

PSF

Treasury Dept.

July - Dec. 1938

TREASURY DEPARTMENT

INTER OFFICE COMMUNICATION

DATE July 5, 1938

TO Secretary Morgenthau

FROM Mr. Haas

Subject: The Business Situation, week ending July 2, 1938

Summary

(1)

Further improvement in various business series confirms previous indications that an upturn in business activity is getting under way.

- (a) Steel activity has shown a contra-seasonal increase for the fourth consecutive week, and automobile production has continued to hold its previous gain.
- (b) Stock and commodity prices have had a further sharp upturn.
- (c) Department store sales have extended their upward trend.
- (d) Heavy buying in the cotton textile markets has continued through the second week.

(2)

The background for the business outlook in this country has been strengthened by an improvement in business confidence in Great Britain, simultaneously with improved confidence in this country. An increased demand for motor cars in England is reported; sentiment in the steel industry is more optimistic; and textile sales have expanded.

(3)

The uprush in the stock market, partly due to heavy short covering, has apparently outrun the immediate business prospect. Investment buying should provide market support on reactions, however, in view of the improved confidence in the business outlook.

(4)

The prospect for increased activity in the country's two leading industries strengthens the outlook for the immediate future.

- (a) Increasing steel operations at a time of normal seasonal decline testifies to an increasing demand, despite some tendency to withhold orders because of price uncertainties.
- (b) The heaviest textile buying since March, 1937, promises a continuation of the recent improvement in cotton mill activity, while the near prospect of serious weevil damage to the cotton crop may encourage a speculative boom in prices.

* * * * *

The steel situation

Steel operations increased this week for the fourth week in succession, reaching 28.7 percent of capacity, up .7 point. Steel orders for the week ended June 23 declined to the equivalent of 26 percent of capacity, as compared with 29 percent the previous week. Although two days of the stock market rise were included in this period, the uncertain price situation has apparently held back new orders.

Since the week of June 23, trade reports indicate some increase in demand for steel, of which the contra-seasonal increase in steel operations provides confirming evidence. On this point, the American Metal Market mentions that earlier plans for a cut in production in some districts were abruptly halted by a broadening of demand. In the Buffalo district, for example, Bethlehem Steel had lighted two additional furnaces on June 13 to take care of a small accumulation of orders, expecting to drop them the following week. However, plant officials said that an influx of unexpected orders had made it necessary to continue all open hearths indefinitely. Republic Steel, operating two out of nine furnaces, also said new business had shown an encouraging upswing during the past week.

Nevertheless, the uncertainties and complications attending the recent price cuts and elimination of basing point differentials have undoubtedly held back a considerable volume of possible business. Buyers now have the additional problem of making new calculations to determine where they can get steel cheapest. A Pittsburgh news item mentions that on the price cut announcement by U. S. Steel, buyers of almost all

finished steel products decided to hold back orders until the whole situation should become straightened out. The American Metal Market says editorially that "By no means will buying and production be immediately stimulated. Rather, buyers may be disposed to hold off until the last word has been spoken." Mid-year inventory taking will also tend to delay steel ordering at this time.

The new price schedules do not eliminate the basing point system, but they do eliminate differentials between basing points. This has the effect of cheapening steel prices most in the districts farthest removed from Pittsburgh. Purchasers in the Southern (Birmingham) district will therefore reap the largest benefits. Many of the smaller steel companies are greatly upset by the change in price policy, claiming it will work to the advantage of U. S. Steel and the large independents.

Following the price cut on steel products, a series of price reductions have been made on other related products. A general reduction of \$4 a ton in pig iron prices is called the most drastic in the history of the industry. Prices on cast iron pipe, on black and galvanized piping, on wire products, and on rivets have been reduced, and the price of coke, used in blast furnaces, has also been lowered.

The various price reductions appear to have improved the outlook for steel activity during the fall. They have been made at a time when they will be of maximum benefit to the automobile industry in its steel buying for 1939 models, and some increase in demand from the railroad and building industries may be expected as a result of the reduced prices. The effectiveness of the price reductions on steel is increased by the upward trend of basic commodity prices.

Improved prospects in textiles

The immediate outlook for the country's second largest industry has been greatly improved by two successive weeks of heavy textile buying, particularly since cotton mill activity had already started a rising trend. The New York Times adjusted cotton mill index for last week rose to 94.6, the highest since early December 1937. If textile sales continue even fairly large, it is taken for granted in the textile trade that mill activity will increase substantially.

Cotton textile sales during the first week of heavy buying were reported as the largest since March, 1937, with print cloth sales equivalent to 5 or 6 weeks' production. Textile prices have been marked up with the improved demand, confirming previous belief that the Government bought its recent huge W.P.A. cloth order at the lowest levels of the price decline. The first week of heavy buying ended with most standard cloth constructions $3/8$ to $1/2$ cent higher than at the beginning of the week.

In Chart 1 we show a comparison of new orders for cotton and rayon received by Pacific Mills, by weeks, with the trend of cotton mill activity. Although orders in recent months had been moderately high, part of them had evidently been filled from inventories rather than from increased production. The recent upturn in mill activity suggests that stocks have become depleted.

Reduced cotton crop prospect

The prospect of an upturn in textile activity during the summer and fall is aided by the possibility of a speculative price boom, since the cotton crop seems headed for a season of severe weevil damage. Reports from the Government and from State and private agencies indicate that weevils are more numerous than last year. The crop is now in the critical weevil period. If cool and showery weather continues during the next two or three weeks the weevil will develop rapidly, and a drastic reduction in yield per acre will be inevitable. In every year since 1927 a period of hot weather has been experienced during June or early July, sufficiently prolonged and with temperatures sufficiently high to destroy most of the first brood of young weevils, and allow the crop to get ahead of the next broods. This year no such weevil-killing weather has yet appeared except in limited areas.

Any rise in cotton prices which might result from a weevil scare would probably not get under way until after the present uncertainty over the cotton acreage has been removed by the official acreage report, which will be issued on July 8. The American Cotton Cooperative Association estimate of cotton acreage, just received, shows a reduction of 27.9 percent from last year, a much larger reduction than expected by the cotton trade.

The price rise would probably not last longer than early September, at which time hedge pressure would become an important market factor. Later in the season the rise might be resumed under the influence of improving industrial demand. The extent of any price upturn would be limited, however, by the volume of loan cotton which would be liquidated as prices rose.

Stock prices outrun business

Stock prices have continued their rise this week on increased volume, with the industrial and utility groups reaching new high levels for the year. It may be well at this point to consider whether the advance may not temporarily have carried stock prices too far ahead of the business upturn which they are in process of discounting, particularly in view of the fact that a considerable part of the recent rise has apparently been due to short covering, a transient influence.

In Chart 2 we compare the trend of the Dow-Jones industrial group since last July with the New York Times index of business activity. The low point for all three major stock groups in the stock market was reached on March 31, hence the rise in the stock market has been under way for a full three months. During this period the Dow-Jones industrial average has recovered 43 percent of the entire decline from last August. Since the New York Times business index at the peak last August was 111, and the low (in early June) was 75, one may say very roughly that the industrial stock average at this level has discounted a recovery in the index to somewhere near 90.

Obviously such an upturn in business would represent too rapid a recovery for the immediate future, which suggests that stock prices may go through a waiting period while actual business catches up with the advance. On the other hand, the increased volume of funds seeking investment since excess reserves were expanded would probably justify somewhat higher levels of stock prices than before in relation to business activity.

The significant fact remains that, regardless of reactionary tendencies from here on, the stock market has given convincing evidence that a turn in business is at hand. This will provide a support to the market in the form of increased investment buying on reactions.

Sentiment improved abroad

The background for business recovery in this country has been strengthened by increased business confidence abroad. Sentiment began to improve in England even before the upturn in our markets. Under the heading "Is Confidence Returning?" the London Financial Times of June 18 stated that it was undeniable that confidence had been gradually creeping back ever since the Czechoslovakian crisis had been boldly dealt with in May. It mentioned that the instantaneous success of the £80,000,000 Defense Loan had given a powerful tonic to markets, and noted the following indications of returning confidence:

1. Retailers of motor cars in Great Britain are reported to have experienced an unexpectedly sharp revival of demand since fine weather set in.
2. "The recent sharp rally in wolfram (tungsten) gives color to reports that the leaders of the British steel industry are becoming a little more hopeful as to the outlook."
3. "Manufacturers' inventories on both sides of the Atlantic are assumed to have already been brought down to healthy proportions. If any large section starts a buying movement the rest will, it is thought, be quick to follow."
4. London stock brokers report that "some of their biggest clients, after having kept for months to the sidelines, are now inquiring what they should buy."

Recent cables to the New York Cotton Exchange state that yarn and cloth business at Manchester has expanded, and that sales by Lancashire mills are running well ahead of current output.

The London Times mentions that "Since the Anglo-American depression of the past nine or twelve months has been so perpendicular, the upward swing may, when it comes, be more rapid and violent than in the normal course of the trade cycles."

Business series improve

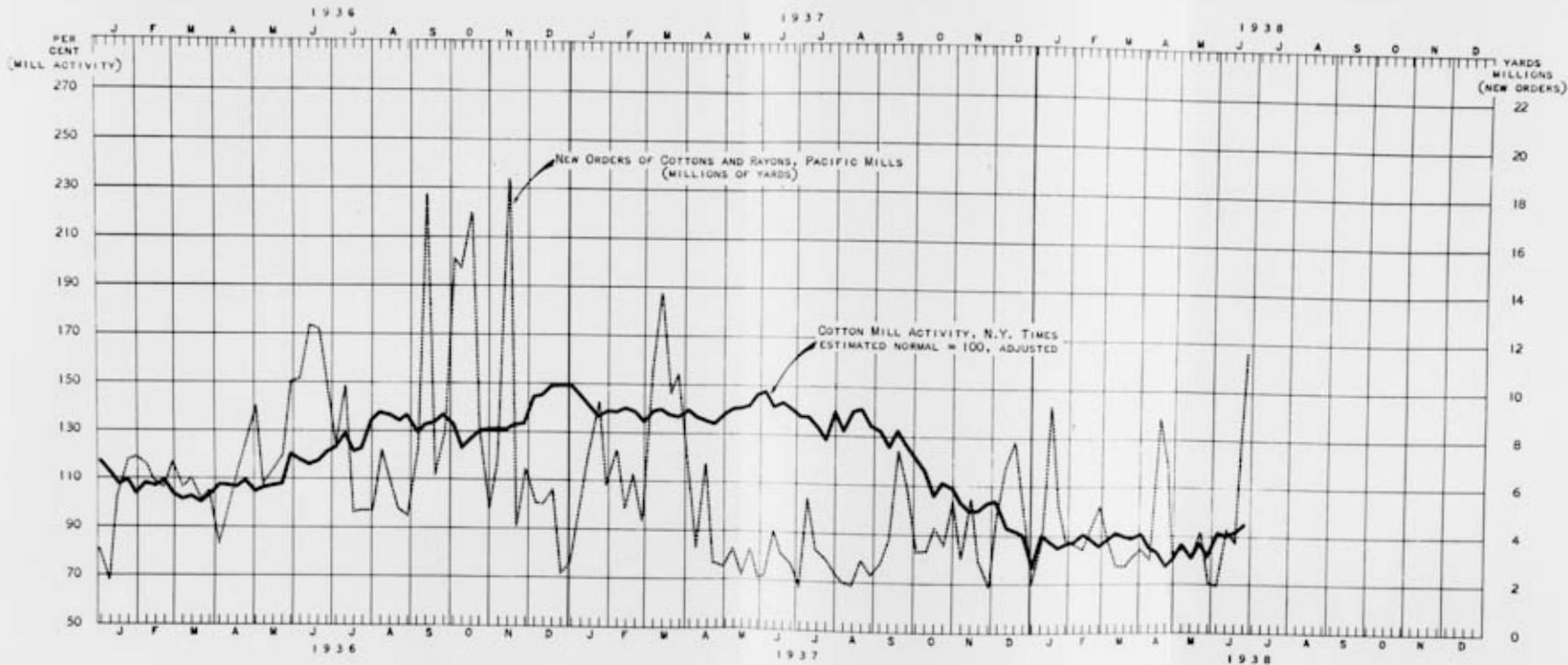
Additional evidence of an improving business trend in the United States appears in the following items:

- (1) Department store sales last week made the best comparative showing since last April, extending their recent rising trend. Apparel stores in New York and Brooklyn registered a 2.4 percent increase over 1937.

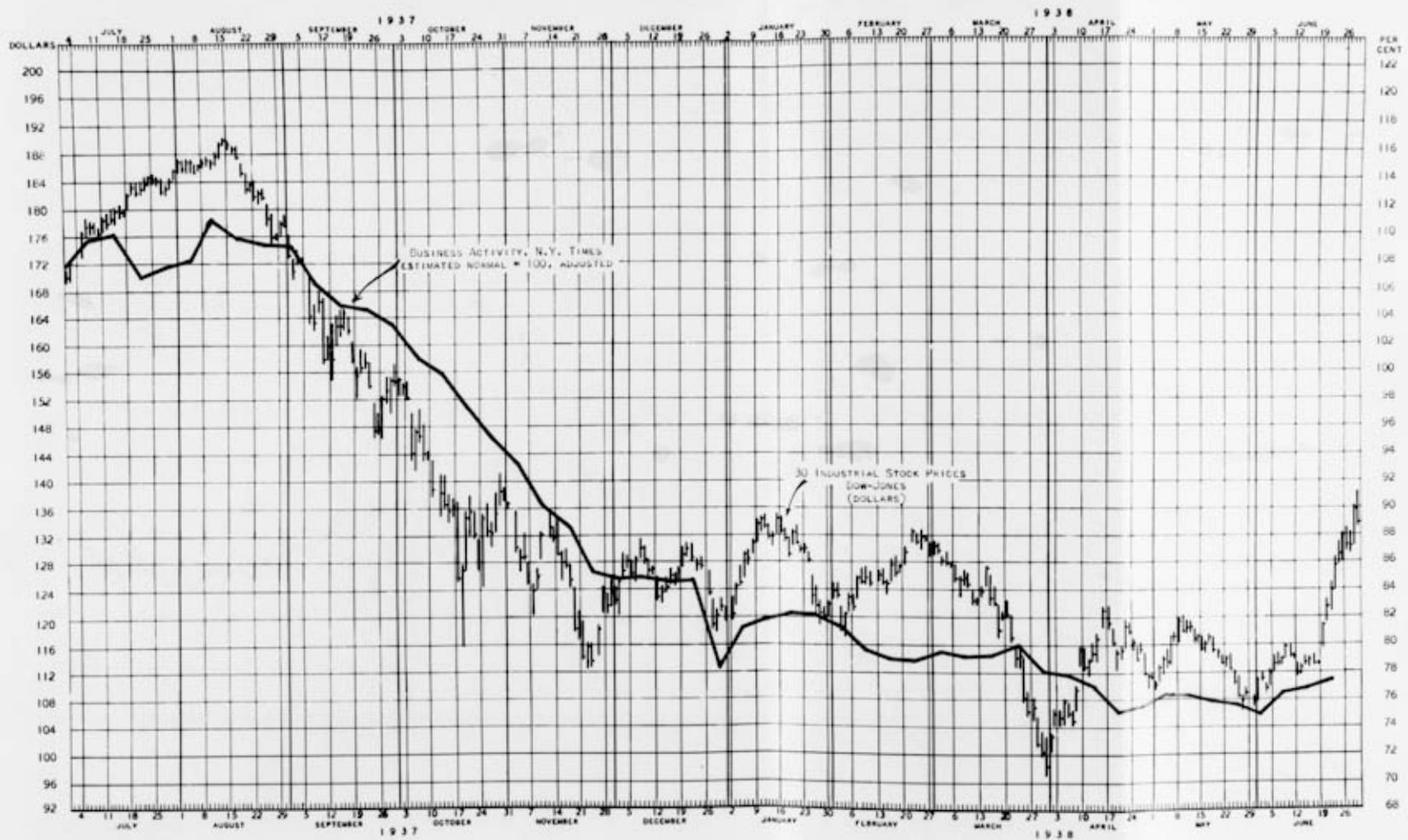
Secretary Morgenthau - 7

- (2) A steel inventory survey by the magazine Steel shows inventories abnormally low among steel consumers generally, indicating that this factor has ceased to be a brake on production.
- (3) The improvement in the steel operating rate has been reflected in the heaviest week-end of iron ore traffic on the Great Lakes since the season opened.

NEW ORDERS OF PACIFIC MILLS AND COTTON MILL ACTIVITY



INDUSTRIAL STOCK PRICES AND BUSINESS ACTIVITY
July 1937 - June 1938



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TREASURY DEPARTMENT

INTER OFFICE COMMUNICATION

~~CONFIDENTIAL~~

DATE July 11, 1938

TO Secretary Morgenthau

FROM Mr. Haas *HA*

Subject: The Business Situation, week ending July 9, 1938

Summary

(1)

The current business trend is obscured somewhat by shut-downs for the Fourth of July holiday, but an upturn in new orders for steel and other products provides a significant indication of improvement in the immediate business outlook. New steel orders last week reached the second highest volume since March, while our combined index of orders for products other than steel rose to a new high for the year.

(2)

A reaction in stock and commodity prices from present levels seems in prospect, since

- (a) Stock prices have been carried to levels that are to some extent artificial, due to heavy short covering in a thin market.
- (b) The demand for commodities has shown signs of falling off at current price levels.
- (c) A decline in sterling to a new low for the year is a deflationary price influence.

(3)

Improving railroad earnings, higher retail sales, and reports of increasing employment are encouraging features in the business outlook. Among the unfavorable factors, however, is an increase in cement prices, which will tend to raise construction costs.

New orders improve

Extended shut-downs in many industries over the Fourth of July holiday tend to obscure the current business trend, but a substantial increase in new orders last week provides strong evidence of underlying improvement. (See Chart 1.) Steel orders have increased to the second highest total since March, at a time when orders would normally be declining. For products other than steel, our combined index shows an increase for last week to a new high for the year. Continued heavy buying of textiles was largely responsible for the increase.

The rising trend of orders, if continued, should lead to increased industrial activity in the near future, since evidence appears to show that inventories have been reduced to a level where they are no longer an important handicap.

The steel situation

New orders for steel last week rose to the equivalent of 33 percent of capacity, as compared with 26 percent the previous week, despite reports indicating that buyers have been hesitant about entering the market because of price uncertainties created by changes in the basing point system. In the Pittsburgh area, the most important steel district, orders booked during June are reported as 10 to 15 percent higher than in May.

In Chart 2 we show by weeks the rate of steel ingot output for the United States and for each of the major steel districts, together with steel scrap prices. The trend of scrap prices is important as an index of underlying demand. The substantial upturn in the important Pittsburgh district appears particularly encouraging.

Steel operations this week have been sharply reduced by the Fourth of July holiday, dropping to 22 percent of capacity from 29 percent last week. An underlying upward trend of operations is indicated, however, by the fact that some important districts reduced operations only slightly despite the holiday, while operations in the Wheeling and Birmingham districts were actually increased. These latter districts, as shown on the right of the chart, have been running consistently above the average for the country as a whole. Steel trade reviews indicate that production generally will be stepped up next week, with operations at Pittsburgh rising about 6 points and at Chicago about 9 points.

Pig iron buyers in some districts have quickly responded to the recent sharp reduction in prices, which many consider too drastic to last. In the St. Louis district, particularly, buyers have rushed in to cover their third quarter requirements, and some have bought even further ahead. The Chicago, Cleveland, and Buffalo districts also report heavy buying, while in other districts buying has been more moderate. The price situation is strengthened by the fact that stocks of pig iron appear to be well depleted. A report on foundries in the Philadelphia Reserve district shows pig iron inventories 62.5 percent below those of a year ago.

The number of blast furnaces in operation on July 1 was reduced to 70, or 29.4 percent of the total of 238 available, which compares with 72 furnaces, or 30.3 percent, on June 1. This contrasts with a peak of 81.0 percent in August of last year.

Price decline appears probable

Stock and commodity prices appear to have reached levels from which a reaction, rather than a further rise at this time, appears more probable. In the commodity markets, three factors appear significant as indicating the probability of a setback:

- (1) Following recent price upturns, the demand for some commodities has noticeably fallen off, suggesting that for the time being the price advance may have gone too far.
- (2) Speculative positions have apparently been built up in some commodities. In copper, for example, the extent of recent buying is indicated by the fact that sales since June 1 have been equal to about 45 percent of the total stocks of refined copper in this country, far too much for industrial requirements.
- (3) A decline in sterling exchange to a new low for the year (See Chart 3) is a deflationary price influence, regardless of its cause. The decline is attributed in some quarters to a rumor that sterling will be stabilized at its old par in connection with the pending trade agreement. As will be noted on the chart, changes in sterling during 1938 have tended to anticipate changes in commodity prices.

In the stock market, the probability of a reaction from present levels is suggested by the following facts:

- (1) The industrial average has recovered 45 percent of the entire decline since last fall, although business activity remains close to bottom levels.
- (2) Stock prices were high in relation to current earnings even before the rise started; in other words, they were at that time already discounting some business improvement.
- (3) A substantial part of the rise has been due to heavy short covering in a thin market, and to that extent has been artificial. Contributing to the thinness of the market has been the fact that odd-lot buyers have withdrawn a considerable volume of stocks from the floating supply. In Chart 4, a confidential S.E.C. chart, it will be noticed that 11,000,000 shares have been taken by odd-lot buyers since July 1, 1937. Such buying is largely for cash, and the shares have therefore tended to pass out of the floating supply, thus forcing recent buyers to bid up prices excessively.
- (4) Buying of stocks by businessmen, which should represent a more informed type of buying, is reported to have been noticeably lacking. While admitting that the trend has turned, businessmen may not agree that the outlook is sufficiently improved to justify present stock prices.

Further evidences of improvement

Gross revenues of the railroads during June are expected to show a contra-seasonal increase over May, judging from reports now being received. A large part of the gain is due to a more than seasonal increase in carloadings during the latter part of June, partly because of a heavy wheat movement and partly because of a pickup in traffic on the Eastern industrial roads. Both of these influences seem likely to continue, in view of the large wheat crop and improving business.

As a direct result of the change in the business trend, employment during July seems likely to turn upward, in place of the usual seasonal decline. Railroad employment increased during June, and reports indicate that additional employes have been added since the 1st of July. Newspapers have begun to print news items from various industries, telling of factories reopening and employes being added, particularly in consumer goods lines.

An improved inventory situation is suggested by a recent tendency toward a levelling out of the decline in business loans, following a substantial drop since the middle of last October. This appears to indicate that, in the net, borrowers now are less inclined to reduce their outstanding loans than they were a few weeks ago, which may indicate that pressure to liquidate inventories is coming to an end. Excluding a July 1 repayment of \$39,500,000 by the U. S. Steel Corporation, the decline in business loans by New York banks during the past four weeks has averaged only \$2,500,000 a week, as contrasted with a previous average decline of \$12,000,000 a week since the first of the year.

Department store sales continue to gain in relation to last year, though their summer decline has begun. For the week ended July 2 the difference narrowed to 9.6 percent under last year, as compared with 18.6 percent at the end of May. In Chart 5, it will be noted that sales in the Boston, New York, Minneapolis and Richmond Reserve districts showed the greatest gains during June, while a downward trend has been evident in certain areas that showed a favorable trend during May, notably in the Dallas and Atlanta districts. It is not known to what extent these may reflect differences in seasonal trends in the various districts.

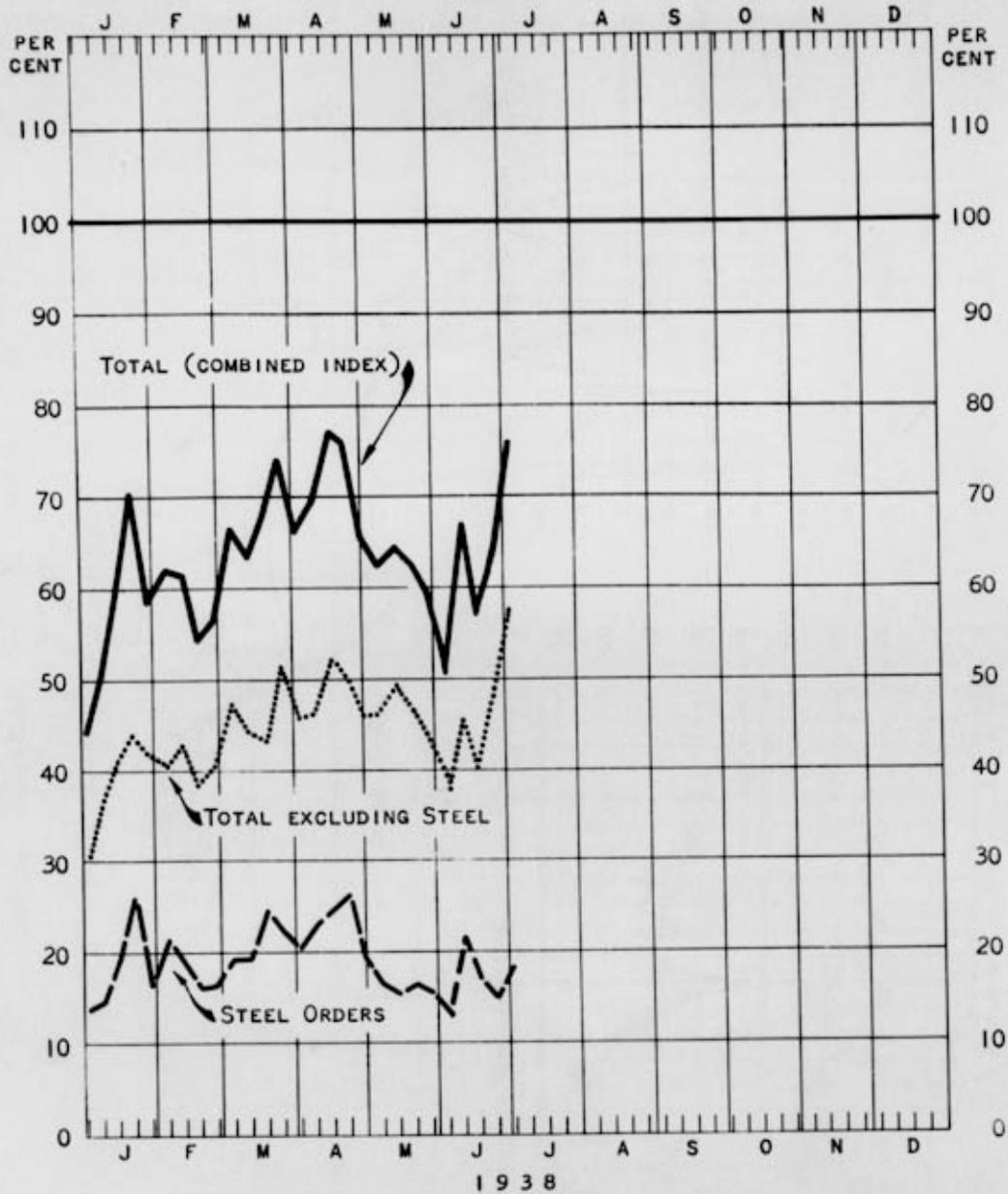
The revival of business confidence has brought an increased demand for higher-priced automobiles. The larger Packards were sold in the first 20 days of June at a rate indicating that June will be the best month since their introduction last September, and will be about 19 percent above May. Cadillac sales have increased during June, with the 6 months of this year showing the best results of any such period since 1929, with the exception of 1937. The market advance is said by Ward's Reports to have been responsible for a considerable number of sales in recent days.

An unfavorable development, on the other hand, has been an increase in cement prices in certain areas, although in some sections prices have been slightly reduced. In the important consuming areas of New York and Boston, advances ranging from 17 to 50 cents a barrel are being put into effect, which largely offsets reductions that had been made near the end of 1936. In Philadelphia the price has been reduced by 27 cents a barrel, and in other limited areas by 10 cents a barrel, apparently to meet foreign competition.

INDICES OF NEW ORDERS

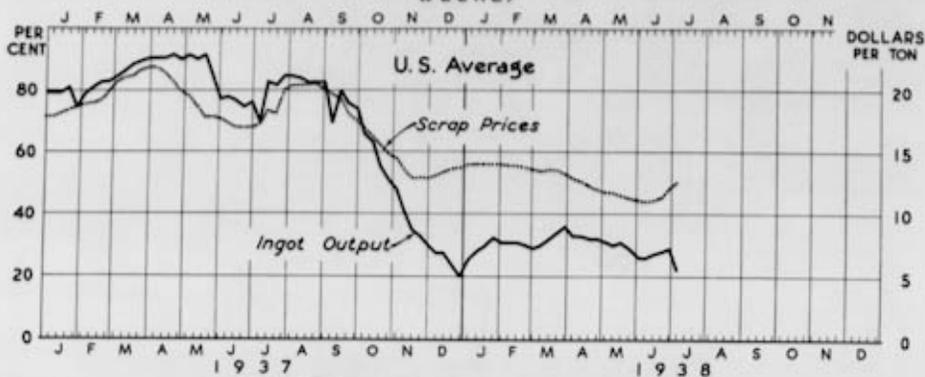
1936 = 100

1938



STEEL OUTPUT AND SCRAP PRICES

Ingot Output in Percent Capacity
WEEKLY



PRINCIPAL PRODUCING DISTRICTS

Ingot Output and Scrap Prices
in Each District

Difference Between District Rates and
National Rate in Percent of Capacity

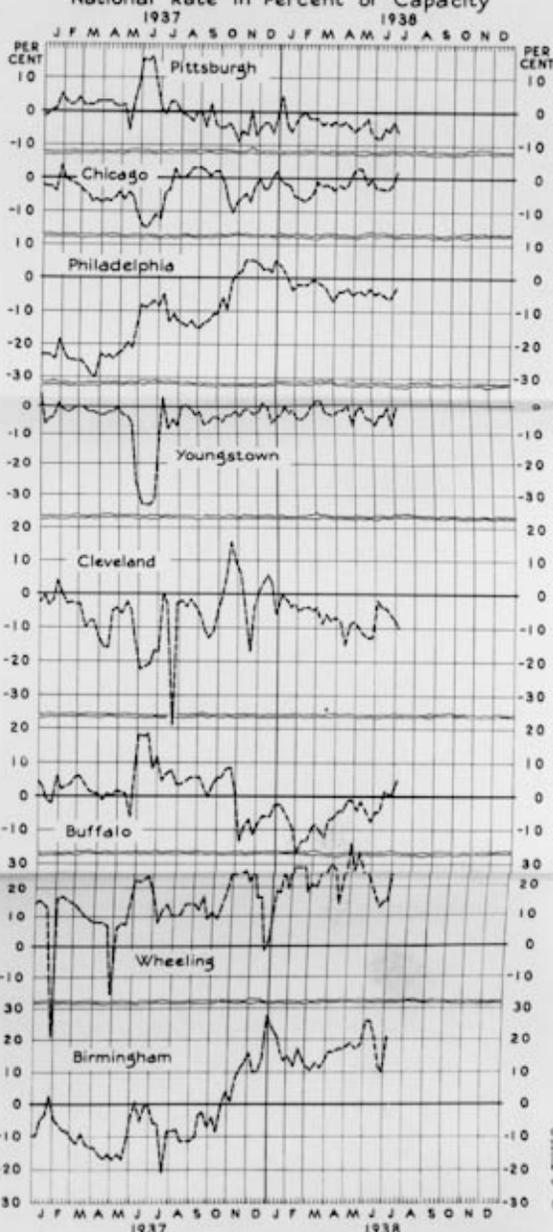
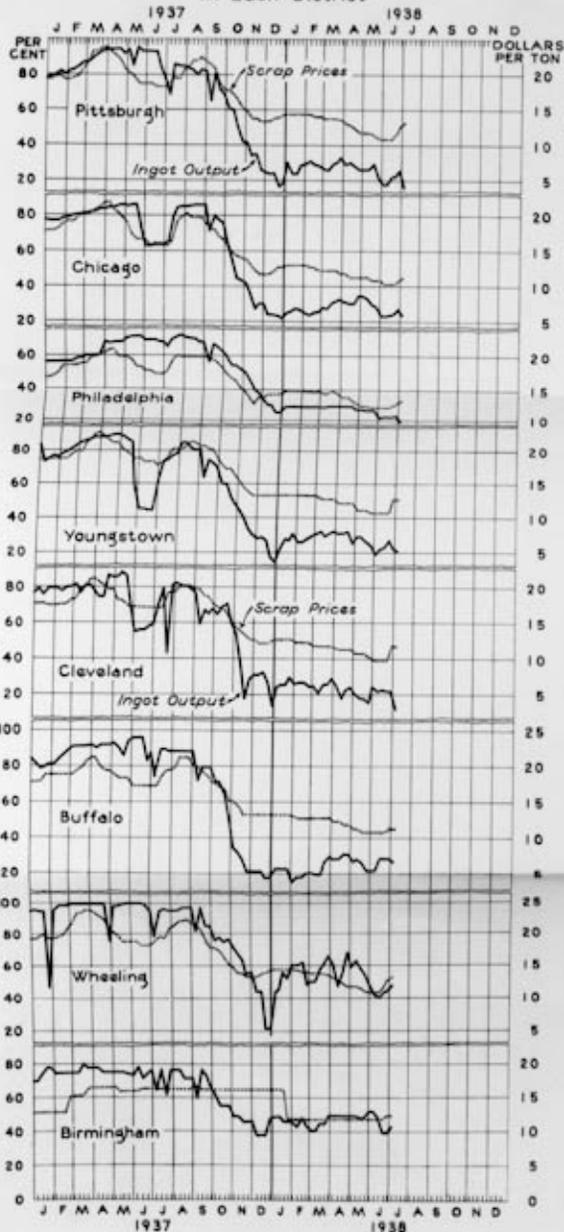
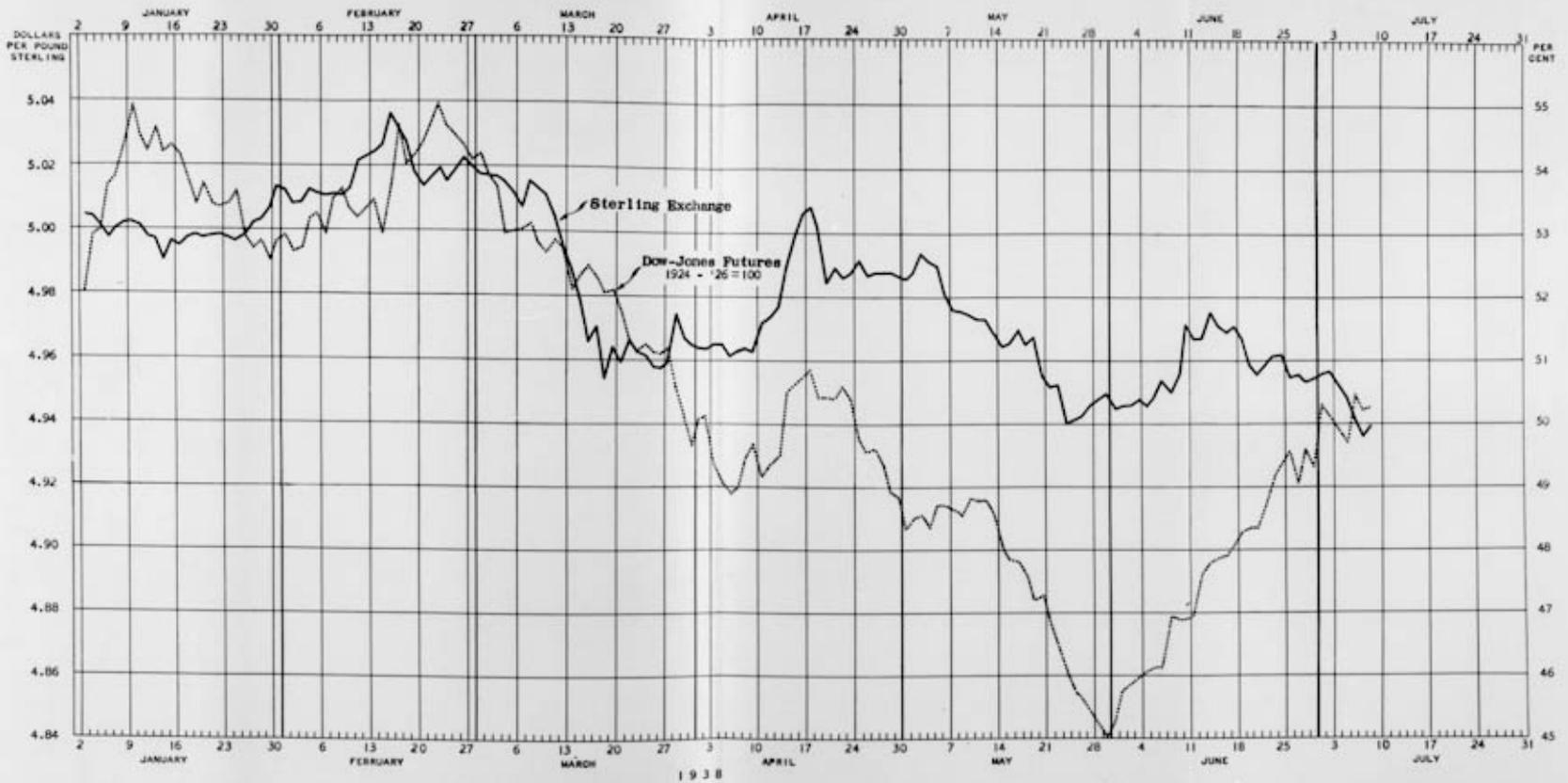


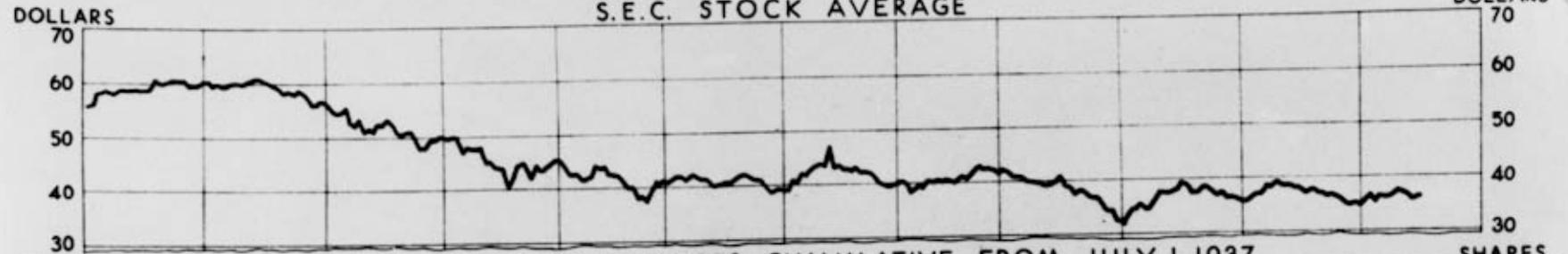
Chart 2

STERLING EXCHANGE AND PRICES OF COMMODITY FUTURES



FLOW OF TRADING ON THE N.Y.S.E.

S.E.C. STOCK AVERAGE



DAILY INVENTORY CHANGES CUMULATIVE FROM JULY 1, 1937

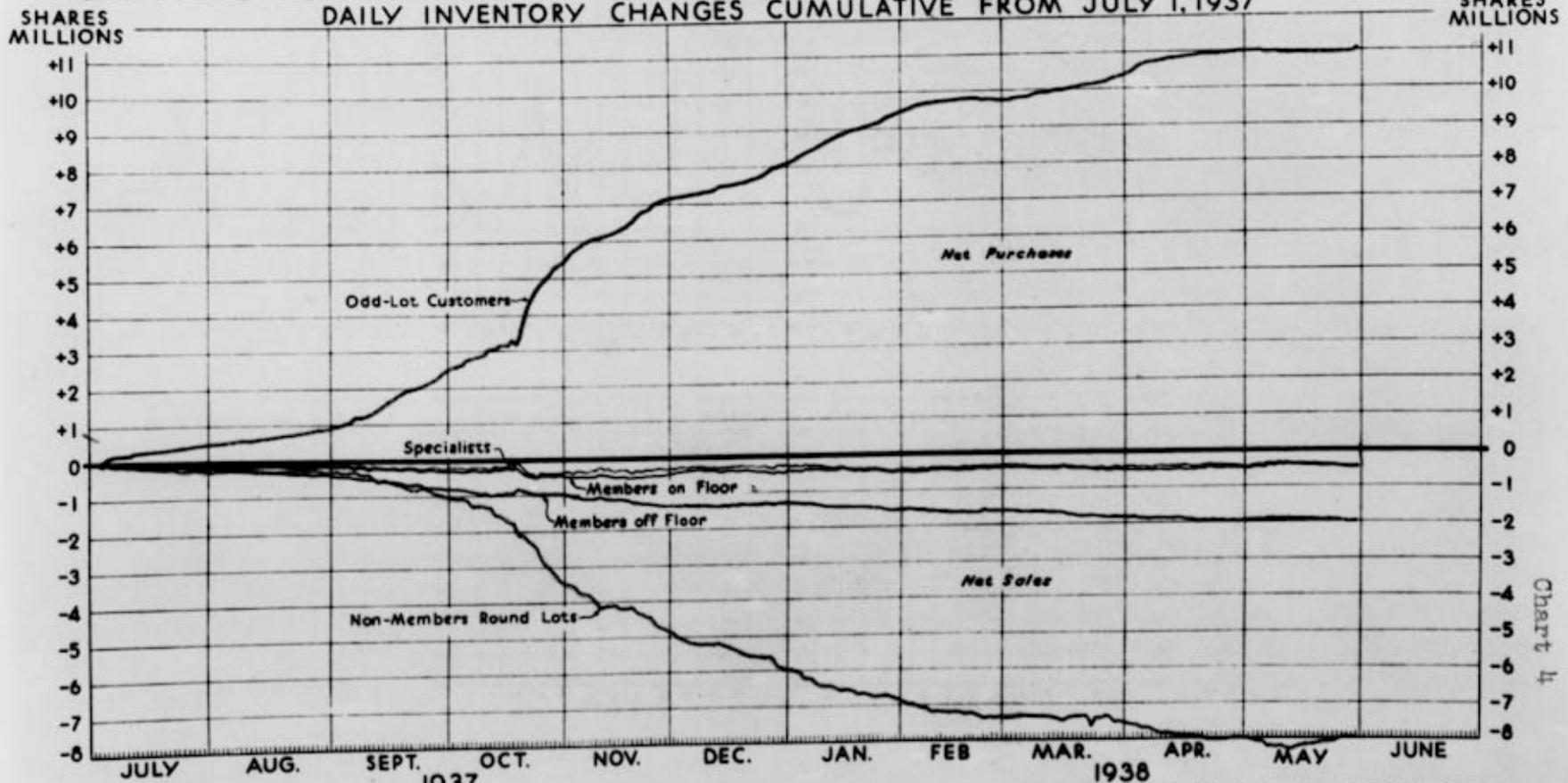
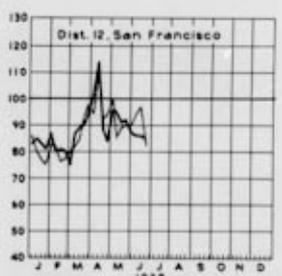
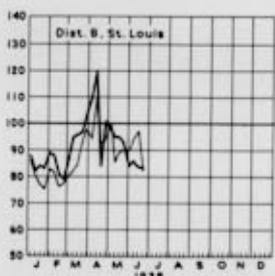
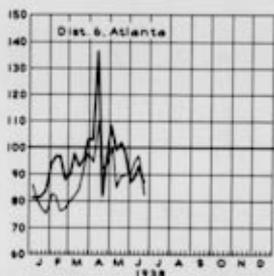
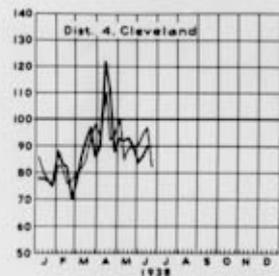
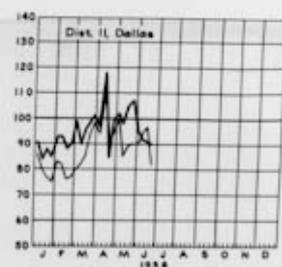
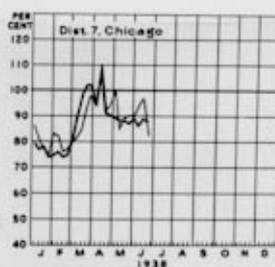
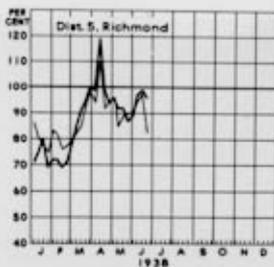
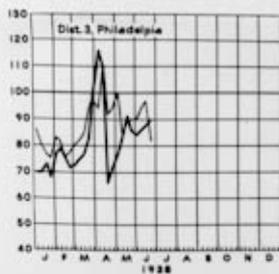
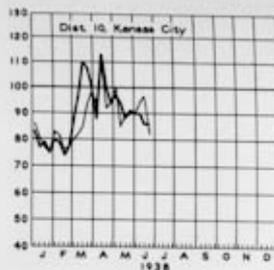
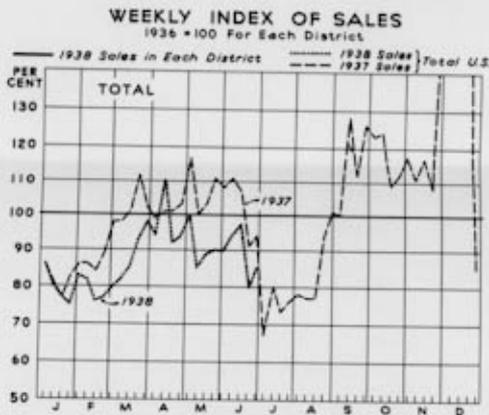
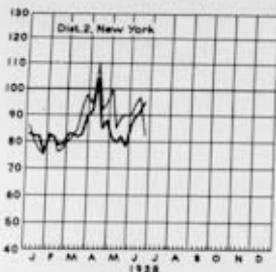
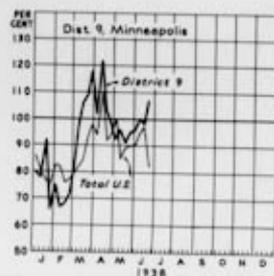
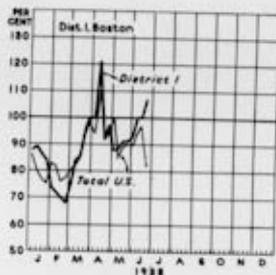


Chart 4

DEPARTMENT STORE SALES

By Federal Reserve Districts





ASSISTANT SECRETARY

*PSF
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TREASURY DEPARTMENT
Washington.

*file
personal*

August 13, 1938.

Treas. files drawer!

Dear Mr. President:

I have been in communication with Secretary Morgenthau at intervals during the past few days, and the situation in the Foreign Exchange markets has become so serious that he asked me to give you a memorandum summarizing the situation. The enclosed memorandum covers the situation up to last night's close. While the markets are somewhat quieter today, the tendencies which I described continue to be evident.

If there are any aspects of the situation which you would like to have me elaborate naturally I shall be glad to do so.

Faithfully yours,

Wayne Taylor

The President,

The White House.

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Memorandum for THE PRESIDENT

August 12, 1938

Secretary Morgenthau has asked me to give you a written summary of the international exchange situation plus an account of his experiences and activities since his arrival in France.

On July 7, the day of your departure from Washington, the pound closed at 4.93 1/2 and the franc at 2.77 1/2. At that time the undertone of the market, while not strong, was steady. However, hoarding of gold, particularly as evidenced by the premium paid for gold coins, continued to be a characteristic of the Continental markets.

Three weeks of comparative quiet followed. Then various rumors made their appearance. These rumors included statements to the effect that the pound and dollar were to be devalued in connection with the new trade agreement, that the pound was going to its old parity, and that negotiations of a new tripartite agreement which would include definite stabilization of the three currencies at lower levels were actively in progress, etc. These rumors, plus the fact that Great Britain's and France's trade balance figures continued unfavorable, plus the downward movement in world commodity prices which started in the latter part of July, tended to accelerate a movement into gold which was started by and dominated by the international political situation. The exchange markets and the gold markets have registered a steady and persistent desire on the part of individuals of large and small

means to get out of foreign currencies, particularly the French franc, and into gold. While the dollar has been fairly strong during this period, the price for gold in the London market has been steadily advancing, reflecting a demand for gold rather than for dollars. For example, the French Fund has lost about \$110,000,000 during the period in question. We estimate that the British Fund has lost some \$90,000,000, while we have gained only about \$31,000,000 in gold in our Stabilization operations. In other words, the movement has been out of Continental currencies into sterling and then into gold.

While our total gold stocks have increased \$64,000,000 during this period and \$20,000,000 is en route, these figures include domestic production and miscellaneous importations not directly attributable to the weakness in Continental currencies.

The movements and tendencies which I have described above have increased in strength during the present week. The French are in serious difficulties again and it is extremely unlikely that they will wish to or be able to hold the franc at its present level through another week. Their market will be closed until Tuesday but London and New York will be open on Saturday and Monday. The market expects a continuation of the present movement until or unless some miracle relieves the international political tension. Sterling closed tonight at 4.87 1/4, and the franc at 2.72 1/2.

Secretary Morgenthau's visit to Paris was extremely well received by the French Press and made an excellent impression in Continental circles generally. After three days in Paris he moved to Antibes where he was comparatively undisturbed until Wednesday of this week. The increased

pressure on the franc prompted Marchandean to request Secretary Morgenthau through the Embassy in Paris to issue a statement denying tripartite stabilization discussions. After consultation with Ambassadors Bullitt and Kennedy, the Secretary replied that an individual statement did not seem to him either desirable or wise but that if the French felt their circumstances demanded a statement the Secretary would be prepared to agree to a joint statement, to be issued simultaneously, in the three countries, provided its form and substance were acceptable. Marchandean stated that he would discuss the question with the British, but up to this time the British have heard nothing from the French.

The only new development since Thursday is a conversation which Secretary Morgenthau had with Bullitt in which the Secretary told Bullitt that the British did not seem opposed to the issuance of an innocuous statement and had so informed the Secretary through Butterworth. Secretary Morgenthau suggested that Bullitt inform Marchandean of the British reaction to the suggestion of a three-cornered statement.

During the period which I have described, we have kept the Secretary of State fully informed and have consulted him on several aspects of the situation.

Wayne Taylor

TELEGRAM

*PSF
Treas.*

*Call
personal*

Treas-1

The White House

Over W.H. Private Wire: **Washington**

Aug. 19, 1938.

For The President,
Hyde Park.

In a telephone conversation yesterday Secretary Morgenthau asked me to inform you of the developments in the foreign exchange situation.

With the exception of a brief period on Tuesday, the pressure on the franc which I described to you in my last report has continued without interruption and we estimate the French have lost over \$50,000,000 in gold and foreign exchange during the week, Wednesday and Thursday being the heaviest days. The movement into gold which I described last week has subsided slightly and there has been a stronger demand for dollars, resulting in an increased gold movement into this country. While sterling has been somewhat stronger, this comparative strength has been at the expense of heavier gold flow to this country. Our stabilization fund has acquired \$25,000,000 in gold from London and private gold shipments have amounted to \$16,000,000. Current quotations are 4.88 for the pound and 2.73 for the franc. The market is quieter to-day, apparently awaiting Daladier's radio appeal and program on Sunday.

While we have been in constant communication with the French treasury and the Bank of France, they have failed to disclose to us any details of what they have in mind. Meanwhile, discussions have been concentrated in London where the British and French failed to reach an agreement. The British have kept us informed of the French conversations and of the British reaction to them, but up to now no working details of any French plan of action have been disclosed to the British treasury. Secretary Morgenthau's impression, which he conveyed to me yesterday, is that the whole situation is so political in character, both from a domestic and an international standpoint that it is just as well that we are not being asked to do anything at this time. He has been in touch with the situation every day and Cochran and Butterworth met him in Basle this morning. We feel here that while curiosity alone may retard the pressure on the Franc until next week, it is probably merely a question of time before we are approached by the French and possibly also by the British with urgent new requests for cooperation and assistance.

Taylor.

MAR 22 1938

GRAM

Over W.H. Private Wire

The White House

file personal
d-1 Treas

Washington, D.C.,
Aug. 19, 1938

Washington

Wx Aug. 19, 1938

~~The President~~

The President,
Hyde Park

Yesterday Daladier made following statement:

"In view of International difficulties the gravity of which has been exaggerated, apprehension has been shown in most events for the future of the various currencies. At the same time gold purchases, gold hoarding which had stopped for some months have started again with intensity on most European markets. Such hoarding which is harmful to a country is moreover an error on the part of those who yield to it. The action produced on the franc is for the most part the expression of such fears and they have been aggravated by rumors circulating both of exchange control and of a further devaluation of the franc. The government is resolutely opposed to exchange control as well as to a further devaluation of the franc. Apart from their harmful effects on the welfare of the nation they would furthermore result inevitably in the rupture of international solidarity which is the most efficacious guarantee for the maintenance of peace in Europe.

On the other hand the President of the Council does not consider it necessary to deny at length the ridiculous and untrue rumors which represent the government as being divided. He will himself set forth shortly (at the end of the week) in a radio address the program of vigorous measures necessary both for the support of the currency and for the defense of the nation. The government trusts that the French people confident in the future of their country will accomplish their duty toward it as it is itself resolved to accomplish its own duty."

Bullitt saw Bonnet yesterday afternoon and comments on situation as follows:

"I asked Bonnet, in the course of our conversation to-day, to explain to me the meaning of Daladier's statement made this morning in the course of which Daladier said that the government was resolutely hostile both to a new devaluation of the franc and to exchange control. The meaning of this statement, according to Bonnet, is that neither measure would be adopted. Bonnet replied to my question of what other alternative there was at a time when gold was leaving the equalization fund with such rapidity by saying that in the speech which he will make at the end of this week, Daladier will suggest certain modifications in the application of the forty hour law which he hopes will produce an increased

MAR 23 1934
TELEGRAM

The White House ② Washington

confidence in the French financial situation.

"Bonnet described at some length the reasons why the government considers exchange control out of the question and said that no other measures were being taken. When I asked Bonnet how long he felt the equalization would last, he said that it contained 13½ billion francs still. I suggested that the figure was not quite so high as this, but Bonnet replied that he had had this figure officially this morning from the Treasury.

"I asked him why the idea of a declaration of the British, American and French governments denying the rumors of a joint devaluation of the pound, dollar and franc had been dropped and Bonnet replied that the British government had refused to make any declaration of this kind. In response to arguments of the French government, the British government had answered that any such declaration by the British government now would create anxiety in England and tend to cause further demands for gold. The American government had not been further approached by the French government regarding this matter merely because of the British ~~British~~ refusal to cooperate with them.

"I made the suggestion to Bonnet that a different interpretation was being put on Daladier's statement. His statement regarding the hostility of the government both to exchange control and devaluation of the franc was interpreted by some to mean that he himself would not remain Prime Minister if a continued flight from the franc should drain the equalization fund, but would resign and leave the ultimate decision to somebody else. Bonnet made the emphatic assertion that this interpretation was in no way justifiable. Daladier had not the slightest idea of resigning his position."

I discussed situation with Secretary Morgenthau on telephone yesterday. This morning I received the following message from Secretary Morgenthau:

"Please see that President and Hull get following message and ask them if they have any advice to offer me 'after conferring in Basel with Cochran and Butterworth and in view of Daladier's public statement of Thursday and his announced address for Sunday plus Bonnet's statement to Bullitt (quoted above), I intend to sit tight and do nothing until after Sunday'".

Treasury opinion here very strong that Daladier's program if it is limited to measures described by Bonnet will be ineffective and that pressure on franc will continue. If this pressure does continue British and ourselves will be approached with new urgent

MAR 23

TELEGRAM

③ The White House
Washington

requests for assistance. Am sending you also brief summary of
exchange developments since last week.

Taylor,
Treasury.

PSF
Treas.

file
personal

THE SECRETARY OF THE TREASURY
WASHINGTON

September 7, 1938

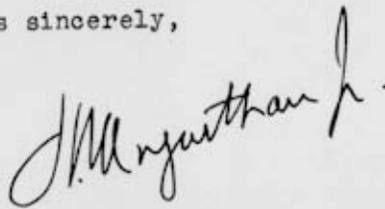
d-1

My dear Mr. President:

I am inclosing herewith for your information Dr. Haas' report on the business situation, for the week ending September 3rd.

I am also inclosing for your reading Ernest Lindley's recent column on campaign funds, which you may find interesting.

Yours sincerely,



The President,
Hyde Park, New York.

TREASURY DEPARTMENT

INTER OFFICE COMMUNICATION

DATE September 6, 1938

TO Secretary Morgenthau

FROM Mr. Haas

Subject: The Business Situation,
Week Ending September 3, 1938.

Features of the present outlook

A general expectation exists, both in this country and abroad, that business activity in the United States will improve substantially after Labor Day, since the automobile and construction industries are expected at that time to add further strength to the current business trend.

We see little in the present situation to justify a confident belief in a further substantial improvement this fall. On the contrary, recent foreign developments have changed the business outlook to one of uncertainty, with the chances now probably less than 50-50 that industrial production during the remainder of the year will average above current levels of around 85 for the F.R.B. index. Weakness in the foreign situation, through its depressing influence on commodity prices and its effect on new ordering, has acted as a strongly opposing factor to the recovery forces developing in this country.

The widespread belief that business will improve during September has caused some stocking of goods, which is in itself a weak feature of the present outlook. It means that a considerable part of the improvement may have already been anticipated. In the steel industry, for example, some estimates credit 65 percent of the recent increase in activity to production for inventories rather than for orders, in anticipation of increased automobile company demand after Labor Day. Lumber inventories are also reported to have increased because of anticipated demand from the construction industry.

The business level during the next few months will be affected to an important degree by the trend of stock prices. There seems little doubt that the stock market foundation has been weakened by the decline in commodity prices and by weakness in security prices abroad. After recovering 50 percent of the ground lost since 1937, prices of industrial stocks have

been unable to make further headway since the middle of July, while utility and railroad stocks since that time have been in a declining trend.

The next week or two, we believe, will be a critical period for security prices, commodity prices, and business. Our analysis indicates that September is likely to prove a month of disappointment, though the outlook might be materially improved if a solution to the Czechoslovakian problem of a more or less permanent nature should be found.

Although various recovery influences continue to support the business trend, our analysis of current business data indicates the possibility of at least a temporary irregularity or slackening in this trend during the fall months, which may depend largely upon the outcome of the situation in Europe. Our index of new orders has shown a declining tendency during August, with no evidence of a fall upturn except to some extent in textiles. While basic conditions in the automobile industry appear very favorable, the lack of demand for steel from the automobile companies suggests that they may follow a more cautious production policy than previously expected. While a further improvement in residential construction and in heavy construction is indicated, the volume so far is not sufficiently large to carry business forward without the help of other industries.

New York Times index higher

The New York Times business index in the week ended August 27 reached 84.8, as compared with 84.2 (revised) for the previous week. Greater than seasonal increases in steel and lumber output and in miscellaneous carloadings featured the week's gains. Other carloadings were also higher, and electric power output held steady. Automobile production declined, however, and cotton mill activity failed to show a seasonal gain.

The foreign situation

European developments during the past week, which have pointed toward a more critical war outlook, have added further deflationary pressure to prices. The decline in sterling exchange to a new low, below its former par, provides some evidence of the weight of these developments. Although commodity prices during the week have held up well in the face of weakening foreign currencies, our experience of the past several months has shown that such developments usually do not affect commodity prices until a week or more after exchange rates have declined.

Steel activity increased

An increase in the rate of steel activity this week to 44.0 percent of capacity, as compared with 42.8 percent during the previous week, extends the recovery in steel operations during the past two months to more than one-third of the amount lost since last summer. The more recent upturn, however, has not been accompanied by an expansion of steel orders, judging from reports received from the U. S. Steel Corporation (See Chart 1). Orders received during the week ended August 25 were equal to about 33 percent of capacity, the same as in the previous week.

It is possible that the independent companies, specializing more largely in light steel products, are receiving orders at a somewhat higher rate than U. S. Steel. Trade comments indicate a moderate gain in demand from miscellaneous sources recently, which would include mostly the lighter products. On the other hand, the Journal of Commerce estimates that only about 35 percent of the recent increase in steel operations has been in response to actual orders, and that 65 percent has gone to build up steel mill inventories in anticipation of increased demand next month.

Practically no buying of steel by the automobile companies has yet appeared, with the exception of a large order from the Buick Company. Some have commented on the slowness of steel demand from the automobile companies as evidence that they are not planning to increase production as rapidly as had previously been expected, but are taking a more cautious view of the business outlook, and will base production schedules on actual sales returns.

The textile situation

A seasonal upturn in textile buying is usually to be expected during the early fall. A tendency in this direction has been shown in orders of Pacific Mills during the last week of August and in orders of Cannon Mills during the week before. (See Chart 2.) For five or six weeks previously, however, sales of cloth by mills were far below production, according to the New York Cotton Exchange Service, and mill activity was maintained largely on the backlog of orders booked during June. On last week's increase in sales, mills sold close to their production, but during the current week cloth sales have again fallen off. Spinners are very dissatisfied with present yarn and cloth prices, asserting that they are below cost.

The current foreign business situation, as reflected in the textile business, does not appear encouraging, according to cabled reports to the New York Cotton Exchange Service. In England the spinning and weaving mills are still losing ground, with sales below production and mill curtailment being extended. France reports that demand for goods is poor and the outlook uncertain because of domestic and foreign political difficulties. Italy reports mill activity down 5 percent, but sales balancing output. Holland reports sales below production and unemployment increasing. Switzerland reports mill sales negligible and the outlook discouraging. Czechoslovakia reports mill order lists contracting, and stocks of yarn large.

Owing to favorable weather for weevil control and crop growth over most of the cotton belt, some increase in the government crop estimate next week is generally expected. The Journal of Commerce, which has a good record in forecasting the cotton crop, places it at 12,189,000 bales, which compares with the last government estimate of 11,988,000 bales.

The construction outlook

A study of the forecasting value of Federal Housing Administration data on mortgages selected for appraisal shows a rather definite two-months' lag between these figures and the F. W. Dodge residential contract awards. Under the new amendments, however, the Federal Housing Administration has covered a greater percentage of total residential construction, hence the 100 percent increase in Federal Housing Administration volume this year foreshadows but a slight increase in actual construction over 1937.

A significant feature of the Federal Housing Administration data is the fact that mortgages selected for appraisal during August have been maintained at a high level, averaging slightly higher than in June or July. (See Chart 3). This is contrary to last year's declining trend. Judging from our study, this indicates the probability of some further improvement in contract awards during September and October.

Heavy construction awards during the week ended September 1 were 25 percent higher than in the corresponding week last year,

though showing some decline from last week's figure. The increase is due entirely to increased public construction, almost entirely in the state and municipal category. Private construction has not yet begun to pick up, being 26 percent below last year for the week mentioned.

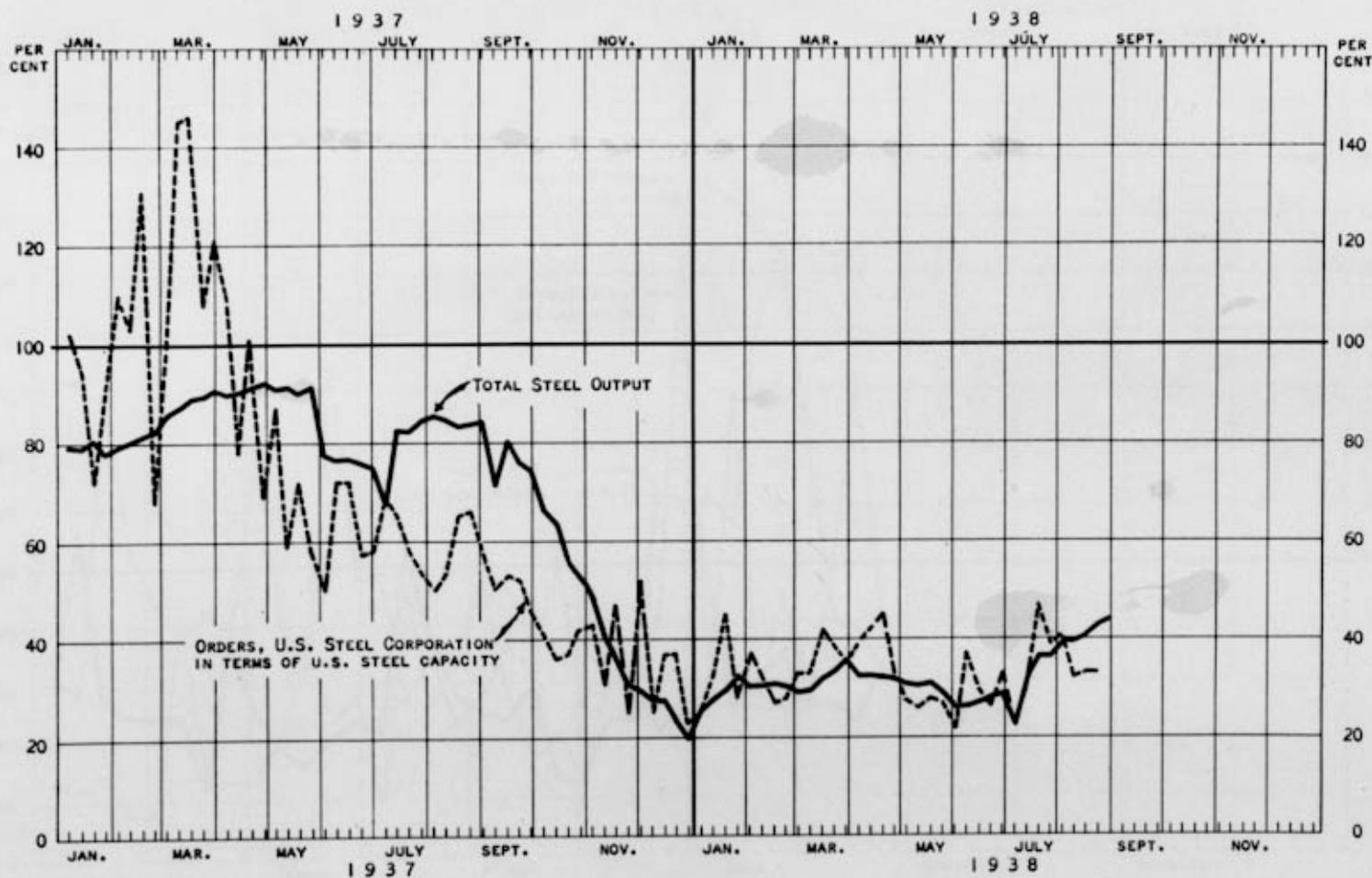
Power production heading for all-time peak

A rapid improvement in electric power production during the recent upturn in business activity has carried it within 8.5 percent of the all-time peak established last fall. If no further general business improvement occurs during the remainder of the year, but merely the normal seasonal increase and trend allowance as used in the New York Times index of power production, the output would reach within 2.0 percent of last year's peak by the end of this year. During 1937 as a whole, the utility industry was operating nearer to capacity than in any previous year, going back to 1921. A production of 3,269 kilowatt hours per kilowatt of capacity for all plants in 1937 compares with a previous peak of 3,164 kilowatt hours in 1923.

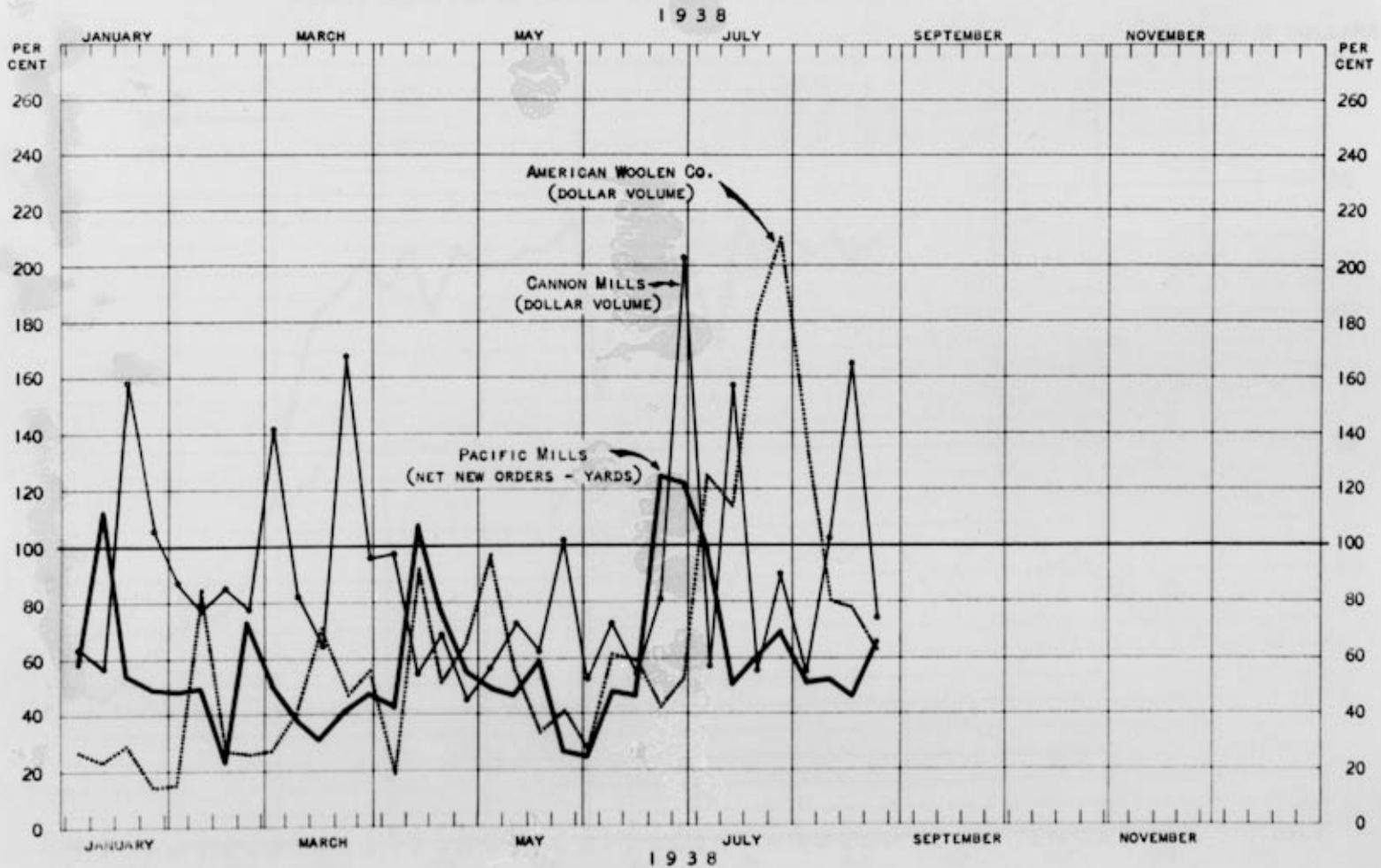
Some increase in efficiency of production methods, together with a levelling out of the seasonal load variations has occurred since 1923, tending to make a somewhat larger output possible per unit of capacity. This may have been offset, however, by the obsolescence of plants which would have been replaced under normal conditions. The nearness of the industry to capacity operations at present, under depression conditions, seems significant in two ways: (1) The shortage of capacity which is most pronounced in the industrial areas, may tend to retard an expansion of industrial production, if not previously remedied. (2) Utility construction looms as a potential supporting factor to business in the relatively near future.

Following the 1923 shortage of power capacity, \$908 millions was spent for utility expansion by the power industry in 1924. This stood as a record until 1930, when, \$919 millions were spent for expansion following a severe test of electrical capacity in 1929.

TOTAL STEEL INGOT PRODUCTION AND U.S. STEEL CORPORATION ORDERS
Expressed in Percent of Capacity

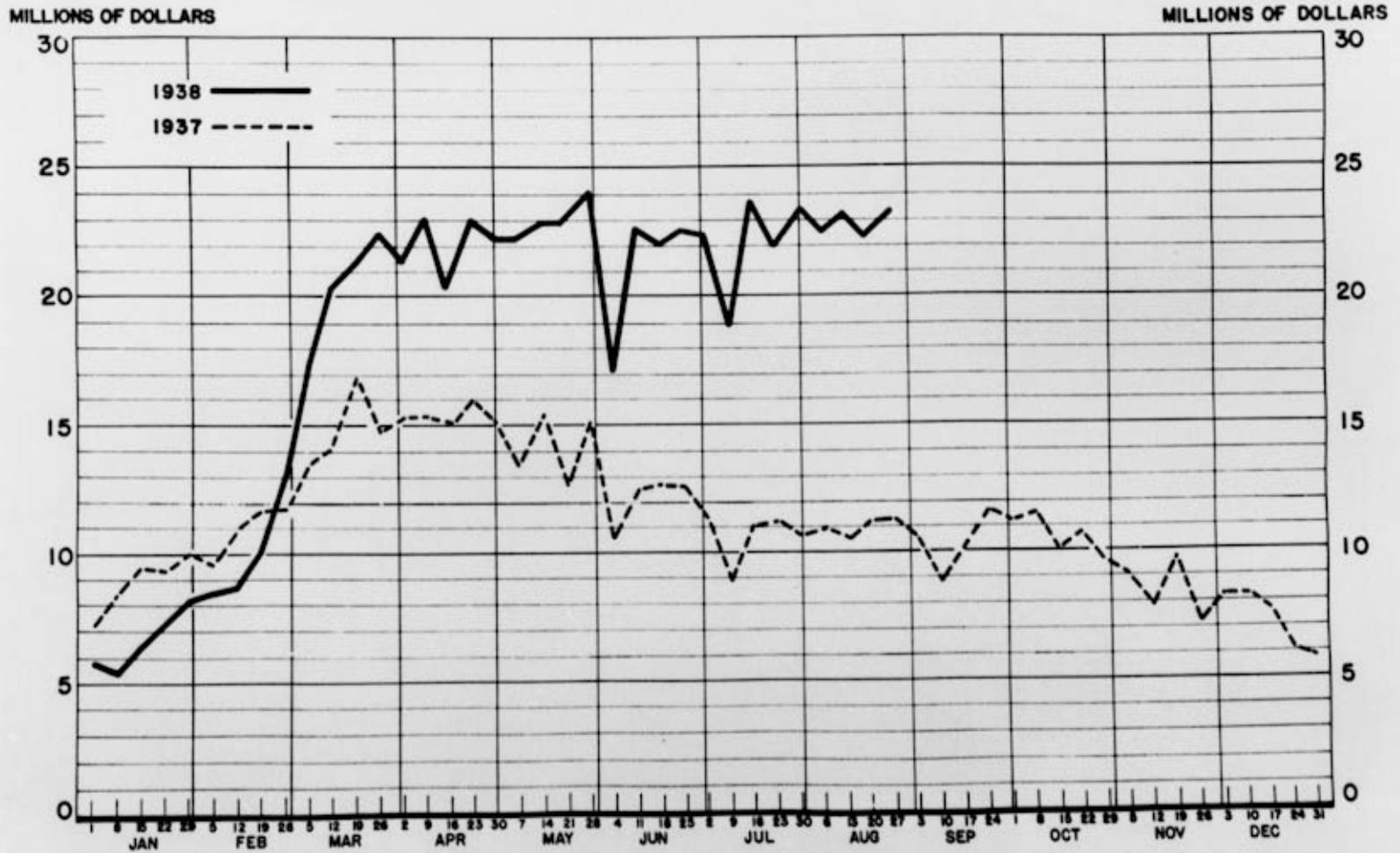


WEEKLY NEW ORDERS OF TEXTILE COMPANIES
1936 = 100



CONTINUED

WEEKLY VOLUME OF HOME MORTGAGES SELECTED FOR APPRAISAL
 Amount Reported by F.H.A. Insuring Offices at End of Each Week



From Federal Housing Administration

PSF Treas.

Is it right?



SECRETARY MORGENTHAU. His views on voluntary campaign fund regulations by Government employees are discussed by Ernest Lindley on this page today.

Campaign Funds

By Ernest K. Lindley

Legality Depends Upon Interpretation

SENATOR SHEPPARD contends that the Government's voluntary regulations by Federal officers and employees of the extension funds of candidates for the Senate and House, Secretary Morgenthau announced last week.

Their difference of opinion is over the meaning of Section 114 of the Criminal Code, as amended, which reads:

"It is unlawful for any Senator or Representative in, or Delegate or Resident Commissioner in, Congress, or any candidate for, or individual elected as, Senator, Representative, Delegate or Resident Commissioner, or any officer or employee of the United States, or any person receiving any salary or compensation for services from money derived from the Treasury of the United States, to directly or indirectly solicit, receive or in any manner cooperate in soliciting or receiving, any assessment, subscription, or contribution for any political purpose, whatever, from any other such officer, employee, or person."

THIS SECTION of the Criminal Code was derived from Section 11 of the Act of January 14, 1935, during the Arthur Administration. Except for unimportant changes in nomenclature, the two sections are the same.

At first reading, each might be interpreted as prohibiting every Federal officer and employee from making a voluntary contribution to any candidate for the Senate or House. However, that section of the Act of 1935 has twice been submitted to an Attorney General for a formal opinion.

In 1936, Attorney General Judson Harmon, under President Cleveland, stated:

"It is well settled that the imposition of this act was not to forbid voluntary contributions for political purposes by persons in the employ of the Government, but to protect such persons from solicitation or coercion with respect to such contributions. Knowing the difficulty of detecting the actual operation of houses and inns, whose employment just beyond a public eye, Congress absolutely prohibited the solicitation or receipt of political contributions by all persons in the Government service, by direct or indirect way, as otherwise such solicitation or receipt would have been impossible. It was not the purpose of the act to forbid the making of such contributions. All persons in the Government service are to be permitted the political action and freedom of

choice in the relation of the Government or employed in the Government or employed in any position or office, but Congress did not attempt to prohibit solicitation or payment in persons not in the Government service, although through Government channels.

ATTORNEY GENERAL Harrow's opinion was requested with approval in 1933 by Attorney General Philander C. Knox, under President Taft, and is as follows:

"The rule of the Civil Service Commission prohibits persons in the executive civil service from using their official authority of influence for the purpose of interfering with an election or affecting the results thereof. And it prohibits persons in the competitive classified service from taking an active part in political management or in political campaigns." It does not prohibit voluntary contributions.

Secretary Morgenthau's views advocate of the merit system, and all implies, cannot strip regulations in August 1934, regarding political activities by and among officials and employees of the Treasury.

Five weeks later he issued a clarifying explanation which stated, among other things, that the regulations did not prevent any such employee from voluntarily contributing to the campaign funds of the party of his choice, if such contribution is made freely and without coercion or improper solicitation, and is not made to a person in the service of the United States.

MR. MORGENTHAU'S regulation seems to be in accord with a construction of the law which has been accepted over a long period of years.

Harry L. Hopkins, who has followed this construction in informing WPA workers that they may make campaign contributions if they choose to, says, however, there are good reasons for discouraging them from using their meager funds for the purpose and especially for encouraging a party to raise a special campaign fund among them.

In practice, the problem is to relieve officials and employees, especially those who are non-political, from the pressure to make contributions. Secretary Morgenthau seems to have done better at the present time.



*file
personal*

TREASURY DEPARTMENT
WASHINGTON

*PSF
Treasury
J.*

September 24, 1938.

The President,

The White House.

My dear Mr. President:

By direction of the Secretary of the Treasury
I am sending you herewith copies of two letters which
were sent Friday evening, September 23rd, by registered
mail to each and all of the directors of the Bank of
America National Trust and Savings Association, San
Francisco, California.

Respectfully,

Herbert E. Gaston,
Assistant to the Secretary.

Enclosures.

RECEIVED
SEP 23 1938



TREASURY DEPARTMENT
COMPTROLLER OF THE CURRENCY
WASHINGTON

ADDRESS REPLY TO
"COMPTROLLER OF THE CURRENCY"

September 23, 1938

Mr. A. P. Giannini,
Chairman of the Board of Directors,
Bank of America National Trust and Savings Association,
1 Powell Street,
San Francisco, California.

My dear Mr. Giannini:

It has been brought to my attention that the Board of Directors of the Bank of America National Trust and Savings Association at its meeting held in Los Angeles on September 13, 1938, declared a dividend half of which is payable October 1, 1938, despite the warning contained in my telegram dated September 13 and communicated to the meeting by R. E. A. Palmer, National Bank Examiner. This warning was prompted by my duty to protect the depositors as well as the shareholders of your Bank.

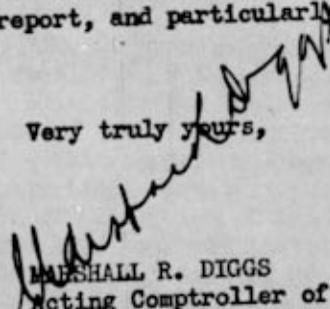
It is my desire in this matter to be fair to all concerned. Accordingly, your personal attention, as director of the Bank, is called to the provisions of U.S.C., title 12, section 93, which provides as follows:

"If the directors of any national banking association shall knowingly violate, or knowingly permit any of the officers, agents, or servants of the association to violate any of the provisions of this chapter, all the rights, privileges, and franchises of the association shall be thereby forfeited. Such violation shall, however, be determined and adjudged by a proper district, or Territorial court of the United States, in a suit

brought for that purpose by the Comptroller of the Currency, in his own name, before the association shall be declared dissolved. And in cases of such violation, every director who participated in or assented to the same shall be held liable in his personal and individual capacity for all damages which the association, its shareholders, or any other person, shall have sustained in consequence of such violation." (Underscoring supplied)

There is enclosed, for your information in this connection, a copy of my letter of criticism based upon the report of the latest examination of your Bank. A complete copy of this report of examination has been sent to, and is open for your inspection at, the main office of the Bank of America National Trust and Savings Association, No. 1 Powell Street, San Francisco, and at the office of the Chief National Bank Examiner, Room 1103, 155 Montgomery Street, San Francisco, and at the sub-district office of the Chief National Bank Examiner, 835 H. W. Hellman Building, Los Angeles. Your attention is directed to the comments, criticisms and conclusions of the examiner contained in the report, and particularly to the last two pages thereof.

Very truly yours,


MARSHALL R. DIGGS
Acting Comptroller of the Currency.



TREASURY DEPARTMENT
COMPTROLLER OF THE CURRENCY

WASHINGTON

ADDRESS REPLY TO
"COMPTROLLER OF THE CURRENCY"

September 23, 1938

Board of Directors,
Bank of America National Trust and Savings Association,
San Francisco, California.

Gentlemen:

The report of examination of your bank, completed September 15, has been received and reveals practically the same criticisms as shown in previous reports. The purpose of those criticisms and of the criticisms set forth in this letter is to assist the Board of Directors in a constructive manner to protect the interests of the depositors as well as of the shareholders of your bank.

Your attention is directed to the examiner's comments under the heading of "Historical Resume of Assets in General" starting on page 2 of the consolidated report. A comparative survey over the past five years reveals that the primary purpose of the management appears to be that of publishing large earnings statements and the payment of ever-increasing ill-advised dividends rather than a frank recognition of the asset problems of the bank and a desire to allocate the bank's earnings toward the amortization of frozen and unbankable assets, the creation of adequate reserves and the correction of the bank's under-capitalized condition. The management of the bank has persistently contested the examiner's classification of assets, has defended unbankable assets, and has rarely admitted losses and charged them off voluntarily.

On page 8, insert 2, there is shown under "Large Lines" the extension of credit to Transamerica Corporation and its subsidiaries, which has been criticised for years, aggregating approximately \$76,000,000, or in excess of one and one-half times the capital stock of the bank. It is noted that the so-called "Guaranteed Loans" amount to \$5,500,000 in round numbers. This amount should be fully collateralized by readily marketable securities, particularly in view of the method used to eliminate the contracts of the Inter-America Corporation by writing up United States and municipal securities approximately \$14,000,000 and applying that amount as a credit on such contracts, which were then indicated to have been adequately secured by marketable collateral. It is the position of the Office of the Comptroller of the Currency that these contracts should have been eliminated, not by a weakening of the asset condition of the bank through writing up certain assets as indicated above, but by actual collection, with any deficiency taken care of out of the securities pledged.

Since the early part of 1932 it has been the bank's policy to sell properties acquired by the bank to the California Lands, Incorporated, and the Capital Company under contracts. At the time of the examination of the bank, the amounts which these corporations owed the bank by reason of these contracts

and which amounts were carried in the assets of the bank, were as follows:

| | |
|------------------------|----------------------|
| California Lands, Inc. | \$12,051,526.09 |
| Capital Company | <u>27,687,820.37</u> |
| | \$39,739,346.46 |

The California Lands, Incorporated was further indebted to the bank in amount of \$351,016.19 and the Capital Company owed the bank a further sum of \$1,443,040.65, making, with the above, the total indebtedness of these two companies to the bank \$41,533,403.30.

With reference to the contracts of the California Lands, Incorporated and Capital Company, the bank maintains that real estate owned by the bank is sold under continuing contracts with the two foregoing companies. As a result of the terms and conditions of those contracts the bank is enabled to carry parcels of land, which are either unsaleable or can only be liquidated at a substantial loss, for an unlimited period of years, through the device of crediting the proceeds of the sale of a given parcel as a payment on the balance of the total contracts instead of treating each transaction as an individual item.

It appears that no payments were required on those continuing contracts for a period of two years, namely, through 1934 and 1935, following which one-tenth of the purchase price became payable in 1936 and a like amount each year thereafter for ten years. Taxes on such land are paid by the bank. Presumably title does not pass with the execution of the contract. All of these contracts are carried in your loans and discounts, but in reality they appear to represent "Other Real Estate Owned". The lenient terms and conditions of the contracts are such that this arrangement constitutes in fact merely an agency agreement and not a bona fide sale. In the opinion of the Comptroller of the Currency this real estate should be shown as such on the books of the bank and so shown in future published reports of the bank.

A recapitulation of the amount invested in banking houses, furniture and fixtures and other real estate owned is shown on page 14, insert 1, and aggregates \$97,660,265.39, including contracts of the California Lands, Inc., and Capital Company, totaling \$39,739,346.46, previously referred to. These are included in this schedule to show properly the bank's entire real estate investments. Of the aggregate of \$97,660,265.39 the amount of \$47,685,166.67 represents banking houses and equipment, and \$49,975,098.72 represents other real estate owned. When \$14,004,116.02 of actual and probable foreclosures on real estate loans carried in loans and discounts, are added to the aggregate of \$97,660,265.39 referred to, the total is \$111,664,381.41 or approximately the entire amount of the bank's capital structure as shown by its books. It is self-evident that an asset concentration of this magnitude constitutes a problem demanding immediate corrective steps.

Attention is also directed to the concentration of credit in the direct and endorsed lines of A. O. Stewart aggregating \$8,088,003.96 as set out on page 8, inserts 16-17 and 18; and the Pacific Coast Mortgage Company in amount of \$2,925,000.00, as shown on page 8, insert 19, of which company, Mr. A. O. Stewart is president and a director in addition to being a major stockholder. Particular attention is directed to the nature of the collateral securing these lines and to the comments in connection therewith, as set forth on the inserts above referred to.

There are now carried in the International Banking Department, San Francisco, extensions under German Credits, largely under the "German Standstill Agreement", aggregating \$7,964,961.76 of which \$7,820,660.78, are classified as follows:

| | |
|----------|---------------------|
| Slow | \$3,723,441.32 |
| Doubtful | 2,097,219.46 |
| Loss | <u>2,000,000.00</u> |
| | \$7,820,660.78 |

At the time of the October 14, 1936 examination a loss of \$1,000,000.00 was estimated and subsequently charged off on these items. By verbal agreement a like amount was to have been charged off at each succeeding examination until the amount classified as doubtful, which represented the exchange loss, was completely eliminated. At the time of the April 20, 1937 examination the management refused to charge off the second estimated loss of \$1,000,000.00 and it is included in the present classified loss of \$2,000,000.00. However, a recent communication from the bank states that on August 18, 1938 an additional reserve of \$1,000,000.00 representing the loss estimated in the April 20, 1937 report, has been transferred to the International Banking Department, making an aggregate of \$2,000,000.00, which has been applied to reduce the carrying value of these assets. Consequently there remains an additional loss of \$1,000,000.00 yet to be charged off in order to comply with the verbal agreement above referred to. Both the agreement and classifications are believed to be liberal and the exchange loss should continue to be charged off at the rate of \$1,000,000.00 at each succeeding examination. This arrangement is considerably more lenient than the charge offs voluntarily made by other large national banks holding these obligations.

On page 8, insert 1, under the schedule "Loans exceeding the limits prescribed by Section 5200 of the Revised Statutes", there are listed obligations of Transamerica Corporation and obligations of certain subsidiaries thereof in which the Corporation owns or controls a majority interest, aggregating \$23,118,152.87, resulting in a \$14,118,152.87 excessive extension of credit. This violation of Section 5200, U.S.R.S. must be reduced to the bank's legal loaning limit of \$9,000,000.00.

Your attention is directed to the examiner's comments under the heading of "Bonds and Securities" relating to certain substandard bonds carried and the option to purchase granted to the Transamerica Corporation covering 56,600 shares of National City Bank of New York at \$48.00 a share; also his statements

under the caption "Bond Write Up". During the years 1935 and 1936, the management wrote up certain government and municipal securities in amount of approximately \$14,000,000.00 by various book entries and applied that amount as a reduction on the former fully secured Inter-America contracts, reference to which was briefly made elsewhere in this letter. The loss as shown in this report in connection with this write-up should be charged off, and in addition thereto, the remaining unliquidated portion of the original write-up should be reversed in its entirety. In the future investment securities must be carried not in excess of actual cost to the bank, less the required amortization.

A depositor is entitled to the protection of an adequate sound capital structure. According to the analysis of capital position as shown on page 3, insert 1, the net sound capital of your bank at the time of examination amounted to \$96,447,599.77 after deducting estimated losses, doubtful items and liabilities not shown on the books, with deposits totaling \$1,385,494,280.80, or a ratio of 1 to 14.36. The bank is under-capitalized to the extent of at least \$42,000,000.00 without taking into consideration its asset condition. The need for such additional capital should be apparent and sound banking policy dictates that steps should be taken to provide it.

An important criticism will be found under the caption "Management and Supervision by Directors". The reports of the various committees appointed by the Board to supervise the operating functions of the bank should be incorporated in the minutes of the meeting of the Board in sufficient detail to be of value to the individual members thereof. The members of the Board have an important duty to perform in formulating the policies of operation of the bank and seeing that such policies are carried out by the active management. The minutes should clearly show the action, if any, taken by the Board with reference to such committee reports, and also which of the members approve or disapprove a given loan or transaction.

On page 16, insert 1, there is a schedule showing service charges on dormant accounts in the amount of \$520,732.94 since April 10, 1933. The confiscation of dormant balances through such service charges is contrary to the rulings of the Comptroller of the Currency. All charges heretofore assessed contrary to such rulings should be restored to accounts charged. Unauthorized charges against dormant accounts remain deposit liabilities of the bank and must be so reported in statements of condition rendered to this office and in published reports.

On page 5, insert 5, are shown certain loans made upon the security of the bank's own stock in violation of Section 520L, U.S.R.S. These violations must be corrected and the law strictly observed.

Your particular attention is directed to the recapitulation of criticized and fixed assets, showing the major problems of the bank and their relation to its total capital structure, set forth in the conclusions of the examiner. The

criticised and fixed assets of the bank aggregate \$226,002,313.26 book value, of which \$137,818,327.86 is subject to adverse classification. The serious nature of the problems involved is evident when it is realized that the adversely classified assets exceed the total capital structure of the bank by more than \$25,000,000.

The management has persistently refused to either recognize or admit that the unsatisfactory condition of the bank must be corrected. The past practice of capitalizing uncollected profits is pernicious. A sound policy would necessitate the proper charging off of depreciated and unbankable assets instead of deferring such charge-offs until all hope of any recovery has been abandoned.

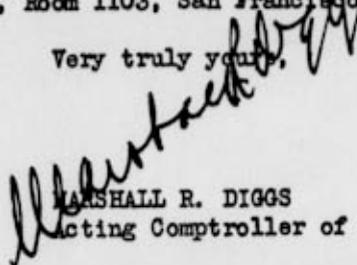
The management appears to be dominated by the desire to publish ever-increasing earnings statements. The bank's earnings have been utilized to enhance dividend payments to the shareholders of Transamerica Corporation instead of being used to charge off the bank's losses and make adequate provision for other criticised assets. The amount of dividends paid by the bank has been the subject of repeated criticism by various examiners. Despite these repeated criticisms, the dividend rate has been constantly increased. During the year 1937 the dividend paid represented 70% of the net operating profits of the bank.

In a telegram to National Bank Examiner Palmer, which was read by Mr. Palmer to the Board of Directors of the bank at its meeting in Los Angeles on September 13, the position of the Comptroller of the Currency with reference to the declaration of any dividend was clearly stated, and the Board was advised that, in his opinion, the declaration of any dividend at this time would, unless proper provision for the criticised assets of the bank were first made, be and continue an unsafe and unsound practice in conducting the business of the bank, and, the Comptroller, pursuant to the provisions of Section 30 of the Banking Act of 1933, further warned the bank, its officers, the Board of Directors and the members thereof to discontinue such unsafe and unsound practice. The Office of the Comptroller of the Currency is informed that, despite this warning, the Board of Directors of the bank declared a dividend without first having made proper provision for the criticised assets of the bank. No further comment in connection with the declaration of this dividend is being made at this time except to state that nothing contained in Mr. A. P. Giannini's letter of September 15, 1938, alters in any way the comments set forth in our telegram of September 13 in respect of the declaration of the current dividend.

You are requested to consider the present letter at a special meeting of the Board called for this specific purpose and to reply in detail over the signatures of the attending members, setting out the corrections effected in each of the criticised matters and your plans for the complete elimination of

the same. Copies of your reply to this letter should be forwarded to Chief National Bank Examiner William Prentiss, Jr., and National Bank Examiner L. E. Sedlacek, 155 Montgomery Street, Room 1103, San Francisco, California.

Very truly yours,



MARSHALL R. DIGGS
Acting Comptroller of the Currency

COPY

PSF: Treasury

TREASURY DEPARTMENT
Washington

October 5, 1938.

To the New York Herald Tribune:

I want to take the liberty of expressing some comments to you on the subject of Edward Angly's story on the American Federation of Labor convention in Houston, which appeared on Tuesday.

Mr. Angly writes: "The New Deal's habit of taking money out of the social security fund to meet running expenses of the government drew the first fire from the floor today at the opening session of the American Federation of Labor's fifty-eighth annual convention. Arthur J. Altmeyer, chairman of the Social Security Board, into whose coffers more than forty million Americans are making monthly contributions for protection in their old age, was put through quite a quiz when he had finished his speech this afternoon."

Now the Treasury has the responsibility of administering the fiscal provisions of the social security act. It is not "taking money out of the social security fund to meet running expenses of the government" and, of course, the Social Security Board does not collect social security taxes, nor receive any funds except those that are appropriated to it and paid over to it by the Treasury Department.

The expressions used in this Herald Tribune story, however, are mild compared with such terms as "stealing," "embezzlement" and "looting" which have been used by less responsible publications.

There are three accounts in the Treasury that might be called "social security funds." They are the unemployment trust fund, the old age reserve account and the railroad retirement account. Transfers to each of the latter two funds are made on the authority of specific appropriation acts of Congress. It is mandatory under both acts that except for such sums as may be needed to meet current claims the funds so transferred shall be invested in obligations of the United States. They are all so invested. If there is any fault whatever in the scheme of the reserve accounts it is not in their administration but in the laws themselves. Whether the present reserve account system is the best possible system is another matter on which, of course, there can be difference of opinion.

A fact which many people do not seem to be able to grasp, although it is very plain in the law and has been repeatedly pointed out, is that the taxes levied under the social security act and under the railroad retirement act are revenue taxes, which pass into the general fund of the Treasury,

just the same as do all other revenue receipts. Of the three funds mentioned only the unemployment trust fund consists of moneys received in trust. As in the case of the other two funds, however, it is mandatory that it shall be invested in United States government obligations.

The effect of this manner of investment of all three funds in a time of deficit spending is, of course, to relieve the Treasury of the necessity of borrowing equivalent amounts in the open market, while in a time of a balanced budget or a surplus the effect will be to reduce the amount of the outstanding debt in the hands of the public.

To those who object to the investment of these reserves in United States government obligations and who at the same time admit the desirability of creating reserves, the alternative would be to suggest some better plan of investment.

The alternative to abandoning the reserve plan entirely would be to increase the future tax load in order to lighten the present burden.

Very truly yours,

(Signed) Herbert E. Gaston

Assistant to the Secretary.

file personal

TREASURY DEPARTMENT

*BSF
Treas.*

INTER OFFICE COMMUNICATION

DATE October 12, 1938

TO Secretary Morgenthau

FROM Mr. White *HDW*

Subject: British press comments in regard to the sterling-dollar exchange rate.

Summary

1. Toward the end of June, when the sterling-dollar rate was approximately \$4.95, comments appeared in the British press suggesting that sterling was overvalued, but these comments emphasized that the rate had been stable and was expected to continue to be so.
2. During the latter half of July, mention of sterling overvaluation became more frequent. At the same time the hope was expressed that the sterling-dollar rate would be permitted to fall to \$4.86 in the event that the two currencies were formally stabilized, as it was widely rumored they might be.

Several weeks later it was frequently stated that this adjustment to \$4.86 was not enough to correct the overvaluation of sterling but it was generally supposed that the United States would not permit a fall in the sterling-dollar rate below \$4.86 and it was considered better, in view of the international political situation, to lose gold rather than antagonize the United States.

3. About the middle of August, when the sterling-dollar rate was approximately \$4.88, several financial writers took the position that sterling was destined to go below \$4.86 and that the United States would soon become reconciled to this. Press comments were generally to the effect that sterling should be allowed to fall in terms of dollars about as far as the United States would permit.

About this time it came to be accepted that the benefits of a lower sterling-dollar rate would outweigh the adverse effects of an accelerated short-term capital outflow such as might result if sterling were allowed to go below \$4.86.

4. During September (sterling below \$4.86): Approval widely expressed at the breaking through of the traditional parity rate, which had been regarded as an important psychological barrier to the needed correction of overvalued sterling.

Figures from \$4.10 to \$4.70 were mentioned as possible appropriate equilibrium points for the dollar-sterling rate.

(Incidentally for the first time there appeared statements that sterling was considerably overvalued in terms of several sterling bloc currencies.)

5. During October, attempt to justify fluctuations in sterling because of the critical period but approval of the lower levels. (Press and periodicals for October not yet available except the cable quotations.)

Intimation that an adjustment of the dollar-sterling rate will not suffice to correct Britain's weakened economic situation and a new note.

The item in the London Times of October 12, 1938, taken together with Keynes' statement of a few days earlier, may be the harbinger of an altered commercial policy in recognition of the weakened British economic status as a consequence of the Munich episode. The item of October 13 introduces for the first time a note of hopelessness in Britain's monetary position in the near future.

Secretary Morgenthau - 2

June 24, 1938 (\$4.961) - The Financial News

Present sterling-dollar rate is stable and can be maintained in the future - although there is an intimation that sterling is overvalued.

".....For the first time since sterling was depreciated, there is now no major maladjustment between the chief currencies. For the last three years the sterling-dollar rate has been very stable: its fluctuations have had an amplitude in the whole period of only 2 percent. Thus, although in objective terms the dollar is still undervalued in relation to sterling, the existing rate is one which has been effectively stable and which seems unlikely to change in the near future. Moreover, the latest franc depreciation has finally removed the overvaluation of the franc. There is thus no distortion in the structure of the sterling-dollar-franc triangle, and that structure could, in all but the most sensational circumstances, be maintained. In fact, we are already in a period of de facto stabilization."

June 25, 1938 (\$4.962) - The Statist

Sterling-dollar rate is stable but sterling may prove to be undervalued if prices rise in United States as a result of the pump-priming program.

"Immediate outlook suggests that dollar will for some time remain in the vicinity of gold export point to the United States." ----- but "in the long run the outlook for the dollar may be unfavorably affected by the implications of the pump-priming program."

July 5, 1938 (\$4.948) - The Financial News

Sterling-dollar rate is stable. However, sterling is overvalued, and a small steady loss of gold will be necessary to support the prevailing rate.

".....In other words, the dollar, in view of our own adverse balance and that of many sterling area countries, seems once more to be undervalued against sterling. That does not mean that any fall below the present rate is to be expected, but a steady trickle of gold to support sterling."

Secretary Morgenthau - 3

July 7, 1938 (\$4.936) - The Financial News

If stabilization were to be effected, rate should be set at \$4.866 to correct overvaluation of sterling which has appeared in recent months.

July 9, 1938 (\$4.936) - The Economist

Capital movements may be masking a real overvaluation of sterling.

July 9, 1938 (\$4.936) - The Statist

If British and American currencies were stabilized - in accordance with rumors - \$4.866 would likely meet with approval by United States and British authorities.

".....If stabilization should come about, the old parity of 4.86-2/3 again seems a reasonable level. It is well known that at the time of the Tripartite Agreement our own authorities had a figure of about 4.80 in mind, and, in view of the American trade surplus the dollar has been manifestly undervalued in recent months....."

"It is, however, possible that these movements of international 'hot money' into gold, and the consequent gold operations of the Exchange Equalization Account are masking what would otherwise be a steady drain of gold from our reserves occasioned by our passive balance of payments."

"If stabilization were embarked upon, it seems not unlikely that the old parity of 4.86-2/3 would now meet with the approval both of the American authorities and our own. This would imply an appreciation not only in the dollar but in the sterling price of gold.

"On current account, however, the dollar is again demonstrably undervalued against sterling. The balance of probabilities thus favors an improvement in the dollar....."

July 11, 1938 (\$4.928) - The Financial Times

A sterling-dollar rate of \$4.60 would be justifiable but \$4.866 would be a compromise between the economic equilibrium and the political requirements of the United States.

July 13, 1938 (\$4.932) - The Financial News

Our export surplus proves sterling is overvalued.

July 16, 1938 (\$4.927) - The Economist

\$4.86 may be a "more natural" level than \$4.93.

".....the old parity of \$4.866 would today imply an overvalued pound. On this basis \$4.60 would be 'about right'.

"This suggests that even the recent recovery in the dollar leaves the pound still overvalued. A rate of \$4.866 would, in fact, be a compromise rate, reflecting both the influence of capital movements and also the desire of Washington not to countenance a lower rate for sterling. Quite possibly it was the rate which has formed the basis of this year's trade negotiations, and if a new monetary agreement is envisaged rumour is probably correct in forecasting the adoption of that rate. Certainly we ought not to accept a higher rate, and Washington would probably not agree to a lower rate. Even if no fresh agreement is in view, sufficient has been said to suggest that if economic forces alone were operative the pound would naturally gravitate downwards, and it looks as if recent rates had been artificially high. For these reasons the long-term view, as well as the short-term view, favors a firmer tendency of the dollar, but with \$4.866 as the bottom limit of any further depreciation."

"The huge American export surplus for the first five months of this year (amounting to \$544,000,000, as compared with a deficit of \$126,000,000 for the corresponding months of 1937) is taken as a clear indication that on current account the dollar is undervalued at any rate approaching \$5.00 to the £."

"It is intimated that on purely economic grounds sterling at \$4.866 may be a more natural level than \$4.90."

Secretary Morgenthau - 5

July 19, 1938 (\$4.918) - The Financial News

Undervaluation of dollar is bringing pressure on the pound by inducing capital flow to United States.

July 20, 1938 (\$4.921) - The Financial News

Sterling-dollar rate should fall considerably before the Exchange Account undertakes to support sterling by selling gold.

July 22, 1938 (\$4.919) - The Financial News

Weakness of sterling is due to general expectation that sterling-dollar rate will fall to \$4.86.

August 4, 1938 (\$4.895) - The Manchester Guardian

Weakness of sterling, exclusive of capital movements, is directly attributable to rearmament program.

"Market quarters suspect that continental quarters with large sterling balances are becoming alive to the manifest undervaluation of the dollar in relation to sterling, and foreseeing a prolonged period of pressure on the pound, are already removing funds from London to New York."

".....It is reasonable that the Exchange Account should release gold to offset the movement of capital, but only if the dollar is in equilibrium on income account. And that can only be when the dollar rate stands considerably lower than it does today."

"That sterling is weak in terms of dollars is due to the fact that, while the number of those who seriously believe in a joint sterling-dollar devaluation is small, there are more people who consider it possible that the rate may eventually be adjusted to 4.86. This accounts for the early covering of seasonal dollar requirements by produce merchants from whom a difference of one percent is of some importance. The weakness of sterling is thus immediately based on a seasonal factor!"

"With the large adverse balance of payments now presumably being incurred by this country, a certain quantity of gold withdrawals is fully to be expected as soon as the masking of this by foreign acquisitions of sterling ceases. And as long as we accept this adverse balance as part of the order of things, necessitated by the rearmament program, gold withdrawals can be viewed in the same way."

Secretary Morgenthau - 6

August 4, 1938 (\$4.895) - The London Times

Pressure on sterling is temporary and will be relieved as business recovery proceeds in United States.

".....There are reasons for thinking that in part at least the relatively favorable foreign trade experience of the United States has been the result of transient influences. In any case until last year an export surplus was a normal feature of American economy. Meanwhile the adverse trade balance of this country is tending to decrease, and if one takes the balance of trade of the wider sterling area, as one should to take the real measure of the economic pressure on sterling, the principal factor in the deterioration has been the trade slump in the United States itself, which will pass with the progress of recovery in the United States. As for the influence of rearmament, large though the British expenditure, actual and prospective, may seem, the expenditure on relief and capital works in the United States is more formidable still, and if it does not immediately reflect itself in an inflation of imports it will do so no doubt in due course as it did from 1935 onwards. There is certainly no indication of other than a purely temporary shifting of the balance of economic power as between sterling and the dollar. That there has been any shift at all is because these days the cyclical movements of trade in different countries no longer coincide. The United States moved first into 'recession' and is apparently moving first out of it."

August 6, 1938 (\$4.895) - The Economist

If sterling and dollar currencies are stabilized, it is likely that the rate will be fixed at \$4.866. Improvement in world conditions will strengthen sterling.

".....These rumors [of a stabilization of currencies of Tripartite signatories] have in their turn drawn attention to the overvaluation of sterling. There is little or no belief in an early devaluation of the dollar in terms of gold, but in Continental circles there is certainly a belief in the likelihood of a return to the traditional sterling-dollar parity of \$4.86-2/3 as a preliminary to any stabilization agreement between the two currencies.

"It is well-known that there is always a time-lag between the exports and imports of the primary-producing countries..... This possibility that the exchange stringency of these countries due to the time-lag is beginning to pass away is of some importance to the outlook for sterling. Most of the countries concerned are members of the sterling area, and any change in conditions which helps these currencies will pro tanto help sterling as well, although the reduction in the primary producers' imports is unfortunately likely to connote a reduction in the United Kingdom's exports."

August 6, 1938 (\$4.894) - The Statist

Overvaluation of sterling, in terms of dollars, will be accentuated in coming months, although it should be recognized that "an enormous short-term bull position in dollars has been built up."

".....An unquestionably more potent influence during the past week has been the growing conviction that sterling is overvalued in relation to the United States dollar and that this overvaluation will become more and more apparent as the autumn approaches."

The weight behind this conviction of the overvaluation of sterling is derived from such concrete evidence as the revolutionary change in the U. S. balance of payments over the past twelve months, and from the belief that this tendency will be accentuated in the immediate future by the bountiful grain harvest in the United States and in the more indeterminate future by the effect of accelerated rearmament on the balance of payments of the sterling area as a whole."

".....The one important qualification that should be made to the view that a further appreciation of the dollar is inevitable derives from the fact that an enormous short-term bull position in dollars has been built up over the past month by foreign exchange dealers. There can be few institutions transacting foreign exchange business on an important scale which are not at the moment running long positions in dollars."

Secretary Morgenthau - 8

August 8, 1938 (\$4.883) - The Financial Times

Sterling destined to return to \$4.86 by mid-September, but if there is stabilization of currencies, the sterling rate may go lower.

August 10, 1938 (\$4.883) - The Evening Standard

Economic forces probably require \$4.50 rate.

August 13, 1938 (\$4.872) - The Statist

The view is gaining ground that it is inevitable that sterling will fall below \$4.866.

".....For long the Continent has been convinced of the overvaluation of sterling in terms of the dollar.

"The several denials and disclaimers by British, French and American officials have failed to remove the impression that the pound is destined for its old parity level and that an all-round devaluation is probable. It is now said that mid-September may be the time for this latter event.

"To what level the currencies are to be lowered is not mentioned; in fact, it is almost impossible to state what is the true parity between the dollar, sterling and the franc."

"Towards 4.50. The view has often been attributed to our authorities that the \$5.00 to the pound rate seriously overvalues our currency, and that a rate nearer 4.50 is more in keeping with the true situation. Accordingly, while our authorities are probably anxious to prevent a too sudden depreciation in the pound against the dollar, over the longer period they may well take the view that economic forces must cause the dollar rate to move towards 4.50. Their recent actions suggest that this is the case."

".....Must one, then, suppose that the traditional parity does not possess this backing, and that the view is spreading that it may well be swept aside by the forces that are pulling down sterling in terms of the dollar? It is unquestionable that such a view is gaining ground. The approach of the autumn season and the steady widening of the deficit on the visible balance of British trade lend it some circumstantial support....."

".....Perhaps the retreat from that stabilization level $\frac{4.86-2}{3}$ had become inevitable by reason of fundamental readjustments in the balances of payments of the sterling and dollar areas.

August 17, 1938 (\$4.881) - The Financial News

British authorities face alternative of losing gold or allowing sterling rate to fall to about \$4.50. In order to maintain cordial relations with United States it may be better to accept a sterling rate of \$4.86 even though this involves the loss of considerable gold.

"The evidence is not conclusive; for international financial statistics do not permit exact calculations. But there is at any rate a strong presumption, backed up by the actual pressure on the pound, that sterling is overvalued. In this position, the authorities have three long-term alternatives. They may initiate a deflationary drive to reduce prices and costs here, hoping in the meantime that American industrial recovery will make the necessary adjustment less than would otherwise be necessary. This must evidently be impracticable.....The authorities are, therefore, left with two alternatives, both unpleasant. They may allow gold to be withdrawn in order to maintain the international advantages of the Tripartite Agreement. Or they may allow sterling to fall to, say, 4.50, at the expense of a certain strain upon Anglo-American economic relations and a possible currency war.

"The depreciation of sterling would certainly be the line of least resistance - provided it were possible to persuade the American authorities of its necessity, and to achieve it within the framework of the Tripartite Agreement. But if the Americans insisted on the maintenance of the old dollar parity, we should be most unwise to destroy the Agreement and to attempt to alter the rate by force. At present, beyond all question, the attainment of the closest possible relations with the United States must be the corner-stone of our international policy. The maintenance of the 4.87 rate might be costly, but in the long run it would be less expensive than a breach in Anglo-American relations. In other words, in order to maintain the Tripartite Agreement, we should be prepared to lose gold. As a long-term policy, of course, this plan is hardly practicable.

Secretary Morgenthau - 10

August 20, 1938 (\$4.880) The Statist

Sterling is said to be overvalued in terms of both the franc and the dollar.

"As far as the three currencies of the Tripartite Agreement are concerned, it is evident that sterling is palpably overvalued in terms of the French franc and that any exchange weakness of the latter currency is due not to normal monetary purchasing power factors, but to inherent distrust in the currency. As regards the dollar, recent experience in the exchange market strongly supports the view that sterling is also overvalued in that direction."

August 26, 1938 (\$4.977) - The Financial News

The Tripartite Agreement prevents correction of sterling's overvaluation but political solidarity of United Kingdom and United States is more important than correcting overvaluation. American views on proper exchange rates are rigid.

".....the [Tripartite] Agreement still prevents the overvaluation of sterling against the dollar from being corrected. In the near future, this country's adherence to the agreement is likely to be tested to the uttermost, for there is little doubt that the defence of sterling at its present dollar value will entail the loss of further large quantities of gold. No doubt it is true that currency depreciation is not the best means of correcting our adverse balance at a time when large imports of materials are needed for rearmament. The best course may well be to continue financing our import surplus by drawing on our overseas investments and, if necessary, a large part of our gold reserve. Even if that were not so, it might be worth while to suffer considerable inconvenience rather than to break away from the agreement, since the latter affords a means of preserving the political solidarity of the democratic nations. But it may seem regrettable, to some, that American views on exchange rates are relatively rigid, and that the securing of the political benefits of the agreement should, consequently, be a matter left so largely to this country."

Secretary Morgenthau - 11

August 29, 1938 (\$4.870) - The Financial News

The fall in sterling rate has not been enough to correct overvaluation of sterling.

August 31, 1938 (\$4.857) - The Financial News

After enumerating the sources of the current selling movement, the position is taken that sterling should be allowed to depreciate about as far as United States Treasury will permit. The United States Treasury is criticized for its "rigid views" on exchange questions.

".....the view was gaining ground that, despite the heavy decline of the past month or two, the overvaluation of sterling against the dollar has not yet been remedied and that the authorities will thus in the long run be forced to permit a further substantial depreciation."

".....Undoubtedly, the sounder course in the long run is to allow sterling to decline in order that our deficit may be paid for by increased exports. If our monetary authorities come to this conclusion (and there is reason to suppose that they too consider sterling grossly overvalued) the initiative passes to the American authorities.....Should our own Exchange Account cease to support sterling, the Americans could always counter that policy by themselves buying sterling. That sterling they would expect to convert, however, into gold withdrawn from the British fund, and in the last resort this country could retaliate by refusing this facility. Any such currency war would be deplorable in the extreme, and yesterday's statement by the U. S. Treasury holds out a welcome hope that America is at last prepared to modify her rigid views on exchange questions. One may well ask, indeed, why it should be left to this country alone to shoulder the burden of maintaining the tripartite pact. That agreement is undoubtedly of immense value as an expression of political harmony between the six democratic Powers which adhere to it. But those political benefits are shared equally with the other participants including the United States, which in the past has profited in addition by a persistent undervaluation of the dollar vis a vis sterling and the franc."

September 1, 1938 (\$4.854) - The Financial Times

British tradition that \$4.86 is proper rate should be destroyed.

"Many people believed that it [sterling exchange] would never be permitted to fall below that level [4.86-2/3]. Apart from the psychological factor, they could produce no argument in favor of their view.

"More than one prominent banker expressed the opinion yesterday that the sooner we tried to forget the level of \$4.86-2/3 the better. Sentiment alone, they contended, surrounded that old parity with a halo."

September 1, 1938 (\$4.854) - The Financial Times

Economically justifiable rate is about \$4.10. Franc is undervalued against both dollars and sterling.

"The theoretical position today thus appears to be roughly as follows:

1. The pound is overvalued by not quite 15 percent against the dollar.
2. The dollar is overvalued by 15 percent against the franc.
3. The pound is overvalued by 30 percent against the franc.

These calculations are based upon price indices alone, and ignore the many imponderables which affect these calculations and which probably mean that the franc is less undervalued than these figures suggest."

September 3, 1938 (\$4.842) - The Economist

Trade balance of sterling area has been shifting unfavorably. Less gold would have been lost by pegging rate at old parity. But, such a policy would have been unwise probably. Fall in sterling rate below \$4.86 is not an unfair competitive depreciation.

".....No doubt there is some solid commercial justification for the recent strength of the dollar. It is evident, for example, in the fact that the visible trade balance of the United States yielded an export surplus..... while both the British and, as far as it can be calculated, the sterling area's, trade balance has been shifting appreciably in the other direction..."

".....This figure [4.86-2/3] once passed, there is no obvious rallying-point, no obvious rate to limit the riot of imagination that can be resorted to in viewing the possible extent of a further depreciation of sterling. There is probably substance in the opinion generally heard in the foreign exchange market

this week that it would have cost the Exchange Equalization Account less to hold the rate above $\$4.86\text{-}2/3$ than it has cost to hold it above $\$4.85$. But this alone provides no adequate criticism of the policy actually followed by the authorities. They are better able to judge of the character of the selling to which sterling has been subjected, and to decide from this and from its weight whether the occasion calls for pegging a outrance or for the exercise of the more normal function of the Account, namely that of 'ironing out' fluctuations."

".....And in any case, this week's fall in the pound sterling has neither been due to movements of British capital nor has it been engineered by the British authorities. In no sense is it an unfairly competitive depreciation....."

September 3, 1938 ($\$4.85\text{-}1/4$) - The Statist

Letting sterling fall below $\$4.866$ was an excellent move. The benefits of a lower exchange rate outweigh the adverse effects of short-term capital outflow. There is no long-term speculation against sterling.

".....The Account has in fact filled its traditional role of smoothing fluctuations and has refused to oppose a trend which, by its recent persistence and by the massive operations to which it has already led, gives every indication of being fundamental. There have been suggestions in the market that the authorities, by allowing the dollar rate to move beyond $4.86\text{-}2/3$, have let the 'bottom fall out of the market'. There is no great evidence to support the suggestion. Admittedly the passing of this level was a psychological factor of some importance and undoubtedly helped to swell the volume of offerings of sterling on Tuesday. But the operations of the Account must clearly be guided by something more than day-to-day considerations of this kind or even by regard for psychological influences. Psychology has to be translated into actual exchange operations before it becomes an effective market factor. It might in this particular instance help to drive more foreign capital away from London than

would otherwise have gone but this is a consideration on which the decision to hold sterling at what may be a definitely overvalued level should not depend.

".....But there is no long-term speculation against sterling such as there has been and such as still persists against the franc. From that quarter the Exchange Equalization Account need fear nothing."

September 6, 1938 (\$4.823) - The Financial Times

Appropriate value of sterling is now about \$4.40 but since future developments indicate a strengthening of sterling the proper stabilization rate is \$4.70.

".....the pound might be held to be overvalued by some 10 percent and therefore bound, say, for a point in the neighborhood of \$4.40. If the hoped-for trade revival in the United States materializes, prices there should respond quickly, especially under the inflationary impetus of 'pump-priming!.....British currency, moreover, will benefit as and when the import demands of rearmament diminish. Such probabilities lend powerful support to the views of those authorities who limit their expectation of sterling's fall to, say, the neighborhood of \$4.70."

September 9, 1938 (\$4.820) - The Times

Overvaluation of sterling against sterling-bloc currencies more apparent than overvaluation against dollar.

"The economic evidence of a recent overvaluation of sterling points to an overvaluation as against the currencies of sterling-bloc members with more certainty than it does to an overvaluation as against the dollar. In the circumstances, the present signs of a wider adhesion to the sterling pivot cannot be an entirely welcome compliment."

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September 10, 1938 (\$4.811) - The Economist

Fall of sterling below \$4.86 is not competitive; in fact it is necessary to achieve equilibrium of international payments on current account.

"It must not be thought that the weakness of sterling is entirely due to capital movements. The pound is also weak for ordinary commercial reasons.If it is true to say that the immediate result of the Tripartite Agreement and the franc devaluation of October, 1936, was to establish a fair degree of equilibrium round the pound-dollar-franc triangle, then subsequent exchange and price movements in the three countries have overvalued the pound against both the other currencies. It has indeed been overvalued against the dollar ever since American prices began to fall in the autumn of 1937. As a long-term view, therefore, and quite apart from the immediate pressure on the pound \$4.86-2/3 has ceased to be an appropriate rate. On this argument, the pound's decline below that rate is not competitive depreciation, but quite the reverse.....

"At a very rough guess, we could stand a total loss to the United States of £150 millions....."

September 17, 1938 (\$4.81) - The Economist

Sterling is overvalued but, since it is impossible to say what the correct value should be, stabilization is not desirable. Authorities should pursue an elastic and frankly opportunistic policy.

".....in times of recession, particularly in the opening stages, the primary producer is hit worst by a fall in his prices, whereas the manufacturer finds that he is unable to reduce his prices and so is unable to sell his goods. The present overvaluation of sterling against the dollar is, so far as England is concerned, nothing more than a particular though striking symptom of this general disease, and so must be regarded as one of the necessary and automatic consequences of the world recession. The extent to which sterling is overvalued is difficult to define. It depends whether it is thought best to measure British manufactured goods prices against American primary product prices or against those of American manufactured goods; or whether it is thought best to attempt a compromise between the two categories of American

prices, which differ fundamentally from each other.
".....We must, therefore, pursue an elastic and, indeed, a frankly opportunist exchange policy."

September 20, 1938 (\$4.823) - The Financial News

If capital flows back to England, authorities should not permit sterling-dollar rate to return to \$4.86.

"For this reason, it would be wise to keep sterling at a level at which it is not unduly vulnerable. Having allowed it to decline below 4.86, the authorities may as well keep it under that level. To allow it to rise above its old parity would serve little useful purpose; for the figure of 4.86 has by now ceased to possess any 'mystic' quality, and no psychological factor, consequently, would tend to facilitate its defence at its historical parity."

October 1, 1938 (\$4.823) - The Statist

Recent action of authorities in allowing sterling-dollar rate to fluctuate widely is justifiable.

".....The tactics of the Exchange Account in allowing these wide movements in rates have met with no real criticism in quarters best placed to appreciate the task that faced the authorities on the critical days of this week. With the outlook so uncertain and threatening there would have been no justification for holding the sterling-dollar rate in the face of the overwhelming volume of sales of sterling which reached the market."

October 12, 1938 (\$4.75) - The Times

The recent decline in sterling has been viewed for the most part with approval and the Exchange authorities have made no great effort to check the decline. Armament demands of the United Kingdom are likely to increase costs and raise British export prices. Also, there is the possibility that the United Kingdom may lose some of its export trade in Southeastern Europe. However, a fall in sterling against the dollar alone is not a cure for sterling overvaluation because exports of the United States and other countries with currencies linked to the dollar do not compete with United Kingdom's exports in several of her most important markets.

"The renewed weakness of sterling since its sharp post crisis recovery has been widely viewed in the city with a complacency not wholly distinguishable from veiled pleasure. It has not escaped notice that no great effort has been made by the authorities to check the movement..... Those who are convinced by the evidence that sterling has been and is overvalued - and they are in a majority - see in this movement a possible adjustment of the exchange value of sterling in accordance with our real commercial needs..... It certainly seems probable enough that the demands of expanded rearmament will tend to increase rather than lower the costs and prices of British goods relatively to those of our competitors. And the desirability of a lower rate for sterling is thus likely to increase rather than diminish during the next year or two. It is also necessary to reckon with the possibility of the loss of some of our trade with Southeastern Europe in favor of Germany although admittedly the total volume of such trade has in recent years been small.

"Unfortunately however it is unduly optimistic to feel that a fall in sterling against the dollar constitutes an easy cure for any existing overvaluation of the pound. The relief provided by a decline in the dollar rate is economically more apparent than real for the United States together with other areas whose currency is based on the dollar is of only limited importance as a market for or competitor of British exports. So far as it goes the relief provided is welcome and valuable. But it must be remembered that the great bulk of British overseas trade is in relation to competitors and markets whose currencies are either within the sterling bloc or can for practical purposes be aligned with it..... The only currency against which even passive depreciation is possible is the dollar and only a very limited and partial corrective for any overvaluation can be obtained in that way. The absence of any natural corrective in the sphere of the exchange

rates is indeed a very real problem and one which could not find any practical solution if solution proved necessary except by negotiation between members of the sterling bloc. Whether the problem will become pressing or not at an early date may depend very largely on the domestic effects of the anticipated expansion of the armament program."

October 13, 1938 (\$4.73-1/2) - The Times

The best policy for the Exchange Fund to pursue - so long as the persistent pressure on sterling continues - is that of orderly retreat, "especially as at the present time Washington seems inclined to view a fall in sterling with equanimity." The alternative policies of determined pegging of the rate, or allowing the rate to fall rapidly to a much lower level are much more dangerous.

".....if the westward flow of funds proves as persistent as at present seems likely the policy of gradual retreat might naturally prove somewhat expensive in terms of the loss of gold involved. The market is inclined to feel that it can take advantage of the authorities policy of gradual recession - an attitude which has found its reflection in an appreciable amount of speculative bear selling of sterling during the past few days. It is difficult to see, however, what new policy the control could logically pursue. It would appear on the face of it that the flight into dollars is of a kind which would not be easily checked either by a determined effort to peg the rate or by allowing sterling to fall rapidly to a materially lower level. The latter policy has certain obvious attractions, especially as at the present time Washington seems inclined to view a fall in sterling with equanimity. But there are serious objections to adopting such a line, partly because there is no real guide as to what sort of level if any would check the demand for dollars, and partly because it is very conceivable that a rapid decline might in any circumstances merely aggravate a flight which is based on apprehensions of an essentially vague kind. In view of the rapidity with which the flight to the dollar was renewed after the Munich Agreement it may well be thought that it is impossible to calculate any particular point at which it can be

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checked or exhausted without some new favorable development in the European political sphere. If that should prove to be so a policy aiming at an orderly decline in sterling - if decline should be necessary - may for the time being be the most reassuring and effective."

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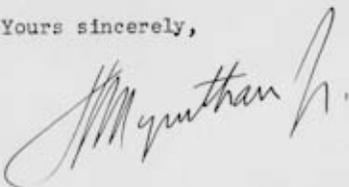
THE SECRETARY OF THE TREASURY
WASHINGTON

November 15, 1938

My dear Mr. President:

I am enclosing herewith a review of the business situation for the week ending November 12, which I thought was particularly interesting.

Yours sincerely,



The President,
The White House.

Enclosure.

TREASURY DEPARTMENT

INTER OFFICE COMMUNICATION

~~CONFIDENTIAL~~

DATE November 14, 1938

TO Secretary Morgenthau
FROM Mr. Haas
Subject: The Business Situation,
Week ending November 12, 1938.

Conclusions

(1)

The foundation for further business improvement has been strengthened this week by an expansion of industrial buying, particularly in textiles and steel. Accompanying this has been an increase in business optimism, generated by the rapidly rising activity in the steel and automobile industries, and further stimulated by a renewed upturn in stock prices. Weekly business indexes have registered further gains under the leadership of increased output in the steel and automobile industries. Commodity prices have been firmer, and cotton mill activity has begun to improve.

(2)

Reviewing the indications pointing toward further business improvement, we find that:

(a) Industrial production, despite its very substantial rise, is still somewhat below the level of consumer demand, as indicated by our basic demand index and by our recently-constructed index of consumer buying.

(b) The level of industrial buying, as shown by our new orders index, remains somewhat higher than the current level of industrial production.

(c) Employment is increasing; consumer purchasing power is being strengthened; and business sentiment is becoming more optimistic.

(3)

Weak features of the present situation, while not numerous, provide some ground for caution:

(a) An unusually large proportion of the more recent business upturn is based upon one industry. If consumer demand for automobiles should fall off, it would adversely affect a large section of industrial production, particularly steel production.

(b) The commodity price situation is not as satisfactory as could be wished, though prices of industrial materials have shown considerable improvement under the stimulus of increasing industrial demand. The weak foreign situation, reflected in a further weakening in sterling and franc exchange, continues a deflationary price influence.

(c) The agricultural section of the national economy remains in an unsatisfactory position, due to continued low levels of agricultural prices and overhanging crop surpluses, and agriculture accordingly is not contributing its full share of purchasing power.

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The steel industry

An expanding volume of steel buying has accompanied this week's steep upturn in ingot output to 61 per cent of capacity. Sales of fabricated structural steel for the week ending Thursday increased to 40,000 tons, the largest in about a month and a half. Sales for the year to date have been 898,000 tons, as compared with 1,114,000 tons for the corresponding period last year. New orders reported by the U. S. Steel Corporation for last week increased to the equivalent of 71 per cent of capacity. New orders for sheet steel, which have been increasing during the past week, may have to be filled in part by delivery during January owing to the congestion of orders in this product for December delivery.

Secretary Morgenthau - 3

A weak feature in the steel situation has been a low level of new orders for tin plate, and a consequent low rate of operations in the tin plate division of the steel industry (around 25 to 30 per cent of capacity). This situation is expected to be changed by a \$7 a ton reduction in tin plate prices announced this week by the U. S. Steel Corporation. Since a price reduction had long been awaited by buyers, it is expected in the trade that a considerable volume of tin plate orders will now be released, serving to strengthen steel operations during the coming months.

Steel output during November and December is likely to exceed actual consumption, according to opinion in some quarters of the trade, owing to the speeding up of operations in an attempt to complete delivery on recent sheet steel orders before the end of the year. For this reason, some expect a temporary reduction in steel operations after the present urgency is passed. The magazine Steel expects a levelling off of steel operations after the 10-point spurt of the past three weeks.

Automobile sales increasing

While it is too early yet to judge quantitatively the actual retail sales volume for automobiles, since new-car buying has only recently got under way, it is encouraging to note that General Motors' sales during the third period of October, as shown in the table below, improved more rapidly than last year.

| October | This year | Last year |
|------------|-----------|-----------|
| 1st period | 1,400 | 2,900 |
| 2nd period | 1,400 | 2,700 |
| 3rd period | 3,600 | 4,500 |

Ward's Reports estimate October automobile sales at 25 to 30 per cent over September, and mention that the rising sales volume is continuing in November, as indicated by reports from the field that dealer stocks are not increasing, but are in constant movement from factory through floor showing to purchasers.

Automobile production this week increased to 86,300 units, as compared with 80,000 units last week, exceeding for the first time the corresponding 1937 figure. Production last year amounted to 83,325 units for the week. As compared with the New York Times seasonal trend, however, which rises rapidly at this time, the increase in automobile output was less than seasonal. The New York Times adjusted automobile index for this week will therefore decline to 89.8, as compared with 92.2 for last week.

Ward's Reports expect production "to expand cautiously for another two weeks or so, after which it likely will be held on a fairly even plane for a few more weeks. Then field stock conditions will be the determining factor in output." Since the normal seasonal trend continues to rise rapidly until the middle of December, any tendency toward a flattening out of production, as suggested by Ward's Reports, would be likely to reduce the seasonally-adjusted indexes.

Textile outlook improving

An upward trend of textile production in the near future appears as a prospective support to business activity, replacing the declining trend which has been in evidence since August. New textile orders have improved sharply in the past two weeks. Recent cooler weather and a rising trend of raw wool prices have brought increased buying in all sections of the woolen goods market. New orders reported by the American Woolen Company this week, probably including some share of a recent large Government order, have risen to a new high for the year. During the latter part of this week cotton goods sales have increased to the highest level in several months. In three days, according to trade reports, mills sold about 35,000,000 yards of print cloths, almost double the current weekly output. The increased demand brought firmer prices for a number of mill products, and was a factor in a rise in raw cotton prices to a new high for the movement.

Cotton mill activity, seasonally adjusted, has already begun to show some improvement (See Chart 1), under the influence of increased orders received during the past several weeks. The New York Times adjusted index of mill activity for the week ended November 5 rose to 115.8, as compared with 113.3 for the previous week.

Commodity prices supported by industrial demand

The general commodity price trend continues disappointing, considering that a rapid business improvement has been under way for 5 months and that the monetary expansion program should tend strongly toward raising prices. An increasing industrial demand, however, has operated to support prices of industrial raw materials as contrasted with prices of agricultural products.

In Chart 2 we show weekly prices since the first of the year for industrial materials and for agricultural products, as compiled by the Bureau of Labor Statistics. While the industrial price index has been rising over the past several months in company with improving business activity, the agricultural index has remained depressed, due to a relatively weak foreign demand and continued burdensome supplies. Further declines in sterling and franc exchanges this week, reflecting continued weakness in the economic situation abroad, are discouraging to hopes of a nearby improvement in foreign demand.

The business recovery has helped prices of industrial materials both through an increased demand and by reducing available domestic supplies. The price of rubber, for example, has been improved not only by the increased buying activity of rubber manufacturers accompanying the increase in tire and tube output from an index of 65 in May to 96 in September, but also by a resulting working down of domestic stocks of rubber. Stocks of crude rubber on October 31 were reduced to 270,000 tons, as compared with 277,000 tons a month earlier, and with the year's high of 311,000 tons at the end of April. Furthermore, the price index of industrial materials includes a number of products that are important in the European rearmament program, and thereby enjoy a sustained demand independent of foreign business or financial considerations.

During the current week sensitive commodity prices have tended to improve, with strength particularly evident in Reuter's index of prices in Great Britain, which had recently been relatively weak.

Rise in stock prices renewed

Throughout most of October the trend of stock prices had flattened out while business continued to make further gains. On Monday of this week, with the report of a 4-point gain in steel operations and the prospect that election uncertainties would soon be removed, stock prices started a renewed rise (See Chart 3), which has carried the Dow-Jones industrial stock average to near the 160 level. Prices on foreign stock exchanges, notably on the Paris Bourse, also showed substantial gains. A considerable volume of buying has come into our markets from abroad in recent weeks, as indicated on the chart.

The stock price rise has been a factor in the increased volume of buying this week in various industries, since it has tended to strengthen business optimism regarding the industrial outlook. It may in some measure be taken as confirming the indications given by our index of basic demand, our index of consumer buying, and our index of new orders, which suggest that the recovery has somewhat further to go before it reaches the current levels of both consumer demand and industrial demand.

Unless the demand level continues to improve, however, the present rate of increase in industrial production may raise production to the demand level or above by the end of the year. The trend of demand over the next few months will therefore become a key factor in the business outlook.

A weak factor in the demand situation is the low level of agricultural prices, and uncertainty over prices and crop volumes for next season, which deprives business of part of its normal support from agricultural buying.

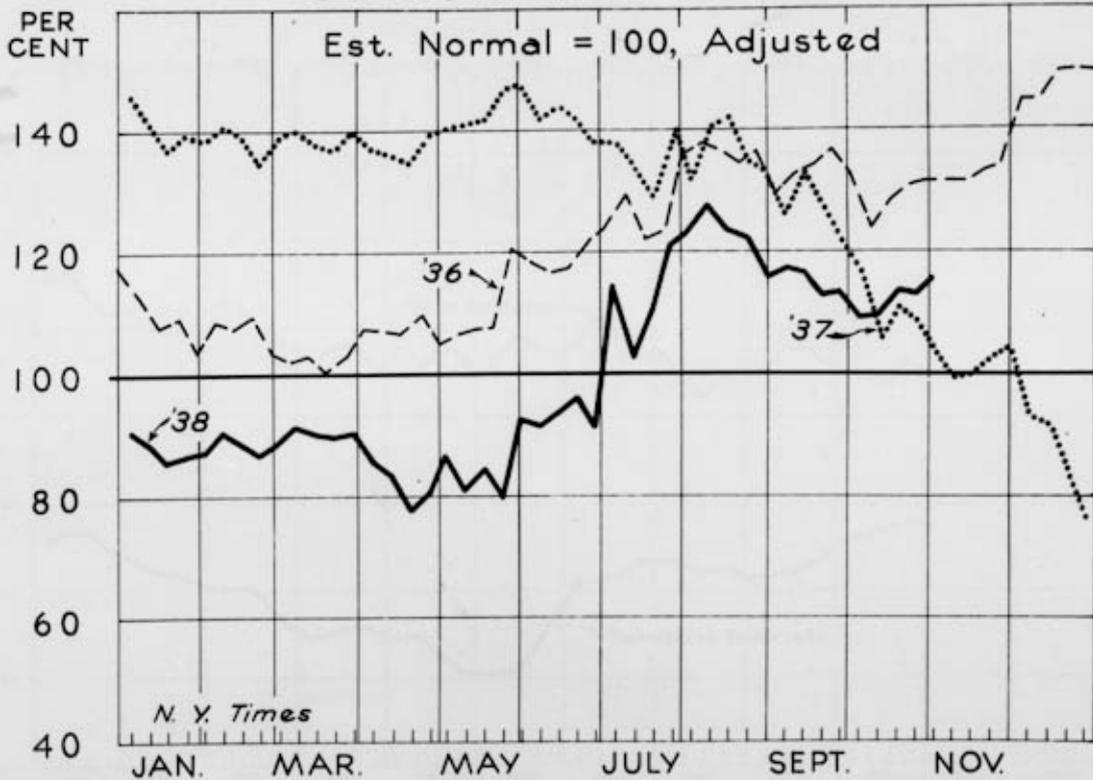
The business outlook is clouded somewhat by the unusual dependence of current industrial activity on the automobile industry and its related industries. While building and textile activity are also providing strong support to business they would probably not be sufficient to prevent a temporary business setback if the demand for automobiles (and consequently the demand for steel and other products) should prove to have been over-estimated. Automobile sales during November will provide an important measure of the level of consumer demand.

Current business news

Our index of new orders (See Chart 4) during the past two weeks has shown the sharpest rise of the year, reflecting substantial increases in orders for steel, textiles, and automobiles. The upturn has been sufficiently pronounced as to suggest that some backlog of orders has been built up, which will serve to support business during the remainder of the year. The heavy textile sales of the current week are not yet reflected in the index.

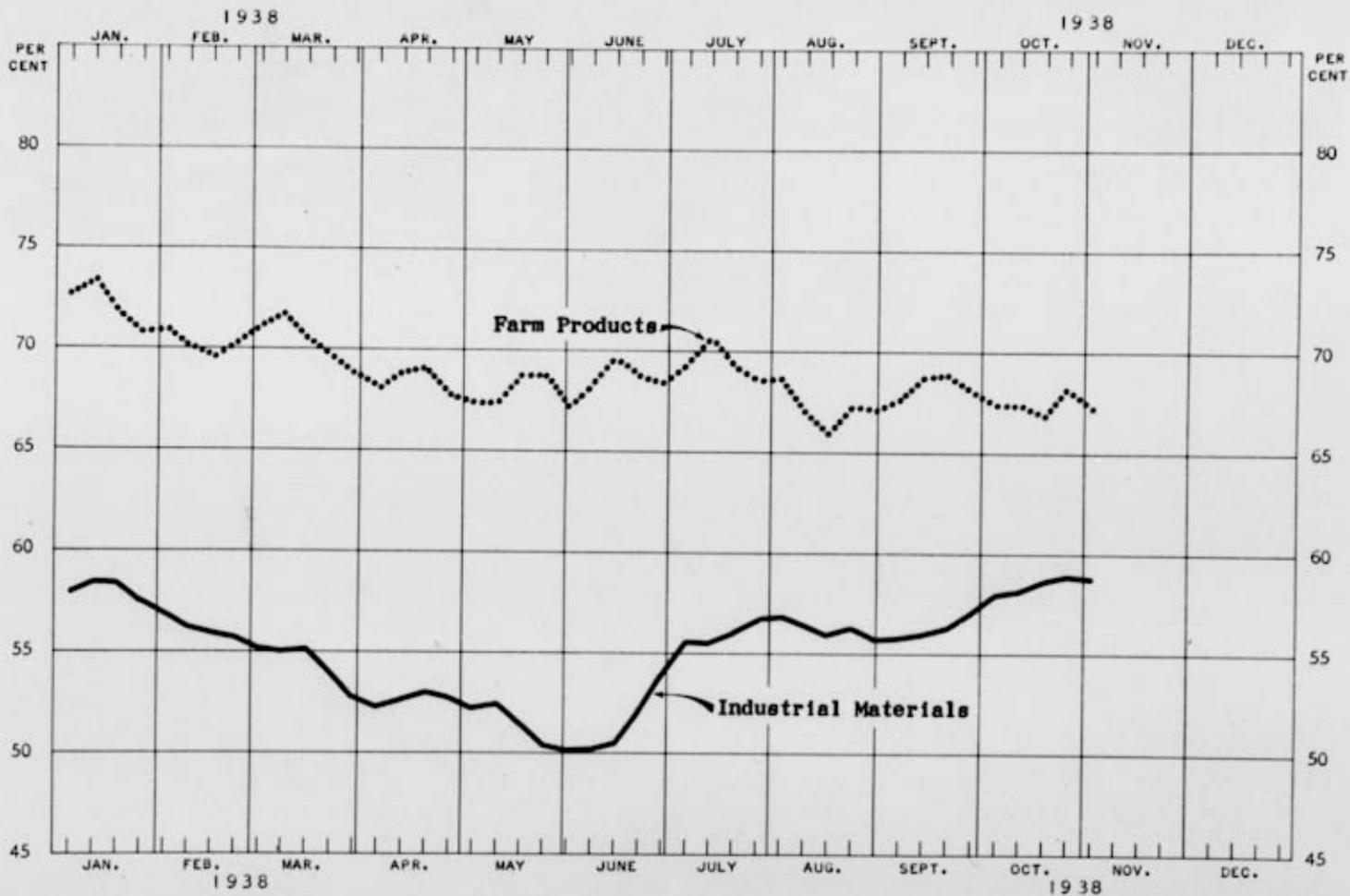
The New York Times adjusted index of business activity for the week ended November 5 rose .5 point to 89.5. Automobile and steel production gained sharply during the week, cotton mill activity was somewhat higher, and the other four components showed minor changes, three of them downward.

COTTON MILL ACTIVITY



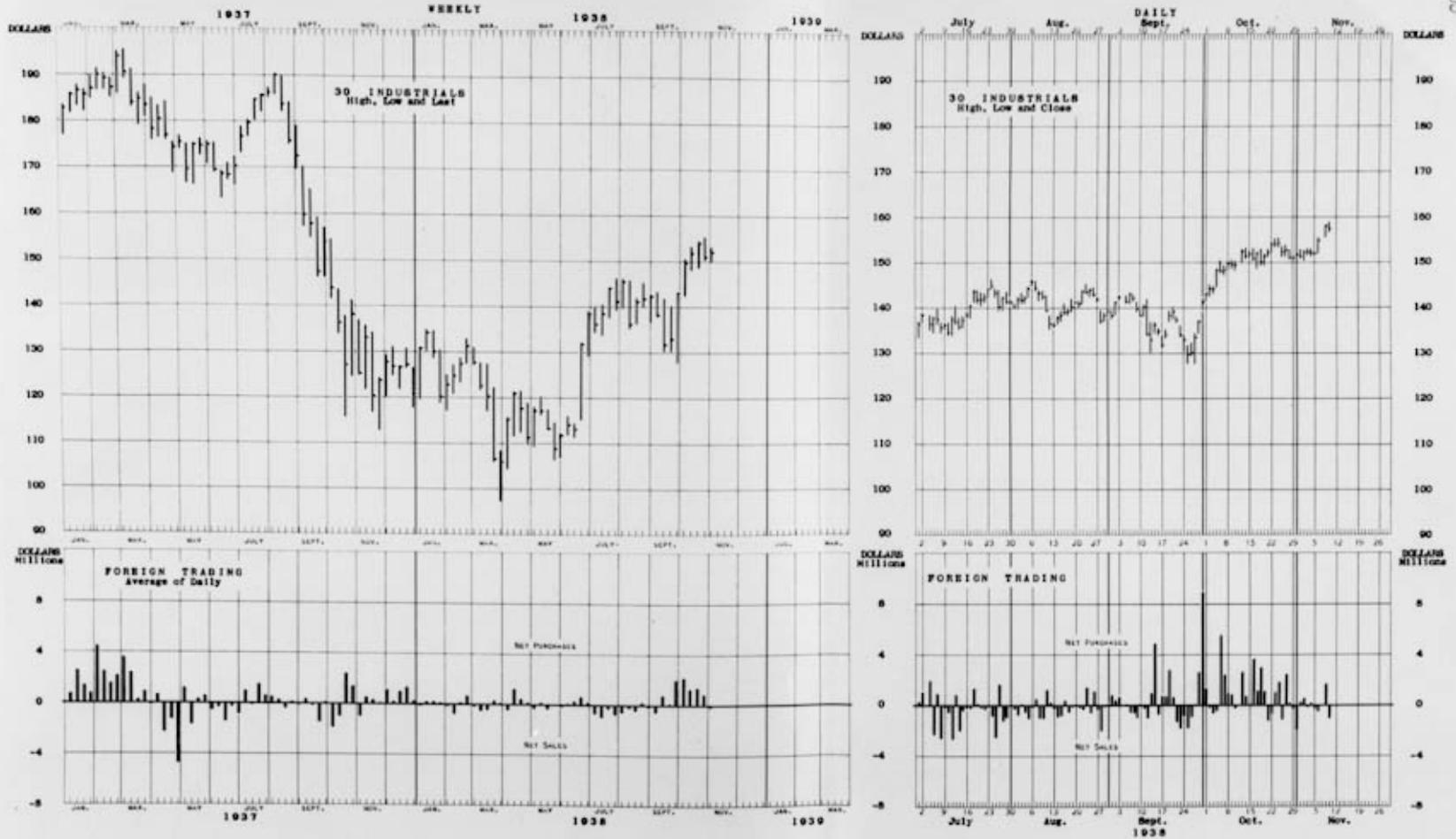
PRICES OF INDUSTRIAL MATERIALS AND FARM PRICES

1926 = 100



SOURCE: BUREAU OF LABOR STATISTICS

STOCK PRICES AND FOREIGN TRADING IN DOMESTIC STOCKS
Daily Movement, Dow-Jones Industrials and Foreign Net Purchases and Sales



INDICES OF NEW ORDERS
Combined Index of New Orders and Selected Components

