936.

Diagram VI.

MAN-DAYS IDLE DUE TO INDUSTRIAL DISPUTES IN THE UNITED STATES.



In the United States, the prices of manufactured goods failed to keep pace with the steep rise in raw-material prices and wage rates, and by the spring of 1937, the latter were considerably higher in relation to 1929 than were the prices of finished products; the cost-price relationship also became less favourable in the United Kingdom. The rapid rise of wage rates in the United States,¹ amounting to nearly 15% between the middle of 1936 and the middle of 1937, was accompanied, as is illustrated in Diagram VI, by a recrudescence of industrial disputes due to strikes and lock-outs.

¹ The wage index shown rose by nearly 29% between June 1933 and June 1934; from then until the middle of 1936 it rose, on balance, by about 5%.

Diagram VII.

WHOLESALE PRICE, COST OF LIVING AND WAGE RATES IN FRANCE.
1929 = 100.

Logarithmic scale.

- A. Industrial hourly wage rates.
- B. Cost of living.
- C. Wholesale prices of national products.

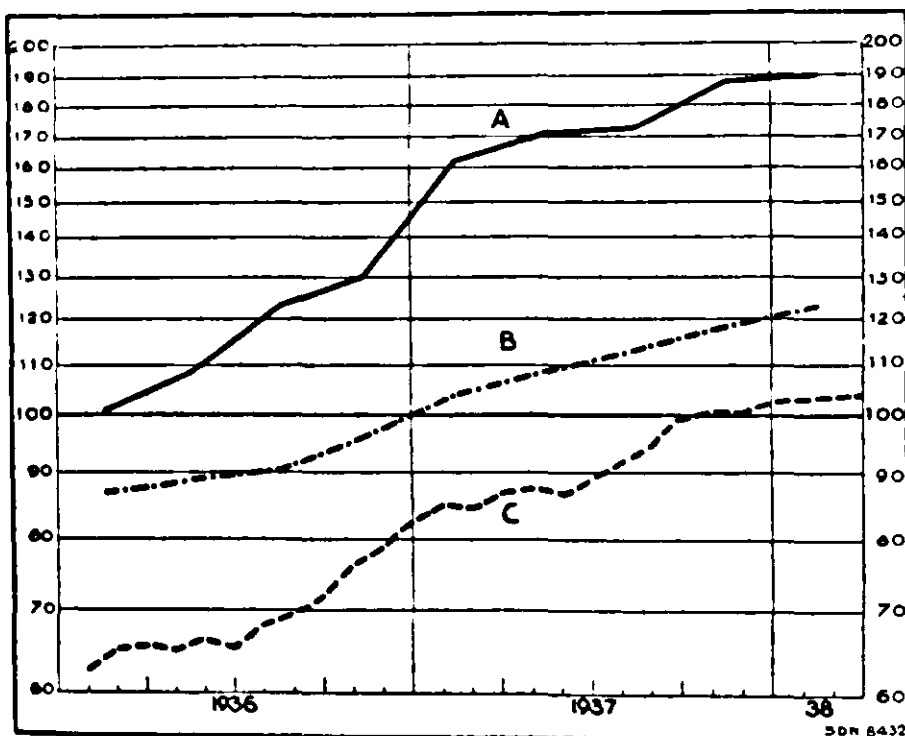


Diagram VII above illustrates the striking increase which has occurred in wholesale prices and the cost of living in France since the devaluation of the franc in 1936. The increase in wage rates was, however, even more striking, the index having doubled in a two-year period. At the end of 1937, the prices of national products were at about their 1929 level, the cost of living was 20 % higher, and hourly wage rates in industries were nearly twice as high. The reasons for the exceptionally large increase in wage-costs in France are well known and need not be enumerated here. But it should be pointed out that the index of hourly wage rates shown above does not take into account the paid holidays and social services

which recent legislation has accorded industrial workers. The index does of course reflect the adoption of the forty-hour week, which has probably been one of the principal factors contributing to its rise.

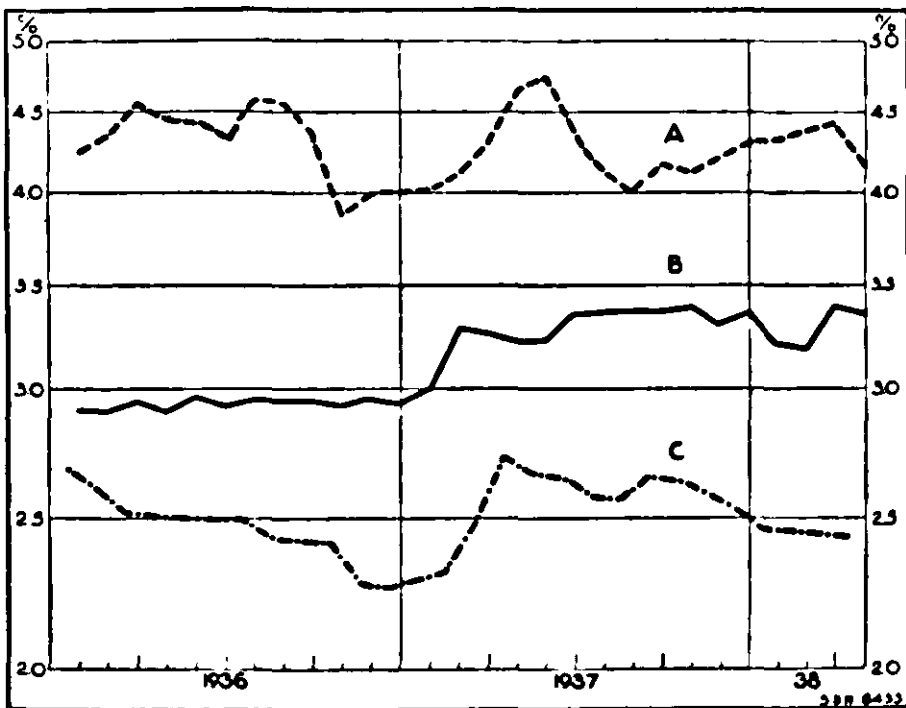
The movement of interest rates in the United States, the United Kingdom and France, as reflected in the yield on Government securities, is illustrated in Diagram VIII below.

Diagram VIII.

YIELD OF GOVERNMENT SECURITIES IN FRANCE, THE UNITED KINGDOM
AND THE UNITED STATES.

Logarithmic scale.

A. France. B. United Kingdom. C. United States.



In all three countries there was a rise in long-term interest rates in the first months of 1937. In the United Kingdom, the large financial requirements of the Defence Programme were announced in February 1937 and the yield of Consols rose from 2.96% in December 1936 to 3.28% in March 1937. In the United States, the average yield of Government bonds rose from 2.27% in December 1936 to 2.74% in April 1937, an increase of over 20%.

In the spring of 1937, there was therefore a simultaneous increase in all three major variable cost factors, though in the United States and United Kingdom interest rates remained low.

(b) *Declining Consumers' Demand.*

The rise in costs per unit of finished product illustrated in the above diagrams necessarily involved a decline in profit per unit of output. It would not, however, necessarily have caused a decline in aggregate profits if it had been possible to expand production further and thus to spread fixed costs over a larger output. The possibility of doing this depends on the volume and distribution of consumers' demand, and it is to an examination of this factor that attention must now be directed.

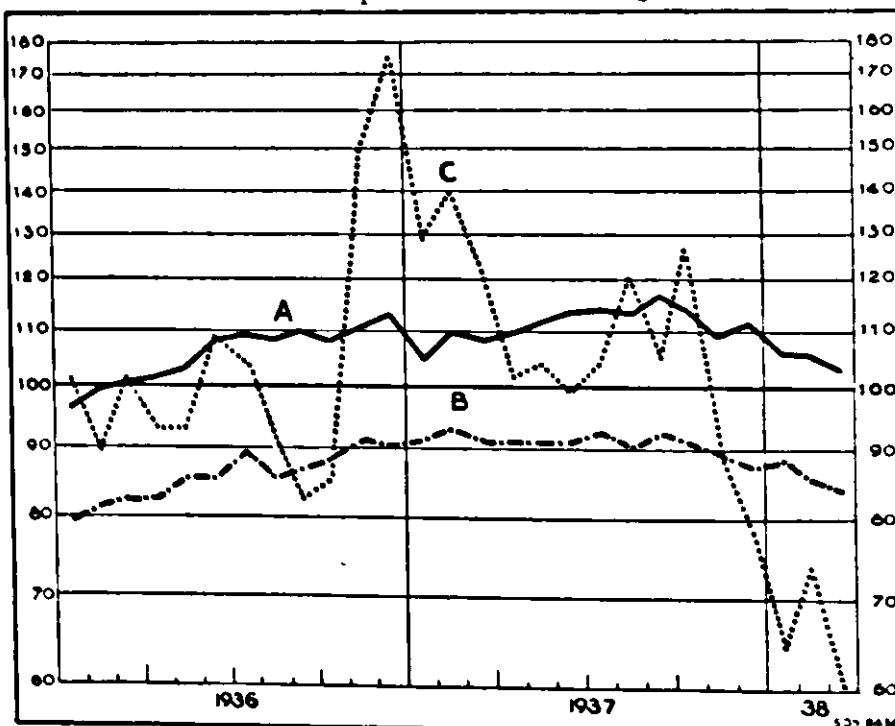
Diagram IX shows the monthly changes, since the beginning of 1936, in three indices reflecting consumers' outlay in the United

Diagram IX.

DEPARTMENT-STORE SALES, CHAIN-STORE SALES AND NEW PASSENGER-AUTOMOBILE SALES, UNITED STATES.
1929 = 100.

Logarithmic scale.

A. Chain-store sales. B. Department-store sales. C. Automobile sales.



States. The most significant feature of these curves is the flattening-out tendency which became apparent late in 1936, after the steady rise of the first months of 1936 and previous years. All these indices are based on values; as prices were tending upward, the volume of consumers' purchases must have been affected even earlier than the diagram suggests.

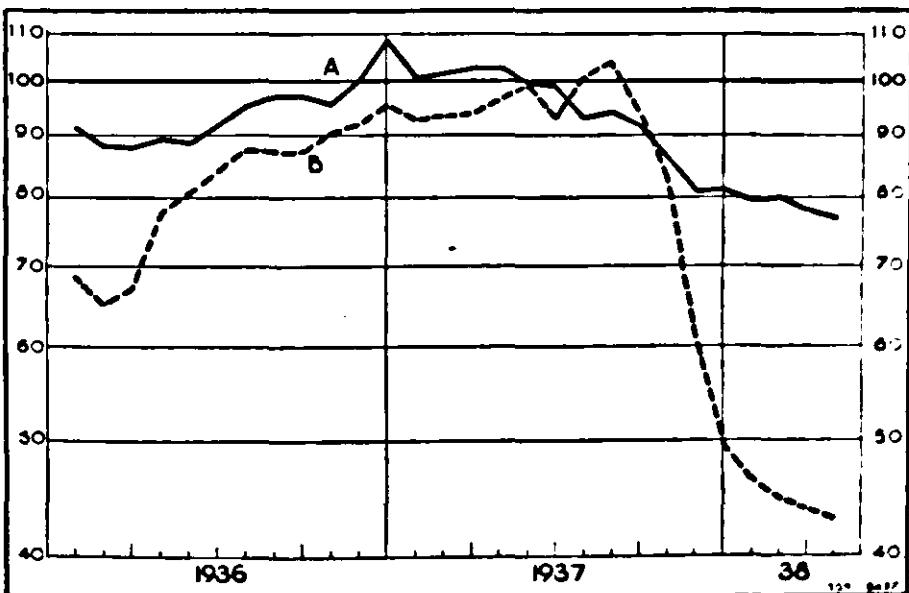
Diagram X below shows that the output of consumption goods in general, after rising sharply in the latter half of 1936, tapered off in the early months of 1937. This flattening of the curve of consumption is particularly significant. Additional plant is required when consumers' demand grows; when it is stationary, it can be satisfied by existing plant. Hence the demand for plant may disappear altogether if the curve of consumers' purchases flattens out or falls. This special relationship between the rate of growth of consumers' demand and the absolute volume of new investment may partly explain the sharp fall in the output of investment goods in recent months.

Diagram X.

PRODUCTION OF CONSUMPTION AND INVESTMENT GOODS IN THE UNITED STATES.
1929 = 100.

Logarithmic scale.

A. Consumption. B. Investment.



There is reason to believe, however, that the rise in production late in 1936, although largely influenced by the veterans' bonus, was due in part to production for stock. If this is true, the manufacturers, faced by the rising costs described already, must have anticipated that they could later pass on those increased costs in the form of higher prices of their goods sold to the public. This, as will be shown, they were unable to do.

In the spring of 1937, the American business-man was thus faced with a rise in costs on the one hand and a decline in consumers' demand on the other. The nature of the situation was concealed so long as inventory accumulations took place on a large scale. But when, as a result of the gold scare and other factors already mentioned, apprehensions became widespread regarding the maintenance of prices at their raised levels, it became clear that the sharp rise in costs had seriously affected profit prospects. Commodity and security prices fell sharply. Consumption of durable goods was restricted and investment activity declined to a low level: the great bulk of postponable purchases were postponed. The consequent fall in profits is reflected in the following table, which shows the combined net profits of leading industrial corporations of certain industries as compiled by the National City Bank.

Table II.
PROFITS OF LEADING INDUSTRIAL CORPORATIONS, UNITED STATES.

(Millions of dollars.)

First quarter	1937	1938	Per cent change
Iron and steel	69.2	4.9 (deficit)	.
Railway equipment	9.4	0.4 (deficit)	.
Building materials	8.0	0.7	— 90.9
Automobiles	44.8	8.2	— 81.6
Auto accessories	8.6	0.9 (deficit)	.
Machinery	8.2	3.9	— 52.7
Food products	18.8	16.6	— 11.8
Liquors	1.5	1.6	+ 9.6
Baking	3.8	4.3	+ 13.2

The value of retail sales in the United Kingdom, as calculated by the Bank of England, shows no tendency to decline until the spring of 1938.

Table III.

INDICES OF VALUE OF AVERAGE DAILY RETAIL SALES IN THE UNITED KINGDOM.

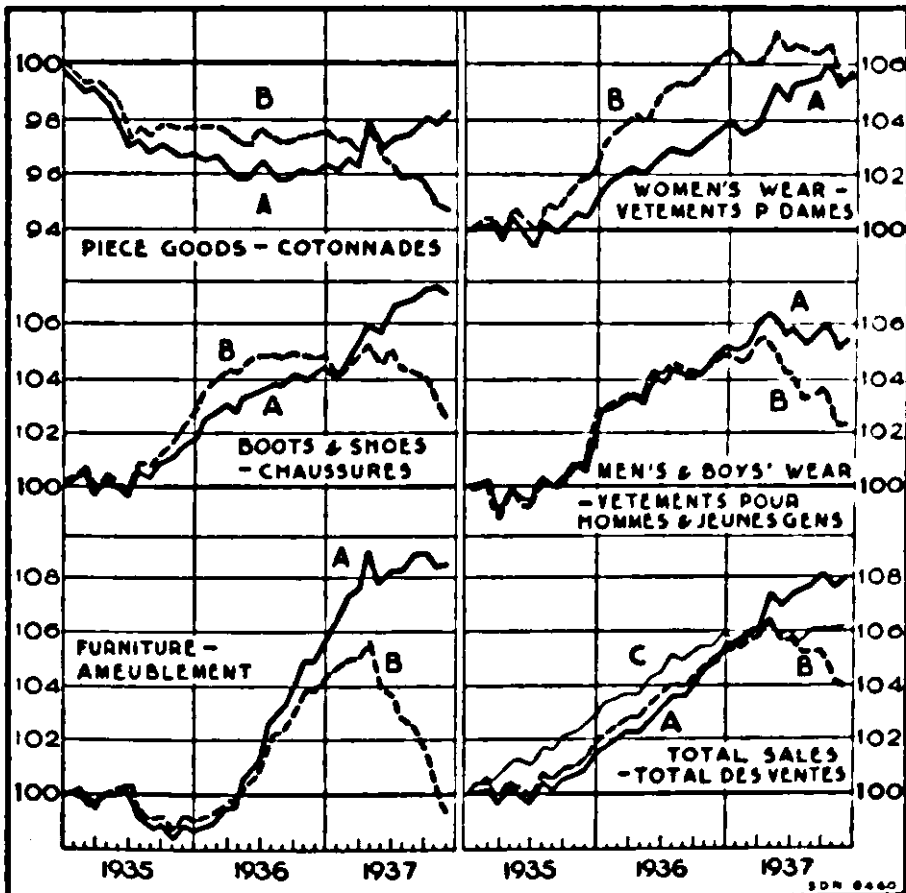
	1933 = 100.			
	Nov.-Dec.	Jan.-Feb.	March-April	May
1936/37	139	115	122	134
1937/38	149	121	120	126

It was not until May 1938 that the index for the United Kingdom was lower than in the corresponding period of the previous year. Sales in Central and West End London, which are more affected by stock-market fluctuations, fell, however, during 1937 and, as Diagram XI shows, there was also some flattening-out of the volume of purchases in department stores, which also cater chiefly for the well-to-do classes.

Diagram XI.

VOLUME AND VALUE OF DEPARTMENT-STORE SALES IN THE UNITED KINGDOM.

A: Volume. B: Value. C: Number of sales.



The falling-off in certain types of consumers' outlay is further reflected in the number of new motor-car registrations shown in Table IV below:

Table IV.

NEW REGISTRATIONS OF PRIVATE CARS IN THE UNITED KINGDOM.

October-March

1936	150,480
1937	165,722
1938	146,843

Such indices of consumption as are available for France also show a fall since 1936. Thus, an index of the volume of sales of department-stores,¹ which stood at 90% of its 1931 level in 1935, had fallen to 80% by the beginning of 1937 and stood at less than 60% in the first months of 1938. But there are reasons to believe that the turnover of these stores fell more than did retail trade in general. Thus the volume of sales of the large stores fell by 25.5% between January 1937 and January 1938, while co-operative store volume fell by 8.6%.

The data quoted in the last three paragraphs show that the condition referred to above under which the pressure of rapidly rising raw-material and wage costs need not have reduced aggregate profits was not fulfilled—that is, consumers' demand fell off. It is necessary to consider, therefore, certain of the factors that have contributed to this fall in demand.

CAUSES OF DECLINE IN CONSUMERS' DEMAND.

In the United States, purchasing power had been injected into the market on a very large scale in 1933-1936. Total interest-bearing Government debt rose from \$19,161 million in the middle of 1932 to \$33,700 million at the end of 1936. A large part of the deficit was financed by the banks, thus increasing the volume of deposit money.

The budgetary situation underwent a rapid change in 1937. In the fiscal year ended June 30th, 1937, the deficit was reduced by more than \$1,500 million.

¹ Calculated by the Institut de statistique de l'Université de Paris and the Institut scientifique de recherches économiques et sociales and published in *L'Activité économique*.

Table V.

TREASURY RECEIPTS AND EXPENDITURES, UNITED STATES.

	Total receipts	Total expenditures	Excess of expenditures over receipts
July 1934-June 1935	3,800	6,802	— 3,002
July 1935-June 1936	4,116	8,477	— 4,361
July 1936-June 1937	5,296	8,001	— 2,707
July 1937-December 1937	3,116	3,783	— 667

Through this change in the fiscal situation, there was thus a considerable net reduction in the volume of new purchasing power created by Government borrowing. The reduction was, indeed, greater than the above figures suggest, for the deficit was covered to a much smaller extent through new borrowings and to a very considerable extent through a new source of current receipts: the Social Security Act tended to restrict consumers' purchases by taxing workers and employers.

In 1936, consumers' demand had been increased from a quite exceptional source—namely, the veterans' bonus. This, as it was gradually spent, especially it is believed in the autumn of 1936, on various types of consumers' goods, both durable and non-durable, stimulated the demand for such products. But the monies thus spent seem to have failed to continue to circulate in their full volume.

There is evidence to show, however, that the producers and traders, seeing their costs rising, built up inventories, the financing of which required credit which was forthcoming in the form of commercial loans.

Moreover, the growth of consumers' demand which took place from 1934 to 1936, and was largely due to Government spending, did not stimulate investment in private industry on a sufficiently large scale to take up the slack in purchasing power when Government spending was reduced.

It may be useful to illustrate the failure of corporate investment to revive from three industries which together account, in normal times, for a large share of total investment activity in the United States, and where the volume of investment in recent years has been relatively low—namely, the railroad, public utility and building industries.

Diagram XII opposite illustrates some of the principal elements of the railway situation in the United States. But this situation, which is an important factor at the moment, may perhaps in its present form be considered rather an effect than a cause of the slackening of business which began in 1937.

Wage rates were well above the 1929 level in 1936 and were sharply increased in the second half of 1937. Taxes and the prices of some materials were also increased, while carloadings, which had never recovered more than 80% of their 1929 level, fell very sharply in the last quarter of 1937. The decline in operating revenue was much sharper than in operating expenses, and in the first quarter of 1938, the net operating revenue of all Class A railroads was \$19 million, compared with \$148 million in the first quarter of 1937. Taking fixed charges into account, the Class A railroads had a net deficit of over \$100 million in the first quarter of 1938. This sharp deterioration in the financial position was naturally reflected in stock and bond prices, which fell to new low levels. The railroads were in consequence unable to market securities to finance capital requirements; in the first months of 1938, new issues fell to zero. Orders for equipment, which had risen considerably in the first half of 1937, fell very sharply; the railroads are one of the most important customers of the steel industry, and there is no doubt that the decline in their purchases of equipment was one of the major elements in the deepening recession.

The dominant factor in the public utilities situation was not so much a deterioration in their financial position, as doubts regarding profit prospects, which were reflected in the very low level of security prices and the postponement of capital replacement and expansion. The monthly average of public utilities' new capital issues from July 1937 to February 1938 was \$45 million, compared with a monthly average of over \$200 million in 1929. Construction expenditures of electric light and power companies remained consistently low after 1933 and, in spite of some rise in 1936 and the first part of 1937, they were less than half the 1930 level in the latter year.

Diagram XII.

RAILWAY SITUATION IN THE UNITED STATES.

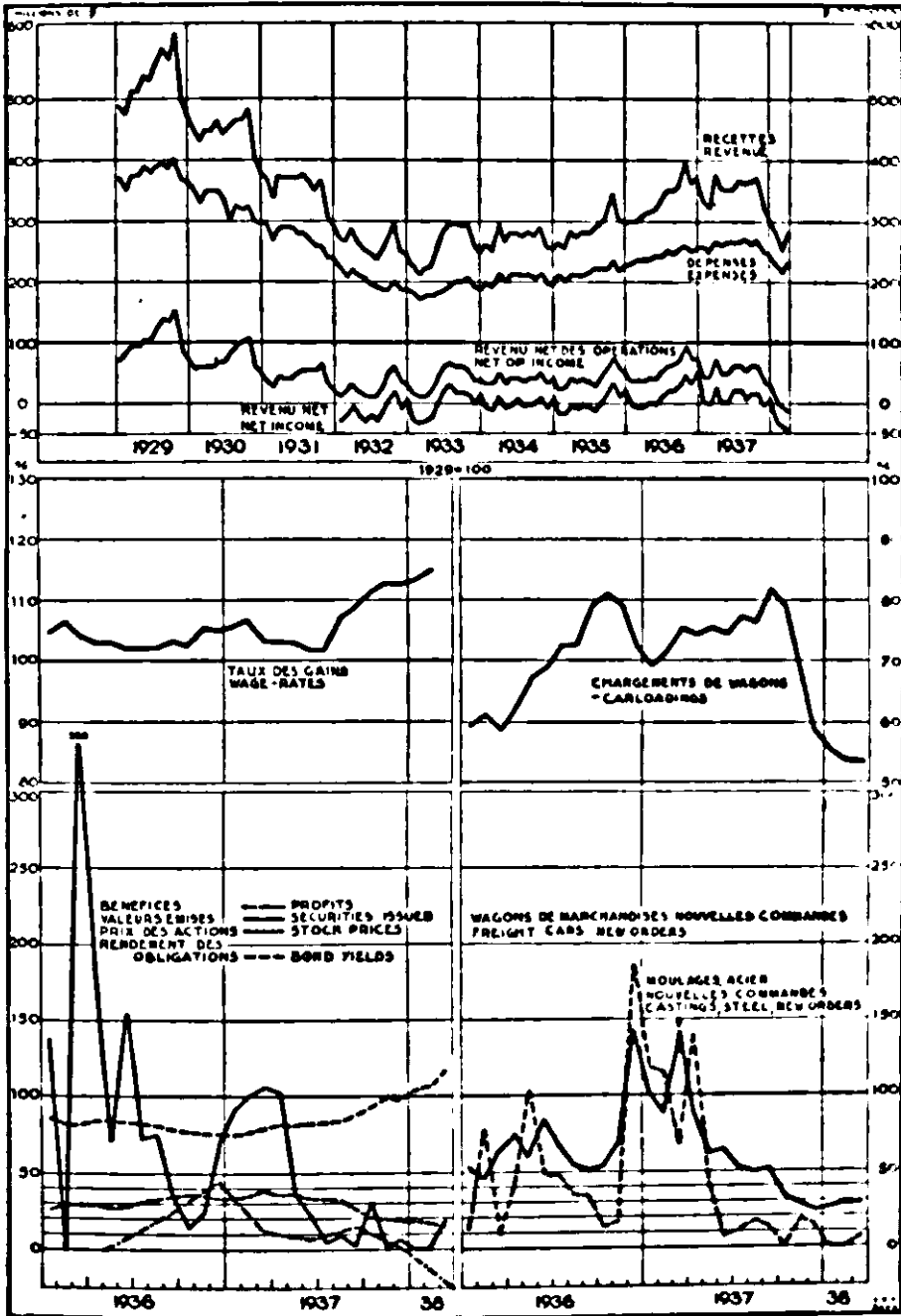


Diagram XIII.
PUBLIC UTILITIES SITUATION IN THE UNITED STATES.

1929 = 100.

I. Construction contracts.

II. A. Profits. B. Securities issued. C. Stock prices.

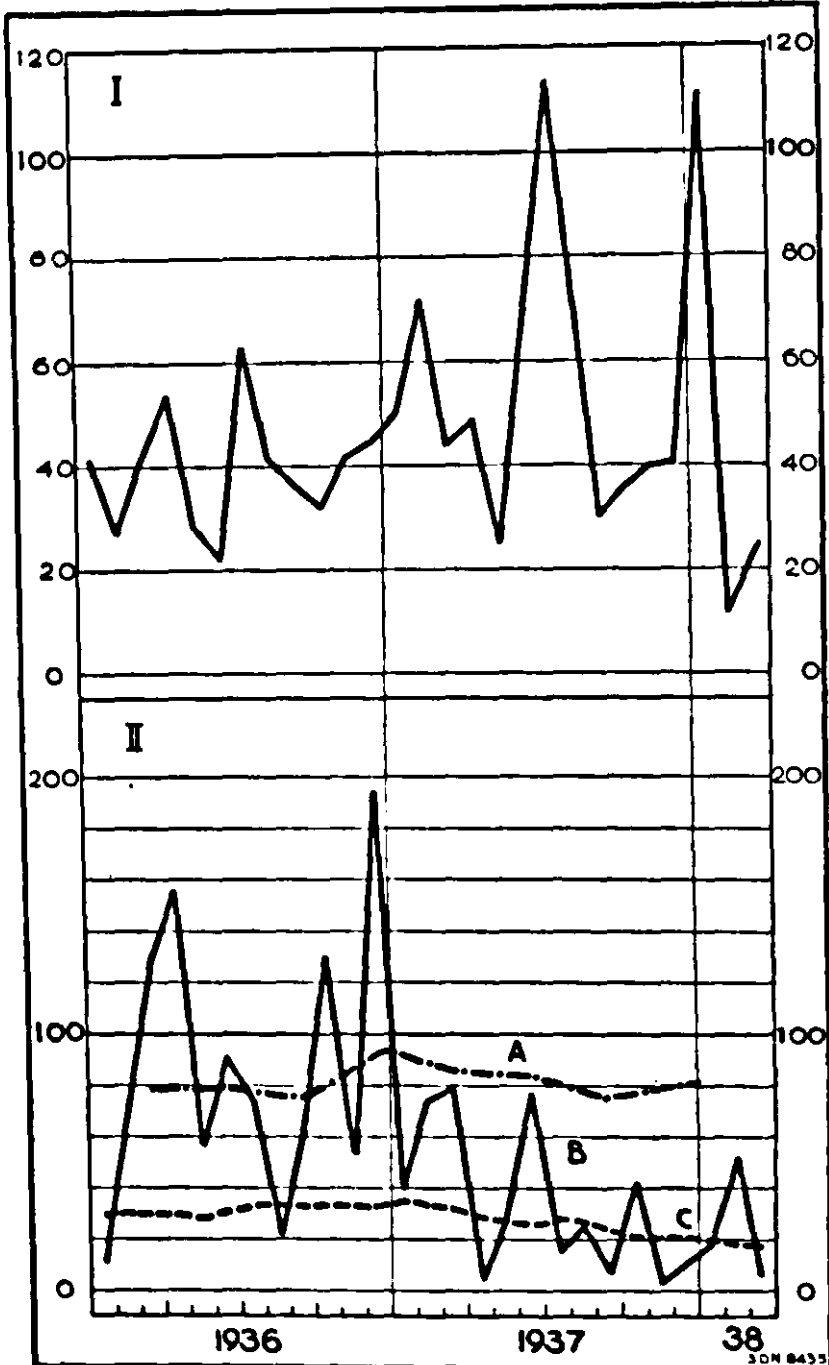


Diagram XIV shows some of the elements of the building situation in the United States. From the beginning of 1935 to the autumn of 1936, rents rose more rapidly than either labour costs or prices of building materials and the volume of building activity, though remaining much lower than in 1929, showed a steady and

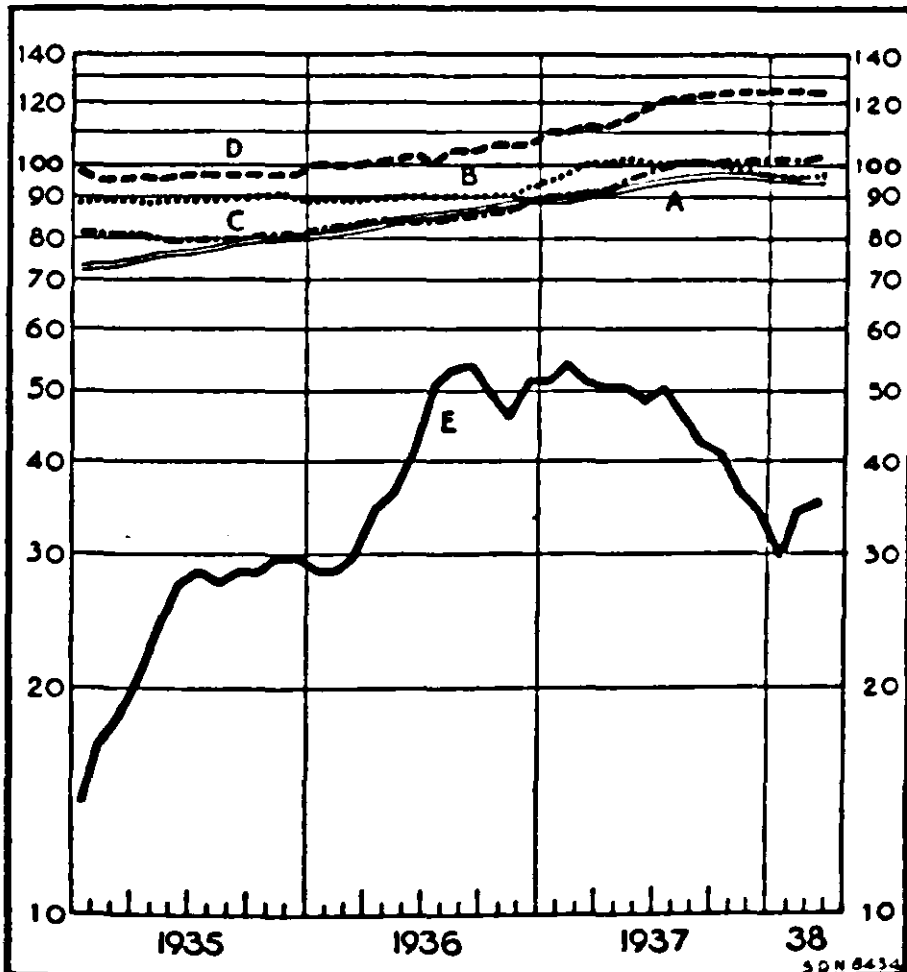
Diagram XIV.

RENTS AND BUILDING COSTS IN THE UNITED STATES.

Logarithmic scale.

1929 = 100.

- A. Rents.
- B. Prices of building materials.
- C. Wage rates (skilled).
- D. Wage rates (unskilled).
- E. Value of residential construction contracts.



substantial recovery. From September 1936 to September 1937, however, prices of building materials increased by 11%, wages of skilled labour rose by 15% and of unskilled labour by 13%, while rents rose by less than 8%. In spite of the fact that building activity was less than 50% of its 1929 level, an acute shortage of certain types of skilled labour developed in 1937. Building activity again declined; in the first quarter of 1938, residential building was about a third as high as 1929. Prices of building materials fell after the middle of 1937, while building wages continued to increase. The great activity in building prior to 1929 naturally postponed revival, but the latent demand for improved housing must be so great in the United States that, if favourable cost-income relationships could be restored and methods of financing developed, a recovery of this industry sufficiently important to affect the whole economy might be expected.¹

Reference should perhaps also be made to another factor. As mentioned above, the authorities in several countries were concerned during 1936 with the risk of the boom taking unhealthy proportions. In order to reduce the excessive idle funds, the Reserve Board, in August 1936 and again in March 1937 and May 1937, increased the legal cash ratios of the member banks in the United States and the Stock Exchange margin requirements were raised in January and March 1936. The excess reserves of the member banks as a whole were large enough to meet the three increases in reserve requirements, and, while there was some selling of Government securities, interest rates remained very low. When, in the first quarter of 1937, the position had been weakened by excess inventories, the economic system was naturally more sensitive, perhaps largely for psychological reasons, to monetary changes.

The course of events in the United Kingdom was widely different from that in the United States and calls for less detailed discussion. As already indicated, business activity was maintained at a higher level and the recession has been less marked and general. An even

¹ The fact that housing activity has consistently remained at so low a level in recent years is all the more remarkable, as, in the past, a considerable increase in the volume of building appears to have taken place regularly about three years after a shortage of houses makes itself felt.

sharper rise in interest rates than that illustrated in Diagram VIII above might have been difficult to avoid if prices of raw materials had remained high. After their acute fall in the spring and summer of 1937, the Bank of England purchased securities in the open market, thus offsetting the deflationary effects of currency hoarding by foreigners and the internal drain of cash.

Certain indications point to a falling-off of private investment activity in the latter part of 1937. This is reflected in the statistics of capital issues compiled by the Bank of England and shown in Table VI below. These figures do not of course directly measure the volume of industrial capital made available to business enterprises through the issue market in the quarters to which they relate, but they no doubt reflect the ability of the market to absorb new issues.

Table VI.

NEW INDUSTRIAL CAPITAL ISSUES IN THE UNITED KINGDOM.

	1935	1936	1937	1938
	£ (000,000's)			
First quarter	29.4	50.5	50.5	15.2
Second quarter	34.0	39.2	27.3	
Third quarter	56.0	26.3	16.4	
Fourth quarter	20.1	49.6	19.7	
	139.5	165.6	113.8	

In France, unlike the United States and the United Kingdom, the central bank made large advances to the Treasury from September 1936 to the end of 1937, and to these advances were added amounts put into circulation by the fund for supporting public issues. However, the effect of these supplementary means of buying was more or less neutralised by the export of capital, and the net increase in means of payment did not suffice to offset the effect of rising costs and prices. Production remained depressed, taxable income did not keep abreast of the requirements of the State, and the State's repeated appeals to the capital market kept interest rates too high to permit private borrowing, without, however, tempting expatriated capital to return.

RECOVERY MEASURES ADOPTED.

The continued deterioration of the economic situation led the American administration, in April 1938, to announce a new programme of measures to stimulate recovery. The measures include additional spending and additional facilities for lending, and the reform of certain taxes which were believed to have had an adverse influence on investment, such as the tax on undistributed profits and the capital gains tax. At the same time, the gold in the inactive fund was "de-sterilised" and the excess cash reserves of the commercial banks further increased through a reduction of their reserve requirements.

In addition, there has been some liberalisation of the arrangements under which the Government facilitates private borrowing for the purpose of housing, and a very extensive liberalisation of the official regulations governing commercial bank advances.

In the United Kingdom, a certain measure of monetary expansion was adopted in the first months of 1938.

Table VII.

LONDON CLEARING BANKS.

	Cash		Investments		Current accounts		Cash ratio	
	1937	1938	1937	1938	1937	1938	1937	1938
					£ (000,000's)		%	%
January	238	251	669	636	1,254	1,290	10.3	10.8
February	230	243	671	633	1,217	1,242	10.1	10.6
March	226	244	667	634	1,200	1,221	10.1	10.8
April	230	246	661	638	1,194	1,228	10.2	10.9
May	233	231	637	631	1,203	1,220	10.3	10.2

The expansive effect of the £16 million increase in bankers' cash between April 1937 and 1938 was partly counterbalanced by a rise in their cash ratio; the banks continued to be short of bills and some of them preferred to hold more cash to maintain their proportion of liquid assets; investments in Government securities were sold on balance in order to prevent the increase of advances (amounting to £47 million between April 1937 and 1938) from reducing the cash ratio below the desired level. The yield of 2½% Consols in April 1938 was 3.35%, compared with an average

of 2.94% in 1936. The estimated net circulation of notes and coins increased from £409 million in May 1936 to £458 million in May 1937, and £468 million in May 1938.

In France, where the low level of economic activity was due in part to the export of capital and in part to increases in costs, new measures were adopted in May 1938 as to both of these questions. In agreement with the British Government and the American Government, the franc parity with sterling, on the exchange markets, was lowered, a nether limit being fixed, however, at 179 francs. Moreover, the Government took steps to permit private industry to obtain medium-term credit at lower rates than formerly. And, while the forty-hour week was upheld in principle, the Government made it possible for its application to be less rigid and even in some cases suspended. Also a public works programme spread over three years has been adopted, involving a total expenditure of 11 billion francs.

It is too early to judge of the effects of these measures, but as has already been stated, the latest indications are somewhat better than they have been for a number of months.
