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FS

GRAY

London

Dated August 27, 1938

Rec'd 8:30 a.m.

Secretary of State,
Washington.

828, August 27, 1 p.m.

FOR TREASURY FROM BUTTERWORTH.

The momentum of the movement from sterling into dollars has carried over from yesterday to today. The pressure on the dollar was particularly noticeable before gold fixing which was unusually large for a Saturday, 340 bars being dealt in. The easing of the pressure on the rate after fixing indicates that a substantial amount was done for arbitrage although it is somewhat difficult to arrange when the parity at fixing is at a one-half penny premium. The franc remained idle and steady at 178 3/8.

In usually well-informed quarters the report is now credited that the state of Montague Norman's health will necessitate his retirement in the not distant future.

DDM:HPD

JOHNSON

Handwritten initials and scribbles

**FEDERAL RESERVE BANK
OF NEW YORK**

August 27, 1938.

Dear Mr. Secretary:

In this first letter on your return from abroad it seems appropriate to review briefly the past two months' activities in the capital market.

The market for bond issues of high investment rating has been consistently good. The volume of offerings has remained far above the low levels of the first five months of this year and has averaged as high as in the best quarter of 1937. Interest rates on the higher grade bonds have been at or near record low levels, and they have been uniformly well received. The tendency during this period has been for rates to fall slightly. For example, on June 1 \$33,000,000 of Commonwealth Edison Company first mortgage 3 1/2 per cent bonds of 1963, rated Aa, were marketed at 102 1/4, to yield about 3.38 per cent, and were quoted in the market around 104, whereas on August 25 a duplicate offering was made at 103 1/2, to yield about 3.31 per cent, and the market quotation promptly went to around 105.

There have been no large offerings of common or preferred stock during the past two months. An offering to employees of \$2,250,000 Sears Roebuck and Company stock and the public flotation of 30,000 shares of Scott Paper Company \$4.50 preferred stock at 104.75 (\$3,142,500), which was quickly bid up to around 110, have been the only stock issues of any size. The Scott Paper issue is better protected with regard to earnings than many bonds. In addition to the continued absence of stock issues,

two or three bond issues rated Baa or Ba by Moody's have been indifferently received. Some Baa issues have been marketed quite successfully, but issues in this quality range, which is near the bottom or below the grades usually bought by institutional buyers do not generally find a ready market.

The least successful flotation since the revival of the new securities market in June has been \$7,500,000 Industrial Rayon Corporation first mortgage 4 1/2s of 1948, rated Ba, offered at 99, and now quoted at 93 1/2 - 94 1/4. A moderate, though not embarrassing, amount of this issue is still in the hands of underwriters. This sort of experience serves to make underwriters cautious about undertaking commitments in lower grade issues and to make clear the limitations of the current market. Ten million dollars of Crucible Steel Company of America debenture 4 1/2s of 1948, rated Baa, offered this week at 99 1/4, is currently moving slowly and is quoted at discounts below the offering price of "less 2 bid, less 1 3/4 asked".

The larger issues marketed during July and August have been as follows:

July

Standard Oil Company of New Jersey debenture 2 3/4s of 1953 at 99 and serial notes of 1943-47	- \$85,000,000
Southwestern Bell Telephone Company first and refunding mortgage 3s of 1968 at par	- \$30,000,000
Detroit Edison Company general and refunding mortgage 3 1/2s of 1966 at 106, by private sale	- \$15,000,000

August

Indianapolis Power and Light Company first mortgage 3 3/4s of 1968 at par and serial notes of 1939-48	- \$37,500,000
Toledo Edison Company first mortgage 3 1/2s of 1968 at 101 1/2 and debenture 4s of 1948 at 100 3/4	- \$36,500,000
New York Steam Corporation first mortgage 3 1/2s, 1963 at par, guaranteed by Consolidated Edison Company	- \$27,982,000

West Penn Power Company first mortgage 3 1/4s
of 1968, by private sale - \$17,000,000

Phillips Petroleum Company convertible debenture
3s of 1948 being offered to stockholders at par,
now quoted above 106 - \$25,000,000

Commonwealth Edison Company first mortgage
3 1/2s of 1968 at 103 1/2 - \$33,000,000

Lone Star Gas Company convertible debenture
3 1/2s of 1953 at 102 - \$20,000,000

The only offering expected during the remaining few days of August is \$10,000,000 Gulf States Utilities Company first mortgage and re-funding 4s of 1966. If this issue appears, flotations during August will compare with the preceding two months as follows:

<u>1938</u>	<u>(Millions of Dollars)</u>		
	<u>New Capital</u>	<u>Refunding</u>	<u>Total</u>
June (highest since June, 1937)	167.9	127.7	295.6
July	129.7	53.0	182.7
August (preliminary)	68	220	288

It will be noted that the volume of issues for new capital in August is well below that of June and July. The amounts in those months were, however, largely the result of the \$100,000,000 United States Steel Corporation and \$85,000,000 Standard Oil Company issues.

In early September Commonwealth Edison Company will give stockholders rights to subscribe to some \$39,250,000 of convertible debenture 3 1/2s of 1958 at par, an offering similar to the very successful one in June. The only other large issue now in registration is \$30,000,000 Youngstown Sheet and Tube convertible debentures of 1948, whose registration will become fully effective early in September. A number of other large issues, however, are approaching the stage of registration, and the volume of new flotations seems likely to continue substantial.

Municipal awards during the past two months have been somewhat lower even than the low levels during the first half of 1937, the total in both July and August being about \$50,000,000. Prices at which issues have been awarded have, as in the case of corporate issues, been at or near record low levels, though some have been distributed rather slowly. Dealers' inventories are still relatively very low.

Very truly yours,

W. Randolph Burgess
Vice President

Hon. Henry Morgenthau, Jr.,
Secretary of the Treasury,
Washington, D. C.

WRB.H

RECEIVED
AUG 28 1938
FEDERAL RESERVE BANK
NEW YORK

TREASURY DEPARTMENT

INTER OFFICE COMMUNICATION

~~CONFIDENTIAL~~

DATE August 29, 1938

TO Secretary Morgenthau
FROM Mr. Haas
Subject: The Business Situation,
Week Ending August 27, 1938.

Conclusions

(1)

Business activity has continued to improve during August, present estimates suggesting an FRB index for the month of around 85, as compared with 83 in July and 77 in June. A further rise is generally expected during September, largely because the early shutdown of automobile plants this season will probably result in a contra-seasonal expansion during September in this industry and related industries.

(2)

Further business improvement during the last quarter of the year seems likely to be gradual, according to present indications, and irregularity may develop, since

(a) New orders so far have not shown a great improvement.

(b) Weakness in commodity prices has tended to retard recovery. While the domestic situation favors rising prices, its effect has been largely nullified by deflationary foreign developments.

(c) The Government spending program under the Public Works Administration is slow in getting under way, and will not have its maximum influence on business until next year.

(3)

Weakness in the foreign situation is the principal unsettling influence at present. It has brought about a further decline in sterling exchange, a severe price break in the Berlin stock market, and a decline in the London market which has carried railroad stocks to a new low for the year. It has been an important factor in the declining trend of commodity prices.

(4)

The automobile industry, which is in a strong position for advancement, will provide a major supporting factor for business activity this fall. A continued uptrend in residential building permits, past the normal seasonal peak, suggests that the construction industry will also contribute substantially to fall business activity.

(5)

The longer term outlook continues to point toward further business gains in 1939, barring unfavorable foreign developments, under the combined influences of an expected recovery in private spending and an accelerated rate of Government spending.

- - - - -

The general situation

The summer upturn in business activity, which carried the FRB index to 83 in July, as compared with 77 in June, has slackened its pace somewhat in August, owing largely to an earlier than usual shutdown of automobile plants for the change-over to new models. Nevertheless, steel activity in August has increased to an average of about 40 percent of capacity, as compared with 35 percent in July, and prospects favor a gain in the FRB index to around 85 in August. A further improvement is looked for during September, when a contra-seasonal expansion in automobile production is expected to stimulate activity in many related industries.

The New York Times weekly business index (See Chart 1) has shown a continued upward trend during August, the figure of 84.4 for the week ending August 20 representing the highest level since last December. Rapid improvement in electric power production, steel production, and cotton mill activity have been mostly responsible for the rise in this index, as shown on the chart.

The outlook for business activity during the last quarter of the year, however, is clouded by various uncertainties. Further improvement during the late fall and winter may therefore be erratic. The various uncertainties in the present outlook are discussed in the following sections.

The situation abroad

Weakness in the foreign situation seems to contribute most of the uncertainty to our business outlook, particularly in its weakening influence on commodity prices. Involved in the foreign situation have been (1) war fears, intensified by recent developments in Eastern Europe and in Spain; (2) weakness in foreign security prices, which has brought panic conditions on the Berlin exchange and carried railroad stocks on the London market to a new low for the year; and (3) weakness in foreign currencies in relation to the dollar.

The decline in sterling to a new low for several years (See Chart 2) seems to us particularly significant as evidence of foreign deflationary influences. The effect of these influences on commodity prices in the United States, as indicated on the chart, have been quite evident since last February. The decline in sterling which began during the second half of June seems to have reflected foreign deflationary influences which, a few weeks later, weakened commodity prices in this country despite the sharp improvement in business activity. Some improvement in sterling since mid-August has been accompanied by a strengthening of commodity prices.

The fact that business has been able to make rapid gains this summer despite the handicap of foreign weakness testifies to the underlying strength in our domestic situation. Nevertheless, the decline in commodity prices is not in accord with the usual pattern in times of business revival, and creates an uncertainty which will tend to hold recovery back.

A falling off in agricultural buying attributable to the weakness in farm product prices has been partly responsible for a recent curtailment of operations by the International Harvester Company at its Milwaukee plant and its Chicago tractor works, after both had resumed operations following shutdowns during July.

New orders tending to decline

Our weekly index of new orders (See Chart 3) has tended to decline somewhat during August, following the increase in July to a new high for the year. While this may be due to seasonal influences, it casts some doubt on the fall business outlook. Any upturn in business must necessarily be preceded or accompanied by an increase in new orders.

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A decisive upturn in commodity prices and stock prices from present levels would doubtless bring an immediate increase in new orders, as was the case last June, and a corresponding improvement in business activity.

The stock market situation

In view of its effect on new orders, the action of the stock market during September, following its sidewise movement within a limited range over a period of nearly two months, may provide an important indication of the fall business trend. A considerable section of the business public will be influenced in their actions by the direction taken by stock prices after this period of consolidation.

The large volume of idle investment funds and low money rates, together with the prospect of an improving business trend under the Government spending program, continue to provide strong supporting factors for stock prices. On the other hand, the weakened foreign situation and the decline in commodity prices have worked against the market. Stock prices recently have been maintained in part by buying based on the general belief that business will improve sharply after Labor Day. This widespread optimism, without much tangible backing in the form of new orders, may resolt against the stock market if business during September does not show as much improvement as expected. It may be recalled that the same sentiment at this time last year contributed to a building up of inventories and a general over-bought condition which made the stock market unusually vulnerable to unfavorable news during the early fall.

The steel situation

Some tendency to build up inventories of finished products has appeared in the steel industry, according to various reports. This would seem to be borne out by a comparison of current operating rates with the volume of new steel orders, as reported by the U. S. Steel Corporation.

While the operating rate for the industry during the week ended August 27 stood at 42.8 percent of capacity, the highest since the early part of last November, new orders of the U. S. Steel Corporation during the past two weeks have been running at only 32 to 33 percent of capacity. It is possible,

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however, that the discrepancy may be due to the independent companies receiving orders at a relatively higher rate. The independents are running at about 50 percent of capacity as compared with about 30 percent for U. S. Steel.

Commenting on the steel situation, the Journal of Commerce says: "More sizable upturns in steel production are expected after Labor Day, when steel manufacturers look for the release of a good deal of pending miscellaneous and automobile business. Anticipating such expansion in orders, steel mills in Detroit and some other Eastern areas are building up their own stocks of semi-finished steel." Writers in the American Metal Market hold the same opinion.

The inventory situation

Further progress in reducing inventories was made during June and July, according to our estimates (See Chart 4), reducing them to below the level at the beginning of 1937, when they were apparently not burdensome. In certain lines, however, stocks of finished and semi-finished products are still excessive, and will tend to retard production during the early stages of recovery. Tin plate makers and can manufacturers, for example, continue to suffer from large inventories accumulated last year; agricultural implement companies are reported to be over-stocked; and supplies of petroleum products are substantially higher than last year. In certain key industries, on the other hand, as the automobile industry and in retail trade, depleted inventories have become a bullish factor.

Whether present inventories become burdensome, or not, will depend to a great extent upon the trend of prices. If commodity prices renew their rise, present inventories will doubtless be held as assets, while declining prices would tend to force them upon the market.

Auto situation a strong factor in fall outlook

The key to business activity during the early fall may be provided by the automobile industry. In their rush to get new-model cars on the market to take advantage of an improvement in demand that has been evident for several months, auto manufacturers have shut down their plants for the change-over earlier than usual, and expect to be expanding operations on new models during September, which is usually the low month.

The automobile situation appears very favorable. Our chart on basic demand (See Chart 5) shows the automobile industry to be in the most favorable position of any major group. While production in a number of other industries has risen nearly to the level of demand, automobile production during the past several months (seasonally adjusted) has been declining, while the basic demand for automobiles has improved.

Confirming the improvement in basic demand is the fact that retail sales of 1938 models during July and August have shown contra-seasonal strength. The continued heavy retail sales on the eve of a substantial change in models and an expected reduction in prices seems particularly significant as evidence of a strong demand. Field stocks of 1938 models have been reduced to negligible figures, and the used car situation is reported to be the best in several years, thus placing the industry in a particularly favorable position for the fall season. Expansion in this industry will serve to maintain or increase activity in steel, glass, rubber, and other related industries.

The construction outlook

Recent figures on residential building permits, which anticipate contract awards, show a decided upturn during the past two or three months, at a season later than the normal peak of home building. The Department of Labor reports that permits for home building in urban areas during July were 79.1 percent above those in June, and 128.3 percent above those for July last year. This suggests that residential contract awards and actual construction should be well maintained during the fall months.

Residential contract awards during July, according to the F. W. Dodge figures, exceeded those of July last year by 8.5 percent. This was the first month in 1938 to show a gain over the previous year. Total construction awards, however, were somewhat lower than in July, 1937, owing to a smaller volume of awards both in the public works and utilities and in the "non-residential" classifications.

The volume of home mortgages selected for appraisal by the FHA showed no seasonal decline during July, as occurred last year, but remained at a peak 100 percent above the previous year's figure.

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Commodity prices

Contending both with deflationary foreign influences and with large supplies of farm products, the trend of commodity prices this summer has been downward. An adjustment of finished goods prices to lower levels, notably in the case of steel products, has also lowered the general price index. The decline has carried the BLS all-commodity index to a new low since December 1934, and the farm products index to a new low since July 1934.

Some evidence of a strengthening in the price situation has recently appeared, accompanying the stronger trend of sterling exchange. (Refer to Chart 2.) With the prospect of an improving industrial demand, together with measures taken by the Administration to support prices of wheat, cotton, and other farm products, commodity prices would respond quickly to any favorable development abroad. The situation does not appear sufficiently strong, however, to enable prices to force their way upward against the deflationary pressure of recent foreign developments.

Longer term outlook

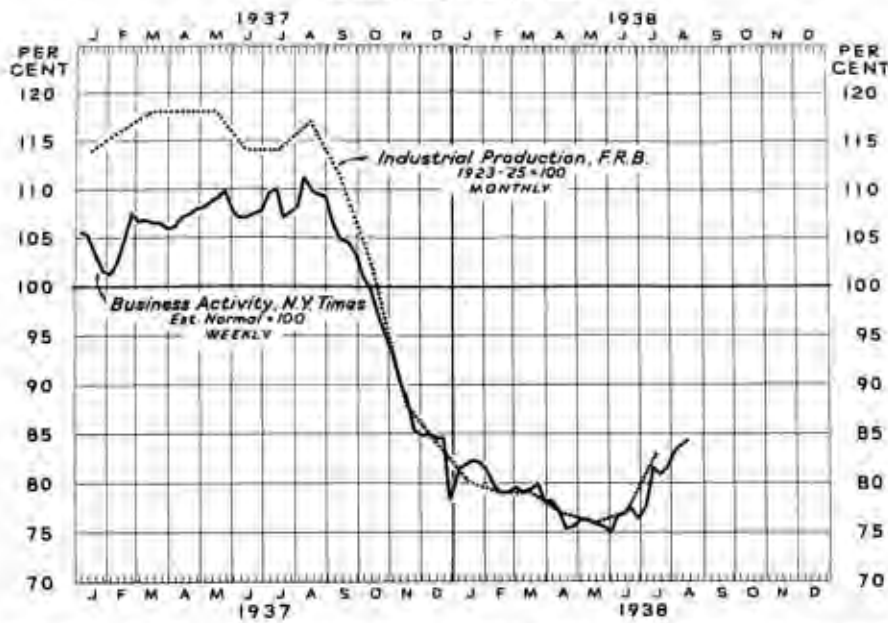
The slowness of the PWA program in getting under way may be an additional factor contributing to a temporary flattening out of the business trend later in the year. In the outlook for 1939, however, this will become an outstanding bullish factor, since a peak in PWA expenditures is expected in that year.

Our studies indicate that business activity next year, in the absence of unsettling foreign developments, should continue upward. Inventories have been drastically reduced to about normal levels. The basic demand for industrial products has tended upward since early in the year, and is still substantially above the level of production. The strong improvement in the capital markets adds another favorable long-term factor.

A danger in the 1939 situation lies in the fact that the peak in PWA expenditures, instead of providing a maximum boost to business in the early stages of recovery, may come at a time when private spending is also at a high level. This might create unhealthy boom conditions during the summer or fall of 1939, and increase the difficulty of shifting the motive power of the recovery over to private business.

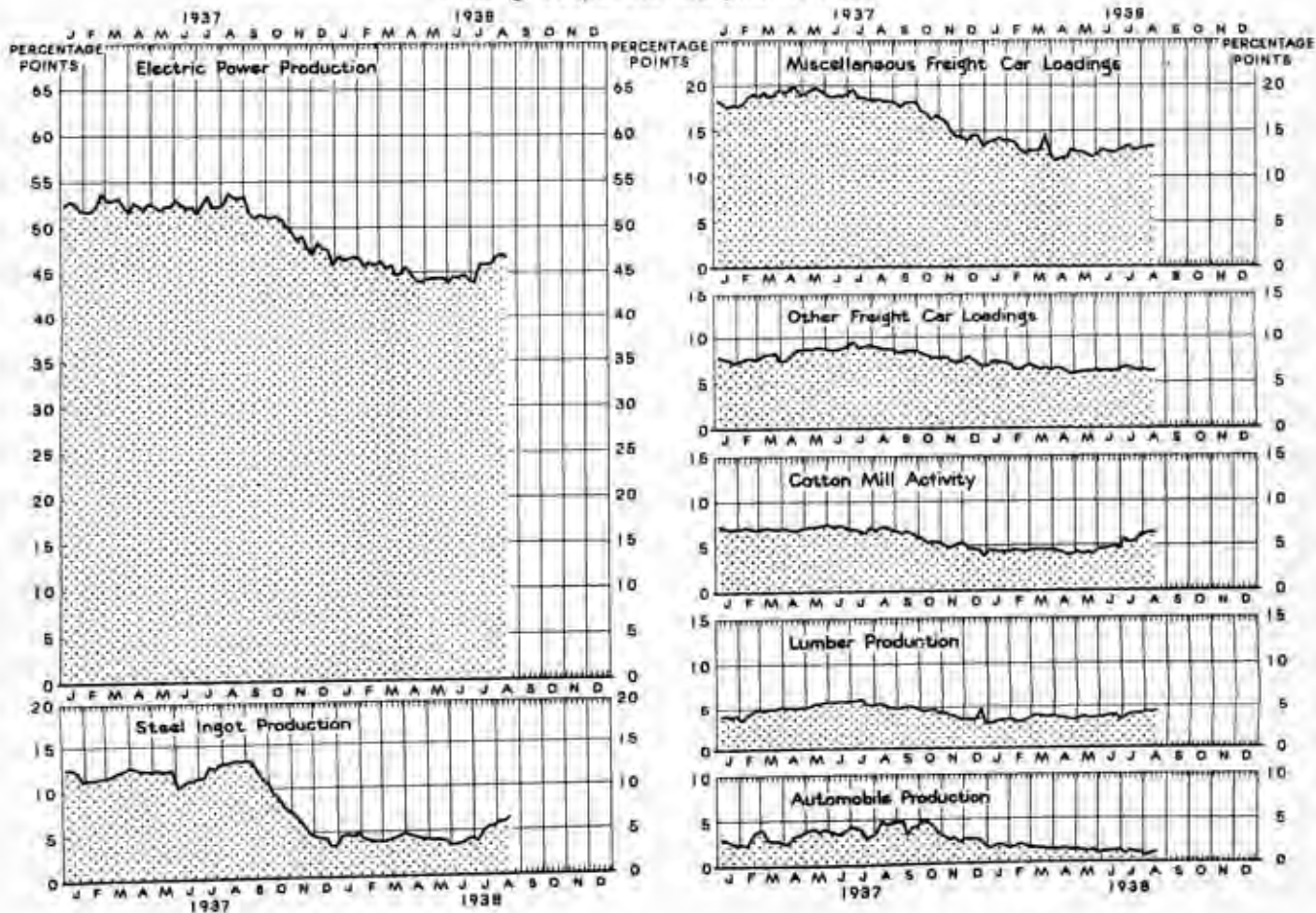
COMPARISON OF BUSINESS INDICES

Seasonally Adjusted



COMPONENTS OF N.Y. TIMES INDEX OF BUSINESS ACTIVITY

Showing Respective Weights in Index



STERLING EXCHANGE AND PRICES OF COMMODITY FUTURES



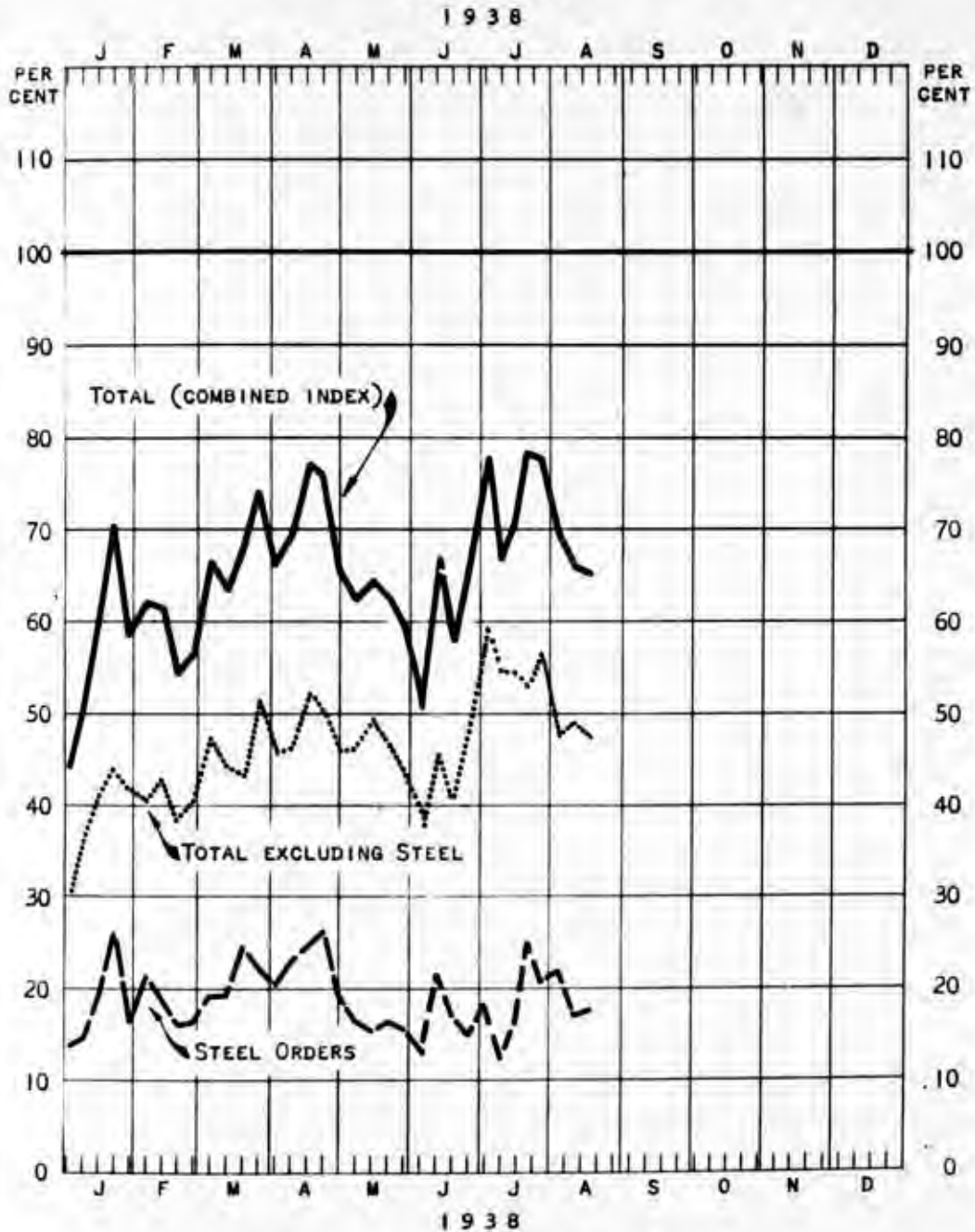
Office of the Secretary of the Treasury
Division of Research and Statistics

M - 68 - C

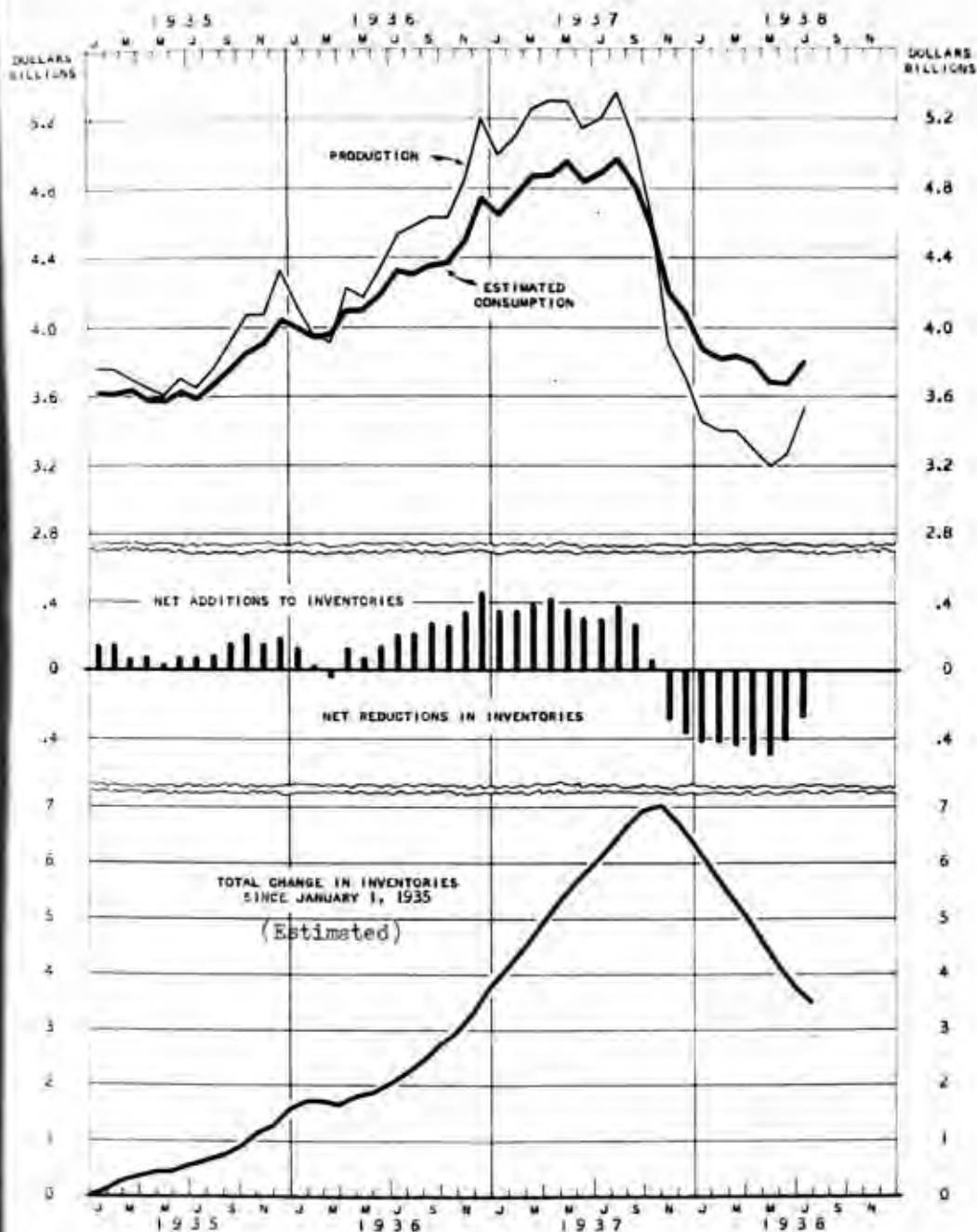
INDICES OF NEW ORDERS

1936 = 100

15



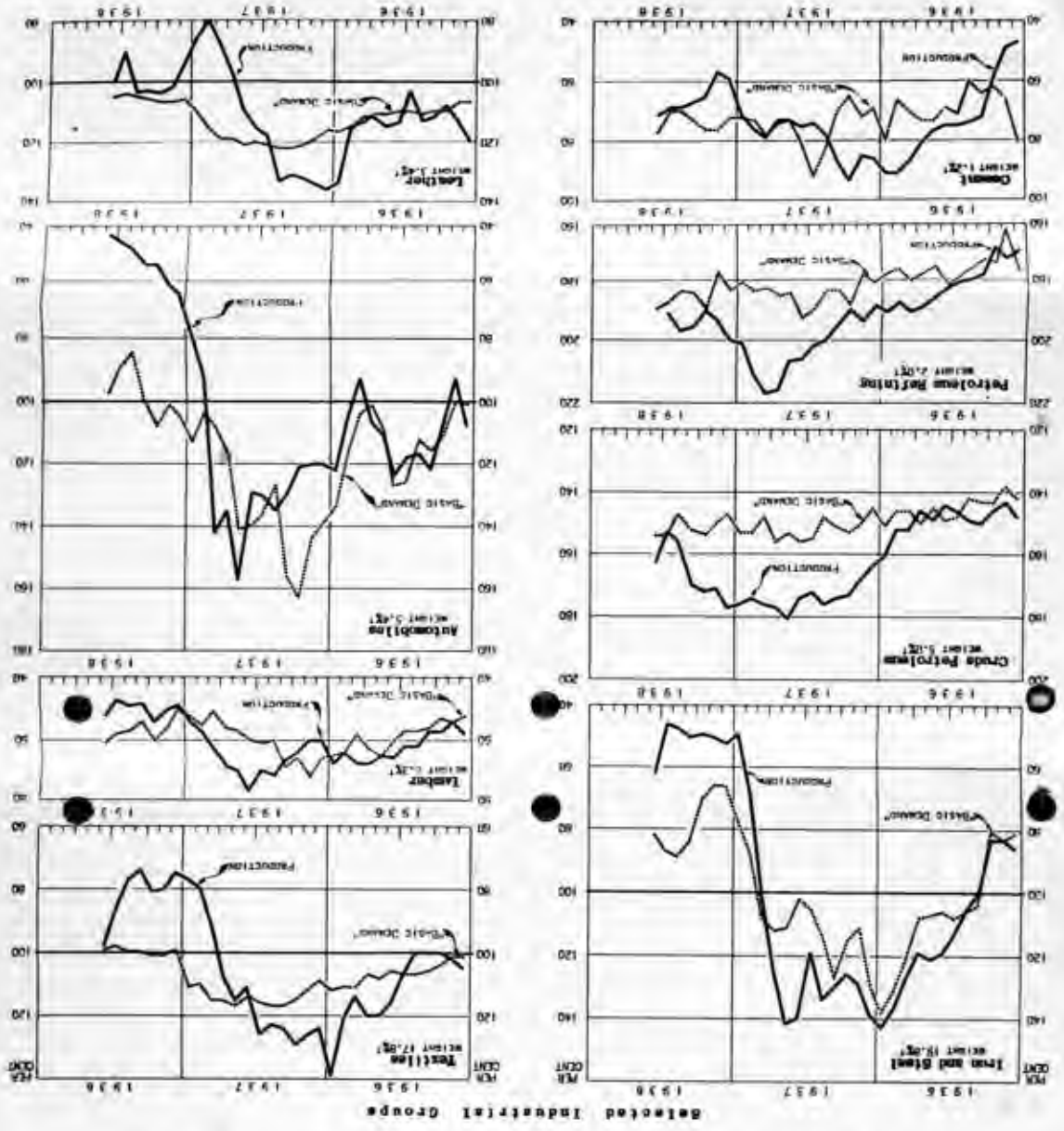
COMPARISON OF PRODUCTION AND CONSUMPTION,
AND CHANGE IN TOTAL CORPORATION INVENTORIES 1935 TO DATE
In Dollar Volume



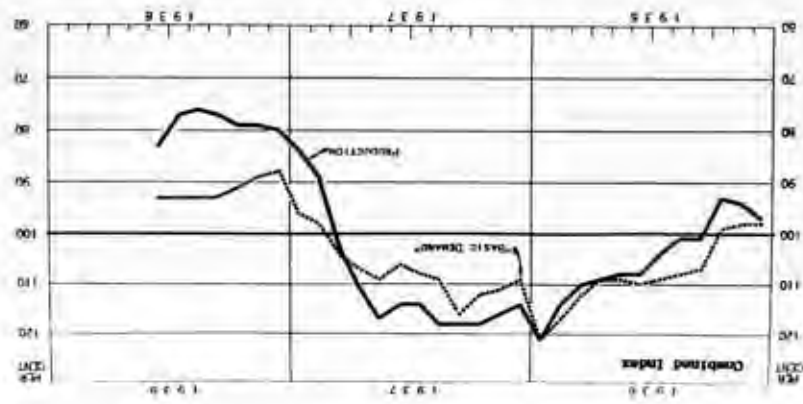
NOTE: LATEST FIGURES ARE PRELIMINARY IN MOST CASES.

PERCENT IN CIRCLES INDICATE

Chart 5
 17



Selected Industrial Groups



PERCENT = 100; 100 PERCENT

August 29, 1938

The Secretary telephoned to the President, at Hyde Park, at 1:20 today. The following is HM, Jr's part of their conversation:

"Fine! How are you? We had a wonderful vacation. You ought to see all the beautiful girls down at Antibes." At this point the President asked, "How are David and Wally?" and HM, Jr replied, "We did not see them. I lost a \$10.00 bet. I bet the children that I would see them."

"I guess you know more about it than I do. There is an awful lot of tension abroad. My own off-hand guess, at home, is that I am mildly bullish. It looks more and more as if this was a real recovery. Of course I need not tell you, if they can just keep things quiet until things begin to freeze over there

"I was most pleasantly surprised to find how much recovery they have in France. The workers get two weeks' vacation with pay and they are all traveling and the place is just over-run with Belgians and Dutch. You can't get rooms. The place is just full and you can't get accommodations anywhere."

"As a Frenchman said to me, 'In the fall of 1936 we had 1,200,000 in the factories not working, but today that is all solved.' Things have definitely turned the corner in France."

"We had a grand three days with Bullitt."

"I am in Washington now. You know what time your wife met us this morning? She boarded the Normandie at quarantine at 7 o'clock."

"I am anxious to see you and I am getting everything together on financing. Your Eleanor said you are fine and that you look very well. I will hold all lunches open until I hear from you. I would love to see you. I am in fine shape. Thanks so much."

The following is the President's part of the conversation, as dictated by the Secretary afterwards:

He, too, is well satisfied and he, too, is mildly

--2--

bullish. He said things are going very well at home and that the tension abroad is bad, but he has had no dispatches today. He said, two or three times, how well he is feeling and that he would like to see me and will try to arrange for lunch tomorrow. He sounded in excellent humor and very friendly.

August 29, 1938
3:19 p.m.

20

H.M.Jr: Hello.

Operator: Secretary Hull.

H.M.Jr: Thank you.

O: Go ahead.

H.M.Jr: Hello.

Secretary Hull: Henry, when did you get back?

H.M.Jr: I got back this noon.

H: Well, good for you. I'm glad you're still alive. I thought you were - so - enmeshed over there with rumors -

H.M.Jr: Didn't think I'd comeback.

H: I didn't think that you couldn't - couldn't get away right soon.

H.M.Jr: Well, I got back quick enough - couldn't come back quick enough.

H: Yes. Well, I'm glad you're back anyhow.

H.M.Jr: Cordell, I'd like - would it be convenient if I dropped in to see you at your apartment tomorrow morning?

H: It'd be all right. Fine.

H.M.Jr: Usual time. Around nine, or a little earlier.

H: Yes, quarter before nine if you'd like.

H.M.Jr: Quarter of nine would be perfect.

H: All right.

H.M.Jr: And anything special from abroad - anything.

H: Well, it's - it's very touchous over there.

H.M.Jr: I see.

H: Yes, very touchous. We don't know exactly what's underneath.

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H.M.Jr: Uh-huh. There's nothing special on - you heard today.

H: No, except that the thing continues this - that way.

H.M.Jr: Yes.

H: In fact, very explosive.

H.M.Jr: Yes. You might be interested, for your own information, that we did thirty five million dollars in gold in the London market today.

H: Yes. Well, it's coming out of there, you know they're all scared over there, aren't they?

H.M.Jr: I know, and -

H: They're very much scared.

H.M.Jr: I don't know how you feel but I hate to see the pound go through 4.86.

H: Yes. Well, we had hoped all the time, you know that it might stop around, right there -

H.M.Jr: Yes.

H: And stay. Well, I'm awfully glad you're back, how are the folks?

H.M.Jr: Fine. And Mrs. Hull?

H: She's not well, but she's about.

H.M.Jr: I'm sorry.

H: I'll look for you then in the morning, Henry.

H.M.Jr: Thank you.

H: Goodbye.

August 29, 1938.
3:23 p.m.

22

H.M.Jr: Hello.

Operator: Dr. Burgess is ^{playing} golf this afternoon, he will be in his office in the morning. Mr. Matteson is there.

H.M.Jr: Oh, is he on the wire?

O: Not yet, no sir.

H.M.Jr: Let me talk to him.

O: All right.

H.M.Jr: Hello.

O: Madison. Go ahead.

H.M.Jr: Hello.

Matteson: Hello, Mr. Secretary.

H.M.Jr: How are you?

M: I hope you're well, sir.

H.M.Jr: I'm very well.

M: That's good.

H.M.Jr: Matteson, I hear Burgess is out playing golf - hello -

M: Yes.

H.M.Jr: And I just - have you heard from Bell about my deciding I'm going to make a speech.

M: Yes, yes. We - we can squeeze it through, our policing will be pretty cursory.

H.M.Jr: Well -

M: But we can squeeze it through.

H.M.Jr: Well, the way I figure the pricing at this time is more important than the policing.

- 2 -

M: Yes, yes, I can understand why that would be more controlling.

H.M.Jr: Yes.

M: And, and as a matter of fact our policing is - is cumulative - we're getting better results.

H.M.Jr: Yes.

M: As a result of what we've done in the past.

H.M.Jr: I don't mean I don't want policing, but I think right now -

M: Yes.

H.M.Jr: I don't -

M: Well, we'll do all that we possibly can.

H.M.Jr: And -

M: But it - but it may be more of a lick than a promise.

H.M.Jr: Well -

M: But we'll do the best we can, and we can squeeze it through somehow.

H.M.Jr: Now, will Burgess be in tomorrow?

M: Oh, yes, he just played hooky for a little while.

H.M.Jr: Good.

M: He thought this the last chance he'd have.

H.M.Jr: Is George Harrison around?

M: No, he isn't here this afternoon.

H.M.Jr: Well you might leave - well I can do it through my operator, tell my -

M: I beg your pardon.

- 3 -

H.M.Jr: I'll leave word, when he gets in I want to talk to him. I'll leave -

M: Could I leave the word for you?

H.M.Jr: Will you do that please?

M: Yes. I'll leave word for him to call you -

H.M.Jr: Tomorrow,

M: Will tomorrow be time enough?

H.M.Jr: Yes.

M: I'll leave word with the Governor.

H.M.Jr: Please.

M: With Burgess?

H.M.Jr: With Burgess and with Mr. Harrison.

M: All right, sir. Very glad to.

H.M.Jr: Thank you. Good night.

M: Good night.

August 29, 1938.
3:24 p.m.

Operator: Operator.

H.M.Jr: Mr. Knoke.

O: Mr. Knoke, yes sir.

H.M.Jr: Hello.

Knoke: Yes, Mr. Secretary.

H.M.Jr: Hello Knoke.

K: Welcome home.

H.M.Jr: It's a hell of a welcome you give me.

K: (laughs) It may be lots worse, sir.

H.M.Jr: Yes. You talk about a thirty-five million dollar welcome, that's some welcome.

K: What?

H.M.Jr: I hear we did thirty-five million dollars in gold today.

K: Yes.

H.M.Jr: That's some welcome.

K: Close to that.

H.M.Jr: Yes. Well, I don't know whether they told you, - because I want to do everything that we can to keep us from breaking through the old parity 4.86.

K: Yes.

Well, I spoke to Lochhead the day - on Saturday.

H.M.Jr: Yes.

K: I had this thought Mr. Secretary. I give it to you for what it is worth.

H.M.Jr: Yes.

- 2 -

- K: Today's figure - today's London price, take it against thirty four seventy seven which has been out cost price and includes quarter per cent handling charge.
- H.M.Jr: Yes.
- K: If you want to contemplate, under your own transactions, charging only an eighth, for instance -
- H.M.Jr: Yes.
- K: Instead of a quarter, you could bid your sterling up to four - higher than four eighty seven today.
- H.M.Jr: You could. Well, you're a man after my own heart.
- K: Well, I just - there are serious pros and cons there, but it's your own - it's on your own transactions, and I think you - it's a perfectly reasonable way - reasonable way of holding up the sterling rate.
- H.M.Jr: I've just - Archie Lochhead's coming in now.
- K: Yes, sir.
- H.M.Jr: Just a minute. (aside. I got Knoke on the wire. I was talking to him. I said I want to keep her up to four eighty seven, so he said, "If I only charged myself an eighth, I can do it." See.)
- Hello.
- K: Yes, sir.
- H.M.Jr: Explain it again. Archie - Archie - the idea of losing an eighth, he got red in the face, but we'll see what happens.
- K: Got gray hair, I guess.
- H.M.Jr: No.

- 3 -

- K: Well, my thought is simply this. At thirty four seventy seven, as the Loohead knows we can today buy sterling if it goes down to 4.86 and 5/8ths.
- H.M.Jr: Yes.
- K: This thirty four seventy seven includes one quarter per cent handling charge.
- H.M.Jr: Right.
- K: If the Secretary is willing to reduce that handling charge on his own transactions, which I think that's easily - can easily be explained, it seems to me. Say, if for instance he is willing to take an eight per cent on that.
- H.M.Jr: Yes.
- K: We could today - sterling could today be purchased - be supported at about 4.87 and 1/4.
- H.M.Jr: Yes.
- K: And that means the Treasury would - would buy that gold, not at thirty four seventy seven, but at thirty four eighty five seventy five. That would still be - would still break even if they sold it flat and still be making an eighth - a quarter, if they sold it at a quarter off.
- H.M.Jr: How do you mean flat?
- K: Well, if you were willing to buy and sell at thirty-five you would still break even.
- H.M.Jr: I know.
- K: If you want to sell at thirty-five and a quarter, you would make a quarter per cent instead of the half that you had been making before.
- H.M.Jr: Well, now, is - is there much sterling being offered now.
- K: No, there is not. I mean, it's premature, but I -

- 4 -

that thought occurred to me this morning, and I figured it out.

H.M.Jr: Well, premature - the thing that I got, it's broke four eighty seven now.

K: It is four eighty seven.

H.M.Jr: What?

K: It is four eighty seven.

H.M.Jr: Now.

K: Yes, but the pressure isn't there.

H.M.Jr: There's no pressure.

K: No, not this afternoon here.

H.M.Jr: Well, what will it show on the quotation, when it closes today, what will it -

K: Well, unless there is - unless the - there is the change - it would show four eighty seven better now.

H.M.Jr: I see. Well now just hold on a second, will you?

K: Yes, sir.

H.M.Jr: Just a second. (aside).....
Hello.

K: Yes, sir.

H.M.Jr: For today only, and in order to help the general situation, see? Now I'm willing today - today only, to bid 4.86 at 15/16ths.

K: Six and 15/16ths.

H.M.Jr: Now that - that works out, Archie says that works out on the basis of an eighth.

K: Yes.

H.M.Jr: What?

- 5 -

K: That is, in the market, yes, I guess - I haven't figured it exactly, but that is my impression. So you are willing to pay 4.86 15/16ths - no to bid on the market 4.86 and 15/16ths.

H.M.Jr: To bid.

K: Yes, because that'll cost you a little - a 16th more.

H.M.Jr: What's that?

K: It'll actually cost a 16th more.

H.M.Jr: Well, it works out at four - we're bidding 4.87.

K: Yes. That we go into the market and bid 4.86 and 15/16ths.

H.M.Jr: Yes.

K: All right, sir.

H.M.Jr: Well now, before I say that, you believe that's a good move for today

K: Well, I think it's - I haven't discussed it with anybody here, but it seems to be a good move, yes.

H.M.Jr: You do.

K: Yes.

H.M.Jr: You recommend it to me, just -

K: I recommend it to you.

H.M.Jr: You do. Well, I feel that - a day like today is the day that the United States Treasury should show courage. Hello.

K: Yes, sir.

H.M.Jr: And if I'm willing to do that for today.

- 6 -

K: All right, sir.

H.M.Jr: And tomorrow we go back to work on the regular basis again at the one quarter.

K: Yes. All right, I'll get busy right away. Thank you.

August 29, 1938.
4:28 p.m.

31

H.M.Jr: Hello.

Operator: Knoke. Go ahead.

H.M.Jr: Hello

Knoke: Yes, Mr. Secretary.

H.M.Jr: Well I've made five bets. I bet Archie we'd do over a half a million dollars. I hear we've done a hundred and fifty thousand pounds.

K: A hundred and fifty - a hundred and forty-five thousand pounds I have here. Thirty, forty-five.

H.M.Jr: Well, who did you relieve?

K: Pardon me.

H.M.Jr: From whom did you buy it?

K: Mostly from bankers, and we just called them up to find out what it is, but they've gone home.

H.M.Jr: Oh!

K: A hundred of that from bankers, and the rest spread - three names.

H.M.Jr: Any comments?

K: No, no comments.

H.M.Jr: But they - they don't know what figure the bankers - they've been giving, do they?

K: Oh, no - the market here doesn't know anything about it. The only one who might wonder is the Bank of England.

H.M.Jr: Well, they should have a pleasant wonder.

K: Well, I am not the least bit disturbed there. I think they certainly indicated today, by their own operations, that they were trying to hold the market, and we have simply continued on a very small scale.

H.M.Jr: Yes. Well, we'll do this for today. You let Archie know if we do anymore. Have you cleaned up the market?

- 2 -

K: Oh yes, yes. The - after the bankers were out-
and that was evidently one order - after that
was taken care of - the market dried up.

H.M.Jr: Ask them, tomorrow, if you can, informally,
what it was for.

K: Yes, as I say, we just called them but couldn't
get an answer.

H.M.Jr: All right, I - I - I'm glad we did it now. That -

K: But I'm quite sure - I'm confident it was the
right thing to do.

H.M.Jr: What are you paying for that?

K: 15/16

H.M.Jr: 15/16. That's all right. That's all right.
I don't know what an eighth on a hundred and
fifty thousand pounds is, but it can't be
a lot.

K: An eighth on a hundred and fifty?

H.M.Jr: Yes.

K: A hundred and twenty five dollars.

H.M.Jr: How much?

K: A hundred and eighty dollars.

H.M.Jr: No. Is that all it is?

K: Yes, that's all it is.

H.M.Jr: Oh, for heaven's sake. That's all right, I'll
take it right out of Archie's hide.

K: Don't take it out of his salary.

H.M.Jr: Well, Taylor is sitting here. He says I already
have taken it out of Archie's hide. All right.

K: All right, sir.

H.M.Jr: Goodbye.

*How Bell
feels to me please*

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FEDERAL RESERVE BANK

OF NEW YORK

August 29, 1938

Dear Mr. Secretary:

Over the past several months comment has appeared in the newspapers that the Treasury has been sterilizing gold since the desterilization of April 14, 1938. In the last few days and, in fact, several weeks ago, we received a number of telephone calls from people in New York, asking whether it is true that the Treasury is sterilizing gold. The belief of these persons that gold is being sterilized at the present time is based upon the constantly rising amount of gold held in the Treasury General Fund, which has been increasing ever since April as the result of gold imports and other gold acquisitions by the Treasury which have not been utilized by making transfers to the Gold Certificate Fund of the Federal Reserve System.

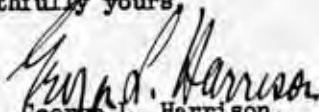
We have replied to the inquiries made of us that the mounting figure of gold in the general fund of the Treasury does not denote that gold is again being sterilized. We have further pointed out that when Treasury deposits in the Reserve Banks (which were greatly increased by the desterilization of April 14, 1938) have been reduced to more normal figures, undoubtedly the Treasury will make "gold deposits" from its general fund to the Gold Certificate Fund of the Federal Reserve System, thereby restoring the loss to Treasury deposits in the Reserve Banks which occurred by reason of the payment for gold imports and other gold acquisitions.

The accumulation of gold in the general fund of the Treasury at a time when Treasury deposits in the Reserve Banks are very adequate is of little importance one way or the other. It must be admitted, however, that the rise in

the bookkeeping item "Gold in General Fund" does have some outward similarity to the rise in gold holdings during the period when the sterilization program was in progress, although at that time gold so acquired was labeled "inactive." This accumulation of gold in the Treasury and the rise in the bookkeeping item "Gold in General Fund" apparently signifies sterilization to some people.

I am not suggesting a change in the current practice with respect to Treasury gold holdings and deposits in the Reserve Banks, but I think that you would want to be informed of the interpretation placed by some persons upon the current treatment of gold and Treasury deposits because it differs from the course generally followed previously when gold was not being sterilized.

Faithfully yours,


George L. Harrison,
President.

Mr. Henry Morgenthau, Jr.,
Secretary of the Treasury,
Washington, D. C.

FEDERAL RESERVE BANK
OF NEW YORK

OFFICE CORRESPONDENCE

DATE August 29, 1922.

CONFIDENTIAL FILES

SUBJECT: TELEPHONE CONVERSATION WITH

L. W. Knoke

BANK OF ENGLAND.

Mr. Bolton called at 10:30 today. The pressure against the franc had somewhat eased but for the long view the French currency remained very weak. Deladier had undoubtedly sacrificed his currency (in order to retain his parliamentary majority), by going back on his promise to modify the 40-hour week. In his radio speech he had emphasized the need for the French to work more and to produce more: it had all been whittled down now to the munition factories being the only ones that would work longer.

As regards sterling, that was suffering from the effects of a war scare as result of which a great deal of foreign money in London was being converted into dollars and gold. The situation in London was very serious. They had sold about \$5,000,000 at the moment (Bolton's subsequent cable stated that his total sales today were \$12,250,000 with a turnover of \$35,000,000). There was one other thing of interest: the Swiss francs and the guilders were beginning to show signs of weakness and were no longer as favorably regarded as they were a week or so ago. The belga, however, was standing up as a result of the French paying off large amounts of belga advances previously granted the French railroads on short term in the Belgian market.

The British Government, Bolton thought, had done as much as they could to bring Czechoslovakia and Germany together and to

FEDERAL RESERVE BANK
OF NEW YORK

OFFICE CORRESPONDENCE

DATE August 29, 1938.CONFIDENTIAL FILESSUBJECT: TELEPHONE CONVERSATION WITHFROM L. W. KnobeBANK OF ENGLAND.

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avoid a clash but it now looked as though the situation was really going to be determined by the whim of one man. The European markets had gotten more excited over this morning's news that the Germans intended to extend their maneuvers to the middle of October.

Cariguel was still feeling as depressed and pessimistic as ever concerning the internal situation in France.

Bolton requested that we do him a favor and give them a little more notice than two or three days when we wanted to ship Treasury gold from London to New York. Their Bullion Department was so heavily overworked now that they found it difficult to act on our instructions unless they had a little more time.

LWKC:KW

RECEIVED
AUG 30 1938
FEDERAL RESERVE BANK
OF NEW YORK

REB

GRAY

London

Dated August 29, 1938

Rec'd 2:40 p. m.

Secretary of State,
Washington.

834, August 29, 6 p. m.

FOR TREASURY FROM BUTTERWORTH.

Marked increase in nervousness over the Sudeten-Czech situation the demand for both gold and dollars increased. 490 bars were dealt in at fixing and there were considerable dealings after fixing at 1 penny over the fixing price. Due to official intervention the range of movement in the dollar was limited to dollars 4.87 3/8-1/16 but the volume was fairly large. Likewise the Swiss franc and guilder were heavily offered but the French franc remained steady and the volume of selling was small.

Most foreign exchange dealers anticipate that the movement into gold and dollars will continue and increase if the European political situation does not take a turn for the better. However, it might be worth recording that one dealer expressed the view that the English market

was

REB

2-#834, From London, Aug.29,6p.m.

was over--in dollars and that any favorable political news would for the moment produce an instant and decided reaction.

British security markets were weak, war loan being down half a point but the turnover has not been large.

JOHNSON

KLP

WWC

PARAPHRASE OF TELEGRAM RECEIVED

FROM: American Embassy Paris

DATE: August 29, 6 p.m.

NO.: 1364

FROM COCHRAN

A half million pounds were lost by the French stabilization fund today holding rate of 178.32. The fund also intervened to keep three months sterling at 3-3/4. The international political situation has worried the market, but apparently not so badly as in London where British control's losses have been large in both gold and dollars.

A Post, Telegraph and Telephone Department 30 year 6 percent loan for an unfixed total to be opened today at 95 was announced by the JOURNAL OFFICIEL. It is rumored that the French Treasury is now studying the possibility of meeting its coming needs through higher taxes or a new "gold" loan.

Bullitt.

EA:DJW

August 30, 1938.
10:14 a.m.

H.M.Jr: Hello.

Operator: Mr. Knoke.

H.M.Jr: All right.

O: Go ahead.

Knoke: Hello.

H.M.Jr: Hello.

K: Good morning Mr. Secretary.

H.M.Jr: Hello Knoke.

K: Here is what London said. They were - they are - they have had a terrible time this morning. They've done over twenty five million dollars - seventeen million of that in one and a half hours.

H.M.Jr: Yes.

K: At the moment the markets are steadier at 4.95 and 7/8ths and they would carry on and use all their efforts to hold the rates.

H.M.Jr: Yes.

K: The demand is - the demand for gold has disappeared. The demand for hoarding has disappeared. He said all they did in gold was about eight hundred thousand pounds which was arbitrage. The movement was distinctly and definitely one into - away from Europe into cash in a country that was distant to Europe.

H.M.Jr: Yes.

K: In other words it was entirely a war scare - the war scare that prompted the movements.

H.M.Jr: Yes.

K: It was - he didn't see any evidence of - of speculation, it was legitimate efforts to get out of sterling into another currency. He mentioned

for instance, that American firms were withhold - were withdrawing their balances from London. He mentioned Paramount and Ford and others who had been carrying sterling balance, and they think it's better to carry dollar balances at the moment. I mentioned - oh, he said Stockholm, the Reichs Bank - Stockholm are taking two and a half million dollars.

H.M.Jr:

Yes.

K:

I mentioned what we had done last night.

H.M.Jr:

Yes.

K:

He said, well he hadn't even figured it out - He had noticed it, but he said, "Glad to see support from anywhere."

H.M.Jr:

Uh-huh.

K:

Any support that sterling can get under present circumstances is welcome.

H.M.Jr:

Good.

K:

I told him why we did it last night, and he thought that, for him, during the day, to try and lift the sterling rate was probably more than could be handled. All he could hope to do was to hold the rate.

H.M.Jr:

Yes.

K:

But he thought that possibly late in the afternoon we - we might have a chance to do a little pushing up here before we closed.

H.M.Jr:

Yes. I - I agree. Now, what was this about the Germans calling out additional reserves?

K:

The - the news from Prague and Berlin ^{he said -} were more depressing than yesterday. They were rumored - There were rumors to the effect that the Germans were calling out additional reserves.

H.M.Jr:

Yes. Rumors?

K:

Rumors, yes.

- 3 -

- H.M.Jr: I see. And there are no facts?
- K: No, no.
- H.M.Jr: I see. I see. Well, -
- K: How does the news strike you today, Mr. Secretary?
- H.M.Jr: Well, it - it - I can't see any - anything hopeful or cheerful in it.
- K: Well, no, but I - I - I'd like to say this that as - as compared with yesterday I'm a little less disturbed today than I was yesterday because I think it's becoming more obvious that the whole thing is the act of a show man. When I read in the paper that Hitler travels from Beichtesgaden to look at the fortifications and sees to it that that appears in every front paper - every foreign paper, I think that's done for a purpose. That is the work of a show man.
- H.M.Jr: Well, I hope you're right, -
- K: Well, I - I may have to eat my words tomorrow, but that is my feeling at the moment.
- H.M.Jr: Well at least - I - I can't - with the thing - with the foreign exchange acting the way it is I don't see anything cheerful, but let's see as the day goes tomorrow.
- K: Oh, no, I didn't mean I'm a little less disturbed today than I was yesterday. I'm not cheerful by a long shot.
- H.M.Jr: I see that our - that Industrials are up a point for the first hour.
- K: Oh they are.
- H.M.Jr: And our commodities are up a third of a point.
- K: The London stock market is weaker. I was told, in Paris the market was idle that French were being supported.

H.M.Jr: I talked to Cocaran, and he said they're not under great pressure in Paris.

K: Well, that checks with what Boulton said. Idle in Paris.

H.M.Jr: Well, if you hear anything more, we'll talk to each other.

K: All right, sir.

H.M.Jr: Thank you.

August 30, 1938.
10:29 a.m.

H.M.Jr: Wayne Taylor tells me that in order to buy a hundred million dollars of wheat to dump on the world's market, the surplus commodity corporation is going to borrow from the RFC thirty million dollars, and then eventually indemnify them against future section thirty two money. Hello -

Dan Bell: Yes.

H.M.Jr: I claim it's absolutely illegal, besides being about the most stupid and asinine performance I've yet witnessed. Now - I don't know whether it went through your shop or not, but I wish you'd get ~~it~~ ask ^{Ed} Olyphant to get on it legally.

B: Uh-huh. Well, I don't know, the day that I was back, late that evening, they called me from the White House and said that the President was advising the Commodity Credit that it approved corn and wheat loans of some kind. I think that must be different.

H.M.Jr: This is to buy a hundred million bushels of wheat and dump it on the world's market, and -

B: And the loss would be -

H.M.Jr: And the loss would be taken by the surplus commodity corporation.

B: Ry section thirty-two

H.M.Jr: Well, Taylor says they're going to commit themselves in excess of seven million dollars, or whatever it is.

B: Yes.

H.M.Jr: And you and I know that - my figures are rough, I can't - last year as I remember it they committed themselves to sixty or sixty two million dollars on this year's cotton program out of this years section thirty two money.

B: Sixty five million.

H.M.Jr: Sixty five million.

B: Yes.

- 2 -

- H.M.Jr: And all the rest - that when you and I went in and tried to get them to get money to buy this food to give these starving people, everything was committed.
- B: Yes, they've only got, as I recall, the beginning of the first year about seventeen million dollars to play with.
- H.M.Jr: Well, I wish you'd put your best man on it, because you and I are here to protect the President against this kind of thing.
- B: All right, I'll get a memorandum on it right away.
- H.M.Jr: I mean - there's - they say the Comptroller has approved of it, but that doesn't mean anything to me. I mean you - you and I have got to protect the President.
- B: Yes, I'll look right into it. Right away.
- H.M.Jr: What?
- B: Yes, I'll do it right away.
- H.M.Jr: Thanks.
- B: Right.

August 30, 1938.
11:46 a. m.

H.M.Jr: Hello.

Operator: Mr. Cochran.

H.M.Jr: Hello.

H. Merle
Cochran: Hello, Mr. Secretary.

H.M.Jr: Go ahead.

C: I talked with Tripp at Amsterdam.

H.M.Jr: Yeah.

C: He thought the decline in sterling below 4.86 was purely temporary, resulting from a flight of continental capital, frightened by the Czech situation.

H.M.Jr: Uh huh.

C: He thought flight bonds were principally those held in London on continental account.

H.M.Jr: Uh huh.

C: He thinks the holders do not want gold.

H.M.Jr: The what?

C: But are seeking dollars; ^{he} is convinced that this is a flight out of Hague.

H.M.Jr: Ah - repeat that.

C: I say, since the people do not want gold

H.M.Jr: Yeah.

C: as much as dollars

H.M.Jr: Yeah.

C: he feels that this is evidence that a real flight of capital away from Europe is involved.

H.M.Jr: I see.

- C: He felt that the British authorities were opposed to this drop and were doing their utmost to check it.
- H.M.Jr: Uh huh.
- C: When he talked by telephone with his friend in London earlier in the day
- H.M.Jr: Yeah.
- C: he was informed that they had already spent twenty-two million dollars.
- H.M.Jr: Yeah.
- C: Ah - then consequently gold will be shipped to you people by the Bank of England, rather than go into the hands of brokers or private arbitrauers.
- H.M.Jr: That's right.
- C: Then Tripp said the Dutch Board was strong today and required no support.
- H.M.Jr: Yeah.
- C: People in Amsterdam were naturally following the Czech crisis intently...
- H.M.Jr: Yeah.
- C: there was no
- H.M.Jr: No what?
- C: We convinced him, in spite of all the talking, no one wants to start a war, not even Hitler.
- H.M.Jr: Yeah.
- C: He is convinced that there will be no war. He says this crisis in international politics has developed just like crises developed in international conferences....
- H.M.Jr: Yeah.
- C: and they get over them.
- H.M.Jr: I see.

C: The people were calmly looking forward to a celebration of the fortieth anniversary next week.

H.M.Jr: Say that again.

C: I said, he said the Dutch people were calmly looking forward to celebrating next week the fortieth anniversary of their Queen's reign.

H.M.Jr: I see.

C: At 4:45 I talked with Janssen, the Governor of the National Bank of Belgium, at Brussels.

H.M.Jr: I see.

C: He says that the monetary authorities in London are very practical people, and deal with their problems in the most practical manner.

H.M.Jr: Talk a little slower.

C: He thinks the monetary authorities in London ...

H.M.Jr: Yeah.

C: are very practical people.....

H.M.Jr: Yeah.

C: ... who deal with their problems, as they come up, in the most practical manner

H.M.Jr: Yeah.

C: and they buy and sell at the best possible price.

H.M.Jr: Yes.

C: He said that the mere fact that trade treaty negotiations are still going on between the United States and Great Britain

H.M.Jr: Yeah.

C: convinces him that neither party has any plan in mind for altering its currency.

H.M.Jr: Yeah.

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C: He said that if the British had such a plan either he or ourselves ought to know something about it.

H.M.Jr: Yes.

C: He said he knew absolutely nothing of such a plan....

H.M.Jr: Yeah.

C: though he's in constant contact, with the British.

H.M.Jr: He was?

C: Yes.

H.M.Jr: In contact with them?

C: That's right.

H.M.Jr: Yeah.

C: Ah - he said that the international situation was difficult; he definitely is not pessimistic, and thinks that his Government is not pessimistic.

H.M.Jr: I see.

C: Ah - he referred to his own experiences in the war....

H.M.Jr: Yeah.

C: Incidentally he was one of their first aviators.

H.M.Jr: Yeah.

C: And he said that he hoped there were still enough people in Germany, Great Britain, and France, who are mindful of their own experiences of twenty years ago to use their good sense and avoid any conflict now.

H.M.Jr: Yes.

C: He said his bank had gained a little gold yesterday just to let them see that the situation was not imperative. To-day it isn't quite so good but still nothing to be upset about.

H.M.Jr: Yes.

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C: He referred to a statement which he had made at their meeting of his Directors yesterday to the effect that no negotiations are being carried on by Belgium to any country modification of any sources on the monetary status of Belgium.

H.M.Jr: Yes.

C: You have heard these rumors, probably, that Belgium was negotiating with Great Britain toward attaching the belga to the pound.

H.M.Jr: Yes.

C: But this denies that and I understand confidentially from him that he certainly wouldn't consider any such idea at present just to give reason for more fears about currency.

H.M.Jr: Yes.

C: Then I got Stockholm at four-thirty; De Witt was away. I talked with the Deputy Governor, Walberg. He said that they had been quite anxious there to-day; opinion was very nervous this morning. This afternoon it is easier on news from London and Paris to the effect that the Czech situation was not quite so pressing. He said that he understood the pressure on sterling had been very heavy and he had the word that both the Swiss and the Dutch have been selling sterling for dollars. He admitted that his own bank, that is, the had also been selling sterling against dollars.....

H.M.Jr: That's right.

C:and he said part of this resulted from the fact that he had had to take in so much sterling from his own people.....

H.M.Jr: I see.

C:so he turned it on into dollars.

H.M.Jr: Ah-ha.

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C: And he started to ask me questions. He wanted to know what would happen to the tri-partite agreement if sterling should go much lower than \$86.....

H.M.Jr: Ah-ha.

C:as he had frequently heard in the past it was going to do.

H.M.Jr: Yes.

C: He heard that gossip and I said well it's just crossed out for one day. I said, that question hasn't arisen.

H.M.Jr: Yes.

C: Then I talked with Bachmann at.....

H.M.Jr: Wait a minute - wait a minute - ah - Sweden gave us an order to sell a million dollars worth of sterling at the market.

C: Who did?

H.M.Jr: Sweden.

C: They're the most nervous of any.

H.M.Jr: Well we took care of it.

C: Yes.

H.M.Jr: Yes, bought it.

C: ~~Is that so~~ ^{Is that so} they're the most nervous I talked to.

H.M.Jr: Yes. Go ahead - Bachmann.

C: I talked with Steidway; he said the pound had been very weak this morning and that the Swiss had sold sterling for dollars.

H.M.Jr: Yes.

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- C: This afternoon sterling is better in Switzerland with orders coming on from abroad to buy sterling.
- H.M.Jr: Really?
- C: And I asked him - I said who wants to buy sterling? He said Germany and I said, "What are the Germans paying for sterling with".....
- H.M.Jr: Now wait a minute - hold the wire - just a minute - ah - yes, go ahead.
- C: I asked him what the Germans were using to pay for the sterling that they were buying this afternoon. He said that they had fairly good sized Swiss ~~bank~~ account yet - that they were converting the Swiss francs into sterling.....
- H.M.Jr: Ah-ha.
- C:which I thought very significant.
- H.M.Jr: Very.
- C: And as for the political situation, is quite blue.
- H.M.Jr: Just a moment - wait a minute.
- C: He said he was not very hopeful on the political situation, he wanted me to come up and see him the first day I could.
- H.M.Jr: Ah-ha, well now what - how do you interpret the Germans selling Swiss francs and buying sterling. How do you interpret that,
- C: I think this thing is still bluff, that there's nothing going to happen and I think some of those German bankers or even officials might be on the inside and proceed to purchase/sterling at this rate. some
- H.M.Jr: Yes, well that's very interesting.
- C: From Bachmann. Then I checked with Cariguel just a little while ago.....
- H.M.Jr: Yes.

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- C:and he had just talked with London at quarter past five and they over there thought that the total losses for the day would reach ten million pounds.
- H.M.Jr: In England?
- C: Yes.
- H.M.Jr: Yes.
- C: That much.
- H.M.Jr: Ah-ha.
- C: And he said that the whole thing was people wanting to get away from London, particularly since they feared/air raids.
the
- H.M.Jr: Yes.
- C: And he said the Scandinavian Central Banks were withdrawing ear-marked gold from London rapidly.
- H.M.Jr: Yes.
- C: I referred to withdrawing of the gold. He said, "No, it has speeded up to-day".
- H.M.Jr: Yes.
- C: And he said that Stockholm had even communicated with him here in Paris, asking that one thousand pounds of gold which they had here be shipped out.
- H.M.Jr: One thousand.
- C: One thousand pounds.
- H.M.Jr: My gosh.
- C: Can you beat that?
- H.M.Jr: No.
- C: And he said that his bullion department was being swamped with orders. I mean to get ear-marked gold out of here.
- H.M.Jr: Out of Franco.

C: Yes. And that London is having the same proposition.

H.M.Jr: Uh huh.

C: And for his operations to date he had only lost
s seven hundred thousand pounds.

H.M.Jr: Well, that's not bad.

C: That's not bad. So he's kept his same rate against sterling, of course, while it's very weak.

H.M.Jr: Yeah.

C: Then ah - I think that gives a pretty fair picture of the

H.M.Jr: Ah - that's a good job, Cochran; I'm very much pleased. Are you going to put this in a cable.

C: I have it - part of it in form so I can cable it on.

H.M.Jr: Yes, I would.

C: And I can get that one little paragraph. So on Saturday I spent a few hours with Jacobson

H.M.Jr: Yes.

C: The Swedish economist of the B. I. S.

H.M.Jr: Yes.

C: He had just come back from Helsingfors.....

H.M.Jr: Yeah.

C: where they had a several-day conference of Scandinavian central bankers and economists.

H.M.Jr: Yeah.

C: And he said that those countries were growing closer and tighter together, as a block to resist Germany.

H.M.Jr: Uh huh.

C: He said that the general feeling up there was that Hitler was bluffing and would not resort to war.

H.M.Jr: Uh huh.

C: And he said the German situation has become worse; that business men there were losing confidence

H.M.Jr: Yeah.

C: and dumping securities

H.M.Jr: Yeah.

C: ... and that labor was unhappy....

H.M.Jr: Yeah.

C: over the high cost of living.....

H.M.Jr: Yeah.

C: ... that over being withdrawn from their normal employment, to go into military construction, or military duty.

H.M.Jr: Yeah.

C: And he had two or three more items that I can put in a cable.

H.M.Jr: Good.

C: But that gives about the general idea, I think.

H.M.Jr: Well, that's very good; I'm very much pleased. Now let me ask you a question.

C: Yes sir.

H.M.Jr: Did the Paris papers carry anything about what I said when I arrived?

C: Yes, yes, and one or two papers played up, quite a bit, your statement about - the one paper carried ah - ah - a big statement on your reference to prosperity in the provinces here.

H.M.Jr: Yes.

C: And, ah, the financial papers, this morning, carried the story of - ah - improved outlook here, since 1936, and so on. It was a good story.

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H.M.Jr: Well, you might send me those clippings, will you?

C: Surely, I - I'll send you the clippings.

H.M.Jr: I don't think I did any harm.

C: Oh no, no, not at all.

H.M.Jr: No.

C: And right now, when, when these people needs to put up a bold front, that helps.

H.M.Jr: Well, I knew what I was doing.

C: Surely.

H.M.Jr: And I believe it.

C: And I put my continued story clear up to South Hampton in the pouch which left today.

H.M.Jr: Good.

C: And you'll have everything on the fifth.

H.M.Jr: Fine.

C: I've heard nothing from these people except the day after you got back I talked with the red-head who said that - ah -

H.M.Jr: Wait

C: --- across the channel - had been doing anything that the Central Banks thought should be done.

H.M.Jr: Is your red-head a male or a female?

C: (Laughs) This is a male.

H.M.Jr: This is a male; I couldn't remember.

C: The one who was down with us.

H.M.Jr: Well, that makes it a male.

C: Ha, yes. Anyway, ah, they - they have some other worries right now.

H.M.Jr: All right.

C: Well, you - you'll have the whole story on the fifth.

H.M.Jr: Yeah. Well, we're going to - well, all right, and you get this all into a cable.

C: It'll go out yet this evening.

H.M.Jr: Fine.

C: Goodbye.

H.M.Jr: Goodbye.

August 30, 1938.
3:58 p.m.

H.M.Jr: Hello.

Operator: Assistant Secretary Edison.

H.M.Jr: Thank you.

O: Go ahead.

H.M.Jr: Hello.

Asst. Secy
Edison: Hello.

H.M.Jr: Morgenthau speaking.

E: Oh, yes. How do you do, Mr. Secretary?

H.M.Jr: How are you, Mr. Edison?

E: Well, pretty good.

H.M.Jr: Mr. Edison, I've been reading about these reports of Captain Evans Carlson of the Marine Corps.

E: Evans?

H.M.Jr: Evans Carlson.

E: Yes.

H.M.Jr: on China.

E: Yes.

H.M.Jr: And I asked the President ^{whether} ~~when~~ I could have copies of those to read. Hello.

E: Yes.

H.M.Jr: And I'd appreciate it if I could, for my own information, have his report. I read about it in the New York Times.

E: New York Times.

H.M.Jr: Yes, they reported it as of August 9th.

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E: You mean the report that he's making on China.

H.M.Jr: Yes. He's made a tremendous trip with the Chinese Army.

E: Yes.

H.M.Jr: He's with the Marine Corps, and I imagine he must file the reports with you.

E: You'd like copies of them.

H.M.Jr: Well, I'd like - yes, very much.

E: All right, sir, I'll see what I can do about it.

H.M.Jr: C-a-r-l-s-o-n.

E: What's that?

H.M.Jr: His name is Carlson. C-a-r-l-s-o-n.

E: Yes, all right. Well, I'll look into it right away. I haven't seen him myself, so I don't know what the status they're in. I'll look it up and see if we can't get you some copies of it.

H.M.Jr: Well, we work very closely with Naval Intelligence I don't know whether he's under Naval Intelligence or not, but - that's Admiral Holmes, isn't it?

E: Yes.

H.M.Jr: And Hdmes comes over every so often to see me.
And - on China. So if these reports are available I'd like to have them.

E: All right, fine. I'll - I'll look right into it, and see what I can find. I - I guess perhaps I can catch him this afternoon.

H.M.Jr: Well, thank you.

E: All right, sir.

H.M.Jr: Thank you.

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E: Oh, say, listen.

H.M.Jr: Yes.

E: Do you remember ^{one thing} /the President spoke, one time, about merging this Coast Guard thing -

H.M.Jr: Yes.

E: Well, I haven't done anything further about it.

H.M.Jr: Well, let's get together after Labor Day.

E: All right.

H.M.Jr: Will you give me a ring?

E: Yes. Sure.

H.M.Jr: Thank you.

E: All right. Goodbye.

H.M.Jr: Goodbye.

FEDERAL RESERVE BANK
OF NEW YORKOFFICE CORRESPONDENCE
CONFIDENTIAL FILESDATE August 30, 1938.SUBJECT: TELEPHONE CONVERSATION WITH
BANK OF ENGLAND.

L. W. Kneke

I called Bolton at 1 o'clock and told him of the order we had received from the Riksbank, Stockholm (to sell 200,000 pounds at best) which we had taken in at 485 7/8. The market had been extremely quiet here, I told him, with Guaranty Paris bidding for sterling on a small scale but Dreyfus and Lazard, probably both for Paris account, selling. South America and the far east, I added, were not in the market with any orders.

Bolton stated that the total they had done all day was \$28,000,000 (that is only \$5,000,000 since noontime when he first spoke to me today) and that the pressure in the afternoon had lessened very considerably. The only news that had come from the British Cabinet meeting was a statement that England continued to try and play the part of a mediator between Germany and Czecholovakia. Bolton inquired whether he might expect another order for gold, the latest one of last Saturday having been exhausted by today's operations alone. I replied that I was hopeful we could give him a new order tonight.

LWK:KW

FEDERAL RESERVE BANK
OF NEW YORKDATE August 30, 1958.

OFFICE CORRESPONDENCE

CONFIDENTIAL FILES

SUBJECT: TELEPHONE CONVERSATION WITHL. W. KnokeBANK OF ENGLAND.

Mr. Bolton called me before 10 o'clock today. They were having a terrible time; so far they had sold over \$25,000,000, \$17,000,000 of it in 1 1/2 hours. At the moment the market was, if anything, a trifle steadier at 485 7/8. They would carry on in London and try not to let the rate go lower. If there were any big increase in demand for dollars later on in the day he would give me another ring. He was not going to attempt to push the rate up during the day because he thought that would be simply inviting disaster; if, however, we thought we would like to try it in the late afternoon here, that is "quite the reasonable thing to do if you can." I explained why we had bought sterling late last night at a rate which against gold figured out just a trifle above the equivalent of 34.77 (his desire to hold the rate as evidenced by the size of his operations during the day, the psychological importance of trying to hold the rate above the old parity, the belief that we could do it, at least for that one day, by going into the market late in the afternoon without operating on too large a scale, etc.). Bolton's reply was that he was very glad to see some support in the market and that any support which sterling could get under the present circumstances was welcome.

Today's demand for dollars, Bolton thought, was one for cash away from Europe due to one reason only, that was the war scare. News from Prague and Berlin had been more depressing today and there were

FEDERAL RESERVE BANK
OF NEW YORK

ICE CORRESPONDENCE

DATE August 30, 1938.

CONFIDENTIAL FILES

SUBJECT: TELEPHONE CONVERSATION WITH
BANK OF ENGLAND.L. W. Knoke

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rumors circulating to the effect that the Germans had called out additional reserves. British commercial firms were going out of sterling into dollars just as American firms with branches in Europe (Paramount, Ford, General Motors, etc.) were converting their sterling balances back into dollars. Sveriges Riksbank had bought of him \$2,500,000 this morning. There was no demand for gold either for hoarding or any other purpose; he had done less than £200,000 worth of it for arbitrage with the result that the demand for dollars had been concentrated on the British. The stock exchange was weak in London but idle in Paris although French rentes had had to be supported on a substantial scale. There was absolutely no sign of speculation as would be evidenced by short selling. Forward rates were entirely undisturbed and business in forward delivery small.

I inquired whether the gold price cabled us this morning remained unchanged and he answered in the affirmative.

LWK:KW

August 30, 1938

Mr. Morgenthau, on his visit to Switzerland during his vacation abroad, saw Mr. Royall Tyler in Geneva and the latter gave the Secretary his memorandum entitled "The Break on the Berlin Stock Exchange."

On the strength of this material and in view of his high regard for Mr. Tyler's ability, the Secretary conceived the idea of sending him to visit Germany to observe conditions in that country.

THE BREAK ON THE BERLIN STOCK EXCHANGE.

Prices of securities in Berlin have been declining for months. In the second week of August, the movement gathered momentum, outstripping those experienced this year by other bourses. All groups were affected. Towards the end of the week, the decline slowed down only to begin again the following week. It is still continuing, according to the latest news at the time of writing (August 19th). Many leading securities show drops of 10% or even 15% as compared with a couple of weeks back.

The immediate cause of the break seems to have been a shortage of cash ^{and credit} resulting from a change in the methods of financing public works and rearmament.

Up to last April, contractors were in the habit of getting advances in the form of rediscountable Treasury bills. The total of these bills in circulation was never disclosed, but invited much speculation, secret in Germany and public abroad. The German financial system was said to be getting badly choked up with these bills, estimates of which ranged from 10 or 15 to 30 billion marks. Making all allowances for the difficulty of stating a Reichsmark total in terms of the free currencies, Germany's undisclosed floating debt appears to amount to more, perhaps much more, than Great Britain's published floating debt. Official denials that the total was

anywhere near as large as had been rumoured abroad began to appear, without giving any figures, and Dr. Schacht made a public statement to the effect that the total would soon be decreasing.

In April, in fact, contractors began to receive, instead of rediscountable Treasury bills, a new type of paper known as Delivery-bills, which are not rediscountable, payment only being made upon completion of the contract. A shortage of cash resulted. Contractors may have been able to raise some money on their Delivery-bills, but apparently not to a sufficient extent. They therefore started unloading securities on the market and, as available cash has largely been pressed into the service of the Four-Year Plan, there was not enough demand for what was being offered to check a fall. The banking system had not yet begun to feel the relief which it seems to have been hoped would result from making the Delivery-bills ineligible for rediscount. The situation was aggravated by the stiffening of commodity prices, often camouflaged by deterioration of quality; by the new Corporation tax; by rumours, denials of which have been issued in so guarded a form as to be hardly less disquieting than a confirmation, of a new National Defence tax to amount to 30% of the existing income tax; and by public realisation of the very heavy burden involved by mobilising a million and a half men for at least several weeks, with the accompanying reflections on possible international developments. A further cause of

anxiety is the foreign trade situation. As against an export surplus of 200 million Reichsmarks for seven months of 1937, Germany has had an import surplus of 110 million for the corresponding months this year.

Some Germans say that Dr. Schacht foresaw what would be the result of his Delivery-bill financing and, indeed, devised it deliberately in order to give his own Government a shock and to induce them to slow down on rearmament and unnecessary public works (e.g., tearing down and rebuilding Berlin), so as to ease the strain on the national finances. It is doubtful whether Dr. Schacht will succeed for long in changing the financial policy desired by the Party. He may contrive, for a time, to help the exporting industries to replenish his foreign exchange holdings, but judging by past performances he will yield to Party pressure as soon as it becomes obvious that armaments production or even spectacular public works are being curtailed, and inflationary financing will be resumed in some form or other. The resultant decline in the standard of living may continue for some time to come without causing a breakdown. Conditions still remain better than they were in the latter part of the war and the political system is far more capable now than it was then of preventing malcontents from organising resistance.

However, in a country which claims credit for devising a water-tight economic system, the deutsche Wirtschaftswunder, and where the Government has greater means of controlling markets than anywhere else in the world, it is something

new that so sharp a break should have occurred in security prices. Even if the story is accepted that Dr. Schacht engineered the break for his own purposes, the occurrence shows that there is no escape from inflation in Germany so long as the present armaments and public works policy is followed. It will be seen before long whether there is going to be any effective departure from it.

Economists have been extremely cautious for some time past in judging the German position and have refrained from predictions. Many of them were too quick to foretell disaster in the early days of the Nazi régime and don't want to be wrong again. Still, apart from the question of timing, the economists' main contention may turn out to have been right after all: namely, that a system can't run on indefinitely when it means an unceasing increase in the proportion of its total economic activities which a country devotes to non-productive purposes.

Devaluation rumours.

It looks as if there were no sufficient single explanation of these rumours, which have been going the round for several weeks. Several factors, all of them making for distrust even of the best currencies and impelling people to buy gold, have contributed to give them credence.

(a) The international situation in general has meant increased anxiety ever since the Anschluss and, indeed, since sweeping changes were made, on February 4th last, in the German General Staff and Ministry of Foreign Affairs, men who

were believed to have views more or less independent of the Party being replaced by avowed Party-healers. It was clear that Nazi opinion did not regard the Anschluss as enough of a success for 1938 and that big risks would be run in order to force a solution of the Czechoslovakian question this year. When Great Britain, by taking a firm stand over the May 21-22 weekend, showed that she was not again going to display the same passivity as she did over the Anschluss, some relief was felt, but it was soon realized that Germany was only reconsidering the means of carrying out her plans about Czechoslovakia and had by no means dropped them. It is difficult to see how this problem is going to be steered out of the zone of immediate danger to world peace.

(b) The situation in Germany has given various signs of heavy strain. People ask themselves whether Hitler may not prefer to fight rather than be beaten by economic and financial forces. It may be argued that, with British rearmament proceeding fast and affairs in France rather on the mend, Germany's and Italy's chances of success are now at least as good as they will be next year and probably far better than they will be in two years' time.

(c) In Italy, the economic situation is still weaker than in Germany. The system of autarky is not as competently run, discipline is far less perfect and the fundamental problems are more difficult. Also, the campaigns in Abyssinia and Spain have meant a heavy drain on Italy's resources and caused widespread resentment. In Germany, the régime has

many successes abroad to its credit. In Italy, a victory of doubtful advantage in Abyssinia does not compensate for deferred hopes in Spain and national humiliation for having had to stand on the side-lines and politely applaud while Germany, in Austria, did what Mussolini, only a couple of years ^{ago}, swore Italy would never permit. Belief in the régime has had some telling blows. The price level is getting difficult to hold. Mussolini, many people fear, may think that his only possibility of escape from collapse lies in a successful war and that the chances of success are better now than they will be next year. Some observers attach a sinister significance to his recent anti-Semitic stunt, which they think is aimed at enlisting the support of the Arabs against England and the Moslem populations of North Africa against France, in the event of a general conflagration.

(d) Czechoslovakia got a reprieve last May 21-22, but she may reflect that, if Runciman does succeed in promoting a compromise, it will only result in increasing the German elements' opportunities for weakening the Czechoslovak State and facilitating its absorption by the Reich at a later date. There does seem to be a tendency, in some very influential quarters in Prague, to prefer to force an issue at once, even if from a strictly military point of view chances of success are not as good as they might be later, rather than submit to a process of attrition which might end in their disappearance as an independent country. Russia's view on this problem are a mystery, but there are people in France whose attitude is

the same as that of the Czechs above referred to. It may be that some of the current purchases of gold are prompted by some such plans, or by knowledge or suspicion of them.

Rumour has it that Benes and Hodza do not see eye to eye and that Benes would rather fight than make radical concessions to the Germans.

(e) In France, the situation is in some important respects better than it has been. The spirit in the army is by all accounts excellent. The price-level should not suggest any need for further devaluation. But the public debt goes on increasing, with no prospect of a balanced budget. Optimistic statements by the administration have lost their effect by repetition. There is disbelief in any reversal of the tendency and, if the tendency is not reversed, everyone thinks the currency will have to be the scapegoat once again. People are tired of seeing their holdings shrink again and again by devaluation and are trying to learn how to protect them while there is still time, i.e., by hoarding gold and foreign currencies or sending their money abroad. Lack of confidence in the Government is one important point in France. For some months past, public opinion has been reassured where France's foreign policy is concerned. Not a few Frenchmen attribute this improvement to the fact that France has virtually handed over her foreign policy to Great Britain. They add that France's financial affairs do not seem likely to mend until they are entrusted to the U.S.A.

Peace or War?

Thus, there are plenty of factors, in a number of countries, capable of causing people to try to dodge risks by buying gold. The gold-rush probably has more to do with devaluation rumours than anything else, though there is also, no doubt, deliberate manoeuvring by speculators, who don't care particularly how the free exchanges move so long as they do move and don't remain within the normal narrow limits. If this interpretation is correct, it all boils down to a question of peace or war. If the next few months do not bring war, the devaluation rumours may lose their wings.

In spite of the dangers inherent in the international situation, the forces working against war are probably strong enough to keep the peace this year and it may be hoped that next year the situation will be better rather than worse:

(a) The German General Staff, for all the Party's attempts to absorb it, still contains level-headed soldiers. In their view, the task of the German army is to protect the country and not to serve as the instrument of any visionary policy aimed at "freeing" German minorities abroad.* To the argument that Germany and Italy are losing their advance, militarily, over Great Britain and France and that it would

* Incidentally, an Estonian was asked what percentage of Germans Estonia contained. He replied: About 1%, and that's all that's needed to justify a war of liberation.

be better to strike now, these men reply that the chances for Germany and Italy fall short of the 65% which a famous soldier is said to have stated as the minimum justifying a war. To the argument that the economic situation is getting out of hand, they answer that if there is going to be economic collapse in Germany, the Army's duty is to be there to prevent the country from falling a prey to chaos and that, by holding itself in readiness against such an emergency, it is serving Germany's cause better than it would ~~be~~ by agreeing to start an unpromising war which, if unsuccessful, would drag down the Army into the mud as well as the Party.

How much weight these considerations may have with Hitler, who is reported to seek guidance chiefly from his astrologer, is a matter of conjecture, but there is no doubt that sober views are held by some soldiers in responsible positions.

(b) Although this year may be better than next from the German-Italian military point of view, this year also has its drawbacks. There is a lack of synchronisation, as it were, of the favourable factors. Japan, as the German papers are allowed freely to point out, is still heavily engaged in China, Italy in Spain. There is still an independent Czechoslovakia with a big air-force within half a flight-hour from several of Germany's neuralgic points. Germany needs natural petroleum for her aviation: oil extracted from coal does not serve the purpose. With a view to a war, Germany would like to have assured access to the Roumanian oil-fields.

(c) For all their protestations of harmony and identity of aims, the Germans despise Italy (they say Mussolini's number is Bleibtreu 19-15), and the Italians hate and fear Germany. Germany does not want to wage a war started to reconstitute the Roman Empire. Italy does not see herself fighting to help Germany make herself omnipotent in Central and South-Eastern Europe. It is not out of the question that one of the partners might drop the other at the critical moment: at any rate, that possibility is present to the minds of both.*

(d) The public utterances of the President and of Mr. Hull are strongly discouraging to Germany and Italy and must make both realize that any further attempt to solve problems by force may have incalculable effects on the attitude of the U.S.A.

(e) The danger doubtless exists that Czechoslovakia, driven to despair by the prospect of "peaceful penetration" by Germany, may deliberately let things take a course leading to war. But this danger is well-known to the British, and British influence on French policy is now determinant. It may be hoped that on the one hand the necessary steps will be taken to dissuade the Czechs, in their own interest, from taking any ill-considered ^{action,} steps, and that on the other hand Czech combativity may contribute to make Germany cautious.

* A German recently quoted the following from St. Simon, the 18th century French memorialist: "Le Duc de Savoie n'a jamais fini une guerre du même côté où il l'avait commencé, sauf à une occasion où il a changé deux fois en cours de campagne."

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It may seem foolhardy to venture to lay odds on peace at such a time as this. If a wager had to be made, however, peace still seems the better bet.

19.viii.1938.

JR

PLAIN

London

Dated August 30, 1938

Rec'd 2:15 p.m.

Secretary of State,
Washington.

RUSH.

839, August 30, 6 p.m. (SECTION ONE)

FOR TREASURY FROM BUTTERWORTH.

The demand for dollars has been extraordinarily large and the rate has gradually moved down from \$4.87 to 4.86 then with the opening of New York to 4.85-3/4. Gold fixing was limited to 327 bars at 142S. 11D. because the apparent premium seemed higher. There was a very large demand after fixing which for a while was satisfied by the British fund and it was when they went out of the gold market that the rate dropped from \$4.86-1/2 to \$4.86.

The market was somewhat surprised that the rate broke \$4.86 when New York was open and the impression is general that the increased pressure will continue until some favorable political news creates a momentary turn and it is also generally believed that

the

-2- #839, August 30, 6 p.m., from London.

the authorities will gradually check the movement but are not prepared to stand firm. The franc has been steady at 178.31-33 and has not been under unusual pressure. British security markets have had a firmer appearance today, British Government bonds for example moved up an 1/8 but then gradually slipped back again.

KENNEDY

KLP

PARAPHRASE OF TELEGRAM RECEIVED

FROM: American Embassy, London

DATE: August 30, 6 p.m.

NO.: 839

SECTION TWO

Waley is still away, Phillips has gone on leave for a few weeks, and I have an appointment with his colleague Sir Richard Hopkins tomorrow morning to discuss the subject of my telegram of August 26, 6 p.m. No. 824. Unless you instruct me to do so, I shall not raise the question of the dollar sterling rate. END MESSAGE

KENNEDY

EA:DJW

PARAPHRASE OF TELEGRAM SENT

TO: American Legation, Bern, Switzerland

DATE: August 30, 1938, 6 p.m.

NO.: 41

STRICTLY CONFIDENTIAL.

It is understood that Mr. Royal Tyler is at present in Geneva. You are requested to approach him and say that Secretary Morgenthau would appreciate it if he were to make a trip as soon as possible around Germany, apparently at his own initiative, with a view to making a brief appraisal of economic and financial conditions there. When he gets back to Bern, he should file a cipher telegram through the Legation outlining his views; this telegram should be headed "for the Secretary of the Treasury". The hope is expressed by Mr. Morgenthau that a full picture will be given by Mr. Tyler, and that he will not try to abbreviate his report. His expenses will be paid by the Treasury Department, and an honorarium of \$25 a day is offered him. You are requested to caution Mr. Tyler that absolute secrecy is essential, and it is hoped that he will be able to undertake this trip with a minimum of delay.

HULL.

EA:LWW

PARAPHRASE OF TELEGRAM RECEIVED

FROM: American Embassy, Paris

NO.: 1371 (Section One)

DATE: August 30, 1938, 6 p.m.

FROM COCHRAN

STRICTLY CONFIDENTIAL FOR SECRETARY MORGENTHAU.

I visited for a few hours last Sunday with Jacobson, the Swedish economist of the Bank for International Settlements. He had just returned after having attended a conference at Helsingfors of Scandinavian economists and central bankers. He stated that there was an increasing tendency on the part of Finland to turn toward Scandinavia to form a bloc vis-à-vis Germany. He also said that there were more consultations and more cooperation between the Scandinavian countries. At the conference the general feeling was that although the situation had become so tense that any accident might start real trouble, Hitler was bluffing and would not resort to war. It was Jacobson's opinion that the internal situation in Germany had become worse, with labor unhappy over the high cost of living and the withdrawal of workmen from their normal employment for military service or construction, and with businessmen losing confidence and dumping securities.

Jacobson

2

Jacobson emphasized the degree to which business everywhere is dependent upon recovery in the United States.

(END SECTION ONE)

BULLITT

EA:EB

RECEIVED

MAR 23 1958

INVESTIGATIVE DEPARTMENT
FEDERAL BUREAU OF INVESTIGATION
U. S. DEPARTMENT OF JUSTICE

PARAPHRASE OF TELEGRAM RECEIVED

FROM: American Embassy, Paris

NO.: 1371 (Section Two)

DATE: August 30, 1938, 6 p.m.

RUSH

He stated that the prime requisite for recovery in America is equilibrium between costs and prices. It is his opinion that it is necessary that the interest rate for new investments for building mortgages etc. in America be kept low. He thinks that it may be dangerous, if real recovery is to come in the United States, not to permit the decline of federal bond quotations. Jacobsson thinks that if the rate of 4.86 should be broken, there would be a tremendous pressure placed on sterling. He does not believe that sterling is over-valued at 4.86. He stressed the need at this time of a demonstration of monetary strength on the part of the democracies, who have so much gold but who are making so little use of that gold to counter the militant demonstrations made by the totalitarian states.

at 4:25 this afternoon I had a talk with President Trip of the Netherlands Bank at Amsterdam over the telephone. It was his opinion that the decline of sterling below 4.86 was purely temporary and was the result of a flight of continental capital which had become alarmed by the German-Czechoslovakian situation.

(END SECTION TWO)

BULLITT

Ea:EB

Section Three.

President Trip thought the flight funds were those held on continental account in London. He is convinced that it is a flight out of Europe, since the holders do not want gold but are seeking dollars. He felt that the British authorities were opposed to and were doing their utmost to check this drop in sterlin. Today, when Trip talked to London officials by telephone, he was informed that \$22,000,000 had already been yielded at that hour to hold the sterling rate. Consequently gold, instead of being permitted to pass into the hands of private hoarders or arbitrageurs, will be shipped to the United States by the Bank of England. Trip told me the Dutch florin was strong today and no support was required. Although the market crisis was naturally being/^{intently} followed by people in Amsterdam, no panic had developed. Trip personally is convinced that despite all the talking, there is no one who wants to start war, not even Mr. Hitler, and consequently he is convinced that there won't be any war. Trip believes this crisis in international politics has come just as crises in international conferences develop. He told me that the Dutch are calmly looking forward happily to celebrating the fortieth anniversary of their Queen's reign next week.

I held a telephone conversation with Governor Janssen of the National Bank of Belgium at 4:45. Janssen believes that the monetary authorities in London are very practical and deal with their problems in the most practical manner,

buying

-2-

and selling at the best price possible. Janssen said that neither the United States nor Great Britain has any plan in mind for altering its currency - basing his opinion on the mere fact that trade negotiations between the two countries are continuing.

Section Four

If the British had such a plan, Janssen thought one of us ought to know something about it. In spite of his close contact with the British, he knows nothing about it. That the international political situation is difficult is admitted by Governor Janssen. Janssen personally is not pessimistic and thinks his Government is not either. Janssen hopes that there are enough men in Great Britain, Germany and France who went through the same experiences he did twenty years ago who are still sufficiently mindful thereof to use their good sense to avoid war now. Janssen's bank had gained a little gold less than 100,000,000 Belgian francs yesterday and he said that despite rumors the situation today is still rather quiet. Janssen referred to a statement which he made yesterday at his bank's meeting to the effect that there are no negotiations being carried on with any country with a view to a modification of any kind of the Belgian monetary status. This statement was made in answer to queries about the rumors that Belgium was negotiating with Great Britain toward attaching
the

-3-

the belga to sterling, but my understanding confidentially is that Janseen will not at present consider such an idea lest it give rise to more currency chaos.

Section Five

I got the Sveriges Riksbank at Stockholm on the telephone at 5:00 p.m., and spoke with Deputy Governor Walberg since Governor Rooth was absent. They were having a particularly anxious day in Stockholm, Walberg said, and this morning (?) ^{sterling} had been particularly nervous. Better news from Paris and London in the afternoon to the effect that the Czechoslovak question was not so pressing had slightly ~~slightly~~ eased this market. Walberg said that there must be very/^{great} pressure on sterling, and that the Dutch and Swiss had been selling sterling against dollars. Since his bank had been obliged to take in so much sterling, it had also been selling sterling against dollars. He asked me if sterling should go much lower than 4.96 as he has heard the past few weeks it was likely to go, what would happen to the tripartite agreement.

I spoke with Cariguel at the Bank of France at 5:10. Cariguel ~~is~~ had just spoken with his friend in London who estimated that total losses by the British authorities for the day would reach 10,000,000 pounds. The idea seemed to be that people, fearing air raids, wanted to get their funds away from London. Central Banks in Scandinavia

had

-4-

had been withdrawing earmarked gold rapidly from London. The Bank of France has been requested by Stockholm to ship out the 1,000 gold pounds held earmarked here and the bullion department of the Bank of France was swamped with various shipping orders. Only about 700,000 pounds were lost today by the French Control which kept the franc steady with sterling at 178.32.

I spoke with President Bachmann of the Swiss National Bank at Zurich at 5:30 this afternoon by telephone. Bachmann said that the Swiss were disposing of their sterling holdings against dollars ^{since} ~~and that~~ the dollar had been very strong and sterling very weak at Zurich this morning. Sterling had been sought in Switzerland from abroad this afternoon. I inquired of Bachmann what particular foreign country had been buying sterling through Switzerland and what currency had been paid for the sterling. He said that Germany in particular had purchased sterling with Swiss francs which the German banks still possessed. This seemed to me quite significant since it might indicate that German officials or German banks having official information viewed the situation with less pessimism than outsiders and thought this a good time in which to acquire pounds. Bachmann said that the Zurich morning papers were not very hopeful with regard to the international political outlook. When I spoke with him, he had not yet seen this afternoon's papers. END OF MESSAGE

BULLITT

EA:DNW

August 30, 1938

The Secretary telephoned to the President today at 9:40. Mr. Morgenthau said, "How are you?" and the President answered, "I am fine. Are you coming to lunch at one o'clock?" and HM, Jr said, "That's fine."

Mr. Morgenthau then said, "For the first time, Sterling has broken through the old figure of \$4.96. The Bank of England talked to the Federal Reserve of New York this morning and there was trouble with the connection and they were cut off. Therefore, we had only gotten the news that they are having a terrible time in London and that conditions are worse and also that Hitler has called out more reserves for the Army. I will get that confirmed in a few minutes. They are going to call back again. I did what I could last night to hold it. I am sure that we will get repercussions and will continue to get them until the war scare is cleared up. I just saw Cordell Hull and he is very serious about the whole thing. I am fearful that if this continues, we will get a lot of gold. Denmark and Sweden have all this gold on deposit and I am afraid that we will get quite a flood."

The President said, "It might be good psychology to set up in this country, under the Treasury, an emergency -- I want another word for 'earmarked' gold -- an emergency fund which does not belong to us." HM, Jr said, "I don't get it." The President explained, "Instead of putting the figures in with all of our gold now that we have earmarked, this would be merely a third category, a foreign-owned fund which is here for safekeeping, nothing else, but actually it is the same as earmarked." The Secretary said, "Let me turn that over."

Continuing, the President said, "Psychologically, it would help. It would tell the world that in Scandinavia and England and France they have their gold all right, but they have sent it to the United States where it would be out of the way of foreigners. I think, psychologically, it would help. I was talking with the President of the Norwegian Parliament Hambro, and he said in the event of war Norway will be in the same fix as it was in 1914 and, he said, it would be a very good thing for them if they could have, for their financing, some sort of fund here for safekeeping, because it does not come out in the papers and the people in Norway do not know. If the Norwegians

-2-

knew that they had \$100,000,000 of gold here belonging to them and we would be kind enough to keep it for them until the end of the war, they would feel much better."

HM,Jr then said to the President, "After the Bank of England and the Federal Reserve have completed their call, I will call you."

August 30, 1938

The Secretary today sent for Mr. Moffett, Chief, Division of European Affairs, State Department, and he called at 4 o'clock.

Mr. Morgenthau told him he had talked to the President and it is agreeable to the President that Mr. Morgenthau ask Royall Tyler to go at once, at the expense of the Treasury, to Germany and tour around for a week and get, entirely on his own, his impressions of the economic and national conditions. He would like Mr. Tyler to cable fully his impressions and not to be concerned about how many words he uses in his cables.

The Secretary said that it was his impression that Mr. Tyler was a wealthy man, to which Mr. Moffett replied that he thought he was "comfortable". When Mr. Morgenthau inquired whether Mr. Moffett thought \$35.00 a day was what we should offer Mr. Tyler, Mr. Moffett said he thought that would be very generous.

HM, Jr then informed Mr. Moffett that Tyler was in Geneva and Mr. Moffett commented that if Mr. Tyler was on the Geneva payroll, it would be better just to offer to pay his expenses for traveling. However, he would make inquiry.

Mr. Morgenthau said he thought Mr. Tyler was one of the most interesting and intelligent men he knew and Moffett agreed that he was pretty clever. Mr. Moffett also said that he would let Wilson know that we were communicating with Tyler.

HM, Jr also told Mr. Moffett that, of course, time was the essence and the latter promised to lose no time in getting word to Mr. Tyler. The Secretary remarked that if this works out well, he will ask Mr. Tyler to go to Italy.

The Secretary then explained to Mr. Moffett that the situation abroad has changed; that up to yesterday the movement was the hoarding of gold. He said, "That has changed overnight. It is now the flight to the dollar. That is new. The movement today was enormous. Sweden sold us, at the market, \$1,000,000 Sterling; in London, \$2,500,000." He told Mr. Moffett that he had

-2-

called Cochran and asked him to call up the heads of the Central Banks of Holland, Belgium, Switzerland and Sweden and find out what they think of the general situation.

He said that Cochran had reported that the countries which are in the Sterling area are more nervous. Belgium and Switzerland are not as nervous as Sweden; that the German citizens who have Swiss francs sold them today and bought Sterling. He explained to Mr. Moffett that that might be that they are afraid of the Swiss franc or that Sterling is cheap or that they want to buy Sterling and change it into dollars. Mr. Morgenthau also told Mr. Moffett that Cochran further reported that Tripp is convinced that there will be no war and that the Belgians are not so pessimistic, but the Swedes are the most nervous.

Sterling broke through 4.86, he told Mr. Moffett, and "we moved it back to 4.86." He said when he saw Phillips at Rouen he told him that we would hate to see the £ go to \$4.86. Phillips said that he did not mind and said he thought he would stop it at \$4.80.

Mr. Morgenthau expressed the opinion that in the last two days the people who have Sterling are scared. Moffett said that he felt that we will not know for ten or twelve days whether there will be trouble in Czechoslovakia.

The Secretary asked Mr. Moffett if it would be possible for him to come in every day at four o'clock to keep him posted for a while. He told Mr. Moffett that he had to raise a lot of money on the 8th of September; that he had told the President he would not make any decision on his financing until the 7th; that we do not have to borrow any money; that if things are bad we had enough money to run until the 15th of December. He explained that that was why he was more interested than usual; that normally we would make our announcement on financing on the 6th, but that with things going as they are, he would wait until the 8th.

H.M., Jr also informed Mr. Moffett that he had asked Riefler and Walter Stewart to come down and talk things over with him on Thursday.

Miscellaneous Income Tax
and Excise Tax Matters

-

A Memorandum Submitted
to the Secretary of the Treasury

-

Carl Shoup

-

August 31, 1938

The following paragraphs deal with:

1. Interest as a deduction (income tax)
2. Taxes as a deduction (income tax)
3. Community property, and related questions (income tax)
4. Depletion (income tax)
5. Characteristics of excise taxes.

The material may be considered in each case largely as a supplement to the remarks already made on these matters in other recent reports to the Treasury by the writer and others with whom he has been associated.

Interest As A Deduction.- The income tax usually does not allow deduction of outlays that are simply personal expenses and that hence have no direct connection with the acquiring of the taxpayer's income. There are, however, a few exceptions. One of these exceptions is interest paid out. The present situation is as follows:

- 1) All interest paid out in order to obtain taxable income is deductible. Thus interest paid to a broker on a loan made to carry taxable securities is deductible.

- 2 -

2) Interest on indebtedness incurred or continued to purchase or carry wholly tax-exempt bonds is not deductible. Thus if a taxpayer borrows money in order to buy a state bond, he cannot deduct interest on this debt in computing his net income (there is, however, one exception to this rule: if the exempt security is (a) issued by the United States, (b) issued after September 24, 1917, and (c) originally subscribed for by the taxpayer, the interest on the debt may be deducted). In practice, it appears that this restriction is not very effective. If a taxpayer's financial affairs are complex, it is difficult to prove that he borrowed money for the particular purpose of buying or carrying a tax-exempt bond.

3) Interest on indebtedness incurred to get exempt income (other than interest income, which is covered in No. 2 above) is not deductible, under the general provision of Sec. 24(a) (5).

4) All other interest is deductible. For instance, a homeowner can deduct his mortgage interest. But in practice, the lower courts, the Board of Tax Appeals, and the Treasury have restricted this deduction severely, presumably by a narrow definition of interest. For example, the following payments have been held not deductible: interest on a note given in payment of alimony (alimony itself is not a deductible expense); amounts paid, under installment plans, in excess of the "cash" price and in lieu of interest, although the excess payments may approximate an interest

- 3 -

charge; interest on a note executed as a gift (a gift itself is not a deductible expense); and interest on a note given to a trustee who loaned back to the taxpayer the money he had given to his wife, the whole thing being a tax-saving plan.^{1/}

Difficulties of Present Distinction.- The basic weakness of the present interest deduction is that a non-deductible expense may be transformed - in part, at least - into deductible interest. The dividing line is difficult to find. The interest on the alimony note may seem clearly to be alimony rather than interest, but what of the taxpayer who decides to borrow and build himself a house rather than rent? He is transforming rental expense into (in part) interest expense. Rental expense is not deductible; interest expense is.

Moreover, a curious distinction exists between Nos. 2 and 3 above on the one hand, and No. 4 on the other. If the interest expense results in something that can be called "income" and that is non-taxable, then the expense is non-deductible. If the result instead is some sort of "non-income", the expense is deductible. The law nowhere defines "exempt income". Is the use that a person gets from his dwelling a kind of exempt income, or is it simply "non-income"?

These puzzles result from favoring a certain kind of expense. The favor goes to those persons who happen to be able to transform

^{1/} These cases are taken from C.C.H. '37, Sec. 171.

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some otherwise undeductible expense (e.g., rental) into interest, at the expense of others who cannot do so (e.g., those who can borrow to build a home and those who cannot). It favors those whose position in life happens to involve heavy personal interest outlays rather than other, non-deductible, personal outlays. The economic aspects are apt to be unfortunate, since a premium is placed on borrowing.

Effects of Proposed Change.- If interest deductions were restricted to those connected with the production of (taxable) income (in the words of the general statement in (c) in Article 21-1 of Regulations 94) these equitable and economic difficulties would disappear. The administrative difficulties would scarcely be any greater (see point No. 4 above). To avoid hardship, however, where taxpayers have entered into commitments with the belief that interest payments would be deductible, the change should apply only to interest on loans contracted or renewed after the passage of the law making the change.

This change would remove the present equal income-tax treatment of the two kinds of homeowners - the outright buyers and the borrowers. If a taxpayer is holding securities and with the income therefrom is renting a house, he can decrease his income tax, under existing law, if he builds his own house and either (a) sells the securities and pays for the house outright or (b) borrows on the

- 5 -

securities to pay for the house. If personal-expense interest were disallowed as a deduction, it would still pay him (as to income tax) to sell the securities and build his own house, but it would no longer pay him to borrow and build. However, on the grounds that the income tax should not be used to subsidize home ownership, a removal of this subsidy in the case of the borrower-builder is a step in the right direction, even though it is not the complete step.

Taxes as a Deduction.-- Another example of a personal expense that can be deducted from gross income under the present law is taxes paid. Income, death and gift taxes are not deductible, and local special assessments can only be deducted in the long run, and not always then (by adding the tax to the basis of the property); but there remain some important taxes such as the real estate tax, some of the retail sales taxes, and State cigarette taxes that are deductible even though the thing that gives occasion for the tax (dwelling of homeowner, retail purchase) represents no business or income-producing transaction.

For example, suppose a cigarette smoker spends \$20 a year for 200 packages of cigarettes before a State tax is imposed, and \$20 a year for 182 packages after the State has forced the price up by levying a 10 per cent tax. Is there any reason why he should pay the Federal Government less income tax in the second case than in

the first? The price of cigarettes has gone up owing to a State tax, just as it might have gone up owing to any number of reasons-- higher leaf tobacco prices, etc.

Administrative Aspects.-- The administrative burden would be lightened if the deduction were limited to taxes paid out in connection with the production of taxable income. At present the Bureau of Internal Revenue must analyze State laws to ascertain upon whom a given tax is legally levied. If a consumer buys an article for \$1.30 and pays the retailer 2 cents extra for sales tax, the consumer can deduct the 2 cents in his income tax return if the tax is legally one upon consumers, but he cannot if the tax is a business tax levied on the businessman. Incidentally, this illustrates the unfairness of the present provisions as between consumers in substantially the same economic position (the businessman comes out alike in the two cases).

Home-Owning Subsidy.-- The present heavy weighting of the tax system in favor of home owners and against all other income tax payers would be somewhat lessened by limiting the deduction as suggested above. Much, perhaps most, of the non-business tax deduction represents real estate tax on home-owners' dwellings. The failure of the present tax system to tax any of the imputed income represented by the net use (gross use minus repairs and depreciation) of an owned home, and the deduction allowed for

- 7 -

non-business interest are still further subsidies to home-owning at the expense of other taxpayers. Of course if home-owning (as contrasted with home-renting) is to be subsidized indirectly by the Government, retention of the existing tax-deduction provision is one way to do it. Incidentally, the subsidizing of home-owning should not be confused with the subsidizing of housing.

Disallowance of Possible Business-Expense Element.-- Some taxes represent a mixture of business and non-business tax. For example, a taxpayer owning an unincorporated business may be subject to a State income tax on his entire income--business profits plus simple investment income from bonds, etc. It may, however, be argued that even here the income tax is in no way a business expense. If it really is not shifted to consumers (and this is the usual assumption) it is not an outlay made with the expectation that it will increase gross receipts. This reply will not take care of the case of a real estate tax on a building that serves both as a place of business and as a dwelling. However, allocation between business and non-business use is already required in the case of depreciation under the Federal income tax, and could likewise be required with respect to the real estate tax.

Disturbance of Indirect Aid to States.-- The disallowance of State income taxes paid as a deduction would upset the existing degree of coordination of Federal and State income taxes. This coordination may not be very marked, but it does exist to some

extent. Probably some States have put their income tax rates at slightly higher levels than they would have chosen if the Federal Government had not allowed State income taxes paid as a deduction. A State rate of 10 per cent plus a Federal tax of 30 per cent, for instance, would represent a combined burden of 40 per cent if no deduction were allowed, but actually, it is only 37 per cent since the Federal Government allows a deduction. In effect, the present deduction provision represents an indirect form of Federal aid to the States in so far as State rates are, because of it, higher than they otherwise would be.^{1/}

Community Property, and Related Questions.-- State laws differ with respect to property rights of husband and wife. The differences are of considerable importance for the income tax. Suppose that H (husband) earns \$30,000 and W (wife) earns \$10,000. If the husband has the right not only to the \$30,000 but also to the \$10,000, he might be taxed on \$40,000. If each has the right to his earnings, and thus H is taxed on \$30,000 and W is taxed separately on \$10,000, the total tax paid by the two will be less than H's tax in the first case, owing to the operation of the progressive rates and the earned income credit.^{2/} If each has a right to one-half the total earnings (community-property state), so that H would be taxed on \$20,000 and W separately on \$20,000, the total tax would be still less.

^{1/} For further comments on this topic, see Twentieth Century Fund, Studies in Current Tax Problems, pages 58-64.

^{2/} The capital gains and losses provisions may also be of some effect here.

These matters are usually approached with the eight community property states in mind. In these eight western and southwestern states (including Louisiana) the laws generally provide that each spouse acquires ownership of half of the income earned by the other as well as half of the income from community property. Some income may belong to each spouse separately--for example, income from property acquired before marriage, income from inheritances and gifts, etc. But the splitting of the community income is important enough to permit of substantial tax savings for the moderately wealthy (but not the extremely wealthy, since most of their income is in a part of the income tax scale where the progression of rates taper off).

The natural reaction of most observers is that those persons are enjoying an unfair tax privilege. As soon as one tries to discover a way to eliminate this privilege, however, he finds that he is really dealing with a far more important problem than that of community property. He is dealing with the problem of whether the family or the individual is the proper unit for application of the progressive rate scale of the income tax--a problem that would exist were there no community property states at all.

For instance: one way around the community property problem, it is said, is to require all husbands and wives living together to lump their incomes in a single return, no matter what State they live in. Waiving the serious question of constitutional

validity, there remains the question, why increase two persons' taxes just because they get married? This would be the result in many of the cases where the wife had had a job before marriage and kept it after marriage.

Another proposal, in just the opposite direction, is to permit all spouses living together, whether in community-property States or other States, to split their aggregate income equally between them. This would lower the revenue greatly, and necessitate an increase in rates, with corresponding severe effects on single persons, unless they were given a separate rate.

The problem of the family versus the individual as the unit for a progressive-rate tax is one of the most important in the entire income tax field. It needs much more study. Some preliminary comments can be found on pages C-9 to C-14 of "A Report on the Federal Revenue System" submitted September 20, 1937 to Under Secretary Magill by Roy Blough and Carl Shoup. Since the community property problem is inevitably linked to this broader problem, the present writer's conclusion is that for the time being, and pending further study, no change should be made in the treatment of community income under the present tax, although it is evident that such income is unduly favored.

Depletion.- The provisions for depletion in the existing law result in great favoritism to oil and gas producers and to coal mines, metal mines, and sulphur deposits. The reforms that are needed

are (a) to eliminate the provisions for percentage depletion and discovery depletion, (b) to eliminate the upper limit (30 per cent of the selling price) now imposed on the surtax on the gain from the sale of an oil or gas property that has been discovered by the taxpayer, (c) to require all depletion to be based on cost (or March 1, 1913 value), as it used to be before the discovery provisions were introduced in the 1918 act and the percentage depletion provisions in the 1926 and 1932 acts.

Percentage Depletion and Discovery Depletion.- The present percentage-depletion and discovery-depletion provisions allow the taxpayer to deduct as depletion much more than the property cost him (or much more than its March 1, 1913 value). Thus if an oil well costs \$100,000, the deductions taken year by year for depletion in computing taxable net income of the oil well may finally aggregate much more than \$100,000, under the existing percentage provisions. To the extent that they do exceed \$100,000, the taxpayer escapes a tax on net income as computed for taxpayers generally.

The percentage-depletion provisions are so called because depletion is declared by the law to be a certain percentage of the gross income from the property. The percentage is 27½ for oil and gas wells, 23 for sulphur mines or deposits, 15 per cent for metal mines (copper, lead, zinc, gold, etc.) and 5 per cent for coal mines. The percentages differ presumably because of different

ratios of gross income to capital value of property. Actually, the percentages must be very arbitrary, since properties within any one of the classes above may vary considerably in the ratio of gross income to capital value and, judging by estimates of revenue loss to the Treasury, are in practically all cases high enough to allow the taxpayer to get back, tax-free, far more than the cost of the property to him (or March 1, 1913 value). The yearly deduction is limited in all these cases to 50 per cent of the net income of the taxpayer from the property computed before deduction for depletion (with a qualified exception for oil and gas wells). But there is no overall limit, so the taxpayer can go on taking depletion deductions year after year even though he has long since exhausted the aggregate deduction that would be allowed him on a cost or March 1, 1913 basis.

The discovery depletion provisions are now of little practical importance, since they are confined to mines (thus not including oil or gas wells) other than metal, coal, or sulphur. These provisions allow the taxpayer an aggregate depletion deduction, over the life of his property, equal, not to the cost, but to the value. Thus a prospector may spend \$100,000 discovering and developing a mine that turns out to be worth \$1,000,000. His depletion deductions can total \$1,000,000. Thus he gets his \$900,000 profit tax-free, if he works the mine.

Tax Favoritism.- Taxpayers will argue that they should be allowed a total depletion deduction greater than simply cost of the property, to compensate them for other ventures that merely give them losses that they can not use to reduce income taxes because the losses exceed the taxpayer's income from other sources for the years in question. If a carry-forward of business losses and capital net losses is adopted, this argument for special depletion treatment will vanish. In any case, the extra depletion granted by the discovery or percentage depletion does not correspond, except in cases of sheer coincidence, with the amount of prior loss suffered. Moreover, much of the oil, gas, coal, copper, etc., is mined by large corporations where a prospecting loss can be set off (for tax purposes) against income from other activities carried on by the same corporation. Even where the enterprise is not large, methods have been developed for splitting the risk of one venture among a number of people and thus allowing one person to hold a bundle of split risks in several enterprises (where the chances for offsetting of losses against profits in any one year are good).^{1/}

Economic Aspects.- One of the reasons most strongly urged for the discovery depletion provisions in 1918 was the prospective shortage of crude petroleum, and the consequent necessity for encouraging drilling. This argument is also applicable to percentage depletion as long as the percentages are as generous as they are now. But the argument itself has no force now; indeed, the state and

^{1/} See the memorandum by officials in the Valuation Division, Treasury, in Blakey's 1934 report to the Treasury, p. E-259, on income tax problems.

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Federal governments have been busy in recent years trying to retard the flow of oil. Similarly, no reason appears for offering a bounty to coal, copper, sulphur etc., producers, especially as chances of discovery in many of these fields seem remote, and the chief economic effect of generous depletion provisions is therefore to hasten the rate of utilization of known deposits.

Revenue.- The revenue loss resulting from the excess of depletion allowed over depletion on an adjusted cost or March 1, 1913 basis will steadily grow greater as more mines, etc., get to the point where they will have used up all the depletion allowable on the cost or 1913 basis, so that all, not merely part, of the percentage or discovery depletion will be "excess" depletion. In September, 1934, officials in the Valuation Division of the Treasury reported that for the 39 taxable returns for 1932 that had gone through the Mining Section at that time and had had percentage depletion, the percentage depletion was \$1.2 millions against the \$0.3 million that would otherwise have been allowed. Anyone analyzing the published financial reports of oil companies for 1937 must have been struck by the small amount of undistributed profits tax paid, compared with the large profits reported to stockholders. Apparently, the "undistributed profits" were small because in computing the (taxable) profits the excessive depletion allowances were used. The profits reported to stockholders, on the other hand, were presumably after deduction of only the ordinary depletion.

Administration.- The adjusted cost or the 1913 basis for depletion requires the setting of a value on the property. This is admittedly difficult, but experience with the percentage provisions has shown that it is just about as difficult, and perhaps more so, to reach an agreement on the size of the "gross income from the property". Moreover, the value of the property has to be calculated anyway, whenever (a) dividends paid are likely to be in excess of the net income reported for tax purposes, since the excess is exempt as a return of capital only to the extent that it represents a real excess - i.e., an actual return of capital as computed under cost or 1913 rules of depletion; (b) the property is sold and capital gain or loss must be computed. Therefore in some cases the percentage-depletion provisions have simply added one administrative task on top of another.

Characteristics of Excise Taxes.- The following table represents an attempt to score the excise, stamp, and miscellaneous taxes of the Federal Government by labeling each tax "Good", "Fair", or "Poor" in respect of each of a number of characteristics, outlined below, that are of special importance in determining whether a tax should be retained. A question mark indicates a greater than usual degree of uncertainty in the writer's opinion. In Column N (Burden distribution) it was found not feasible to express an opinion in the terms used, but the column is left in, with

question marks, as a reminder.

The tobacco taxes and liquor taxes are not covered, since there is no prospect that they will be repealed.

This score sheet, it must be emphasized, gives no objective result. The importance of the several characteristics varies; the grading in many cases is largely subjective; the list of characteristics is not exhaustive; and a characteristic that seems to the present writer desirable may appear otherwise to someone else. Moreover, the grading relates to the tax as it stands today in the Federal system, not as it might be if it were altered (but in most cases, no alteration could change the grading materially). Finally, the cryptic column headings in the Table are very apt to mislead unless studied in conjunction with the text below. The table is therefore simply offered as partial information and as provocative of further study by others.

The following list of characteristics, used in the score-sheet table, has been compiled as a help in deciding which commodities and transactions should be relieved of the existing taxes on them, whenever it becomes possible to repeal some of these taxes, but not all.^{1/} The list would be somewhat different, but not markedly so, if the question was instead, which taxes to add (or raise) instead of repeal (or reduce). It would also be somewhat different if other types of tax - e.g., the income tax - were being considered.

^{1/} The list is a revision, amalgamation, and condensation of the analyses in memorandum P, report by Shoup, 1934, pp. 18-21, and in Blough-Shoup Report, 1937, Chapter 1.

Characteristics would then be listed that are omitted here because with respect to them there is very little to choose among the several indirect taxes. For example, none of these taxes is good judged by an ability to tax unmerited gains. Again, they differ little, or to no ascertainable extent, in their effect on volume of saving, willingness to take risks, or willingness to save.

The characteristics to be listed will be those, not of the tax itself, but of the commodity or transaction to be taxed; they are the characteristics that argue for the retention of the tax already laid upon it, and correspond to the "Good" entries in contrast to the "Poor" entries, in the table.

The commodity or transaction whose tax is relatively well fitted to be retained is one that is:

Administrative Considerations

A) Produced or sold, at some stage, by a few, large firms rather than many, small firms (e.g., cigarettes versus toilet preparations);

B) Produced or sold by taxpayers who produce or sell nothing else: record-keeping is easier and evasion more difficult (e.g., tobacco manufacturers versus tobacco retailers);

C) Produced or sold in a business where the mortality rate is low (e.g., roadside stands versus cigarette factories);

D) Purchased only by those consumers ^{1/} who are designed to

^{1/} "Consumer" in all of these paragraphs means the ultimate consumer-- the one who uses up the goods or services.

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bear the burden of the tax; troublesome exemptions are obviated;

E) Capable of precise definition without thereby excluding articles almost completely similar (e.g., "chewing gum" versus "candy", or "yellow" oleomargarine);

F) Enforceable without imposing on the taxpayer the necessity for special installations or design (cf, spirits distilling tax), extensive record-keeping, or other costs of compliance.^{1/}

Revenue, Economic, and Equitable Considerations

G) Growing or declining (in unit or dollar sales or production, per capita) but slightly (whether over a business cycle or a longer time, but particularly over the cycle); tends to stabilize revenue;^{2/}

H) Capable of responding, as a tax base, rapidly to a rise in general prices;^{3/} tends to check inflation^{4/} (defined as excess of governmental outpayments to, over intake from, the public);

^{1/} To some extent this characteristic is a general statement comprehending, among other things, characteristics B, D and E above.

^{2/} This implies that such instability as the revenue system as a whole needs can be amply supplied by taxes other than those here under consideration - e.g., income and death taxes.

^{3/} This is not simply the converse of (G), though it is to a certain extent inconsistent with it; (G) covers physical changes, and cyclical changes.

^{4/} Such a check is not desirable at some times; it probably will be desirable in the coming years.

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I) Controlled by an inelastic demand, i.e., few consumers drop out (or come in) or reduce their purchases (or increase them) when the price goes up, owing to an increase in the tax (or down owing to its reduction)^{1/}; thus (a) the change in yield to be gained or lost by a change in rate can be more accurately predicted; (b) the tax, or any change of its rate, will tend to cause less ^{2/} reduction of capital and labor among industries; (c) the kind of loss of consumers' satisfactions that is not reflected in tax receipts will probably tend to be less;^{3/}

J) Collected from one who sells directly to the ultimate consumer that is designed to be burdened: the chances of getting the tax shifted to the consumer are somewhat increased;

K) Sold to consumer in units of not less than 20 or 25 cents, and, at least, not less than 5 cents: otherwise, under ordinary rates, it becomes necessary to shift the tax by lowering quality or getting sizes, since shifting by a price increase would, under a moderate-rate ad valorem tax, involve much less than 1 cent per unit;

L) Sold at a readily ascertainable price, or otherwise readily valued, making possible an ad valorem tax rather than a specific tax: less danger of a change of real burden of tax^{4/} when selling price to consumer changes;

1/ In a sumptuary tax (designed to repress consumption) this characteristic is of course a fault.

2/ Such results will occur insofar as the consumer restricts his other outlays, but the force will be dissipated over a large number of business.

3/ See footnote 2 above.

4/ Expressed as a percentage of consumer's total dollar income.

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M) Sold to those who benefit by the expenditure to which the tax is dedicated (e.g., in principle, the gasoline tax, for roads);

N) Sold to the group in the community -- income group, geographical group, etc., -- that it is desired to burden.^{1/}

O) Inclusive enough so that close competitors are taxed equally.^{2/}

P) Produced or sold under conditions such that repeal of the tax would tend to give an undeserved bonus to others, rather than reimbursing business individuals that had been injured by the tax.

Q) Suitable for whatever specific control purpose may be in mind, sumptuary (to check use, as in spirits) or otherwise.

Federal-State-Local Relations

R) Not also taxed by state or local governments.

S) Not likely to be taxed by them, or to have existing taxes increased, if Federal tax is repealed; otherwise, retention of the Federal tax would tend to repress state and local fiscal independence.

^{1/} This is simply a general statement, for which (M) above gives a specific example.

^{2/} To a large extent this is a phase of items (E) and (I) above.

Estate and Gift Taxes

A Memorandum Submitted to the
Secretary of the Treasury

Carl Shoup

August 31, 1938

While the income tax has been examined intensively in recent years with a view to making it a more effective fiscal instrument, the estate tax and gift tax have not been subjected to such a careful scrutiny, either in public discussion or within the Treasury. Meanwhile the volume of revenue from this source, and more particularly the revenue of five, ten or twenty years from now, is being cut down by various methods of avoidance.^{1/} Moreover, the pressure for increased revenue exerted by the present and prospective program of Federal expenditures calls for a reexamination of rates and exemptions.

The present report is based largely on several weeks' work in January to March, 1938, and leans heavily on the findings in a detailed report submitted, at the Treasury's request, by C. Lowell Harris on February 26, 1938, "Current Problems of Federal Estate and Gift Taxation."

^{1/} "Avoidance" is a difficult tax term to define, but its general meaning here is that the threat of the tax causes the taxpayer to do something he would not otherwise do in order that he need not pay the tax--this something being clearly within the law.

Rates and Exemptions

An impression exists in many quarters that the Federal estate tax is already so high that further increases would impose an unfair and economically unsound burden.

This impression has been created by the high rates that apply only to stratosphere levels that few estates ever reach. Close to earth, the rates are very modest, and this accounts for the small part played in the country's fiscal system by the Federal estate tax. It is producing only 6 per cent of total Federal tax revenue.^{1/} Federal and State death taxes together produced in 1937 only 3 per cent of total Federal, State, and local tax revenue (there are no local death taxes).

To show what the situation really is, a few computations are given in the following paragraphs.

Present Rates at Various Levels.— A taxable estate^{2/} of \$50,000 pays \$200 in Federal estate tax - 2/5 of 1 per cent of the estate.

If the estate is \$100,000, the Federal tax takes \$4,200, or 4.2 per cent.

State death taxes impose an extra burden which is in almost all cases less than 2 per cent and commonly less than 1 per cent of the taxable estate.^{3/}

^{1/} Estimates for fiscal 1939 in Statement by the President in Summation of the 1939 Budget, July 13, 1938.

^{2/} As used here the term "taxable estate" means gross estate minus all deductions except the specific exemption of \$40,000.

^{3/} Unpublished data gathered by Treasury Division of Research and Statistics (Tax Revision Studies, 1937, Vol. V, p. 59).

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At the \$500,000 level the Federal tax is \$80,400 at the maximum, or 16.1 per cent of the estate. In every State except Nevada (which has no death tax), the actual Federal tax is considerably less, since the taxpayer can deduct from his Federal tax the death taxes paid to the States, within a limit (this limit is 80 per cent of the tax due under the old 1926 act). The net additional burden imposed by the States' death taxes is in several States zero, at this level, since they keep their taxes within the bounds of the maximum of the Federal credit. Several States, however, add from 1 to 3 per cent tax or even more.

A taxable estate of \$1,000,000 pays \$211,000 in Federal estate tax at the maximum--21.1 per cent. Some of the States overstep the maximum credit even at this level, and impose 2 to 5 per cent (a few, even more), but most of them stay within or close to the credit maximum, and thus impose no or little net burden additional to the 21.1 per cent figure.

At the \$10,000,000 level almost all the States stay within the credit maximum; therefore the Federal maximum tax, \$4,936,600 (49.4 per cent) usually represents the combined burden of Federal and State death taxes.

Number of Returns at High Levels.-- There is, however, not much point to discussing estates of \$10,000,000 or more. Not a single estate that large was represented in the estate tax returns filed during the calendar year 1935 (the latest for which published statistics are available). Even at the \$1,000,000 level, where

the rate is 21.1 per cent, the practical aspects are slight, since less than 200 returns showed an estate at or above that level.^{1/}

Indeed, even by dropping to the \$500,000 level (where the maximum Federal tax is 16.1 per cent), less than 400 taxable returns are added,^{2/} giving a total of between 500 and 600 returns above the \$500,000 level.

In summary, then: not more than 600 estates a year^{3/} are affected by the Federal rates that rise above 16 per cent; of these 600, not more than 200 are touched by the rates that rise above 21 per cent. The vast majority of taxable estates are therefore taxed at rates that are moderate.

The figures indicate that, in a time when the need for tax revenue has expanded so greatly, there is ample room for an increase in estate tax rates and a decrease in the average^{4/} specific exemption.

1/ Data from Tables 4 and 5 of 1934 Statistics of Income, Part I, pp. 44-47. A precise figure is not available, since the data are grouped on the basis of "net estate" as defined by the Revenue Act of 1926. The number is no smaller than 164, however, and no larger than 206, and is almost certainly well under 200.

2/ The figure is 313 for returns between the \$400,000 and \$800,000 levels (1926 net estate), and 63 between \$800,000 and \$1,000,000.

3/ The figure will of course be higher for more prosperous years and lower in others. These 1935 data reflect economic conditions of a year or so previous. They also reflect a slightly higher specific exemption than obtains at present.

4/ "Average", because of the proposal, noted below, to make the exemption vary with relation of beneficiaries.

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Suggested Rate Scale. - If it is assumed that the specific exemptions proposed below will average \$20,000 per estate (in place of the existing \$40,000), then about \$800,000,000 a year can be raised on estates and gifts representing business conditions roughly corresponding to those of calendar 1936, by a scale of rates as shown in Table 1 (all figures in this paragraph are to the nearest \$100,000,000). This scale is constructed on the assumption that the estate tax and gift tax would be coordinated in the manner described in later paragraphs. The closing of various loopholes recommended in subsequent parts of this chapter would bring in another \$200,000,000 a year (1936 conditions) within a few years, assuming the rate scale in Table 1. Thus a total of \$1,000,000,000 from the estate and gift taxes on a 1936 basis would be reached.

The Table 1 rate scale is comparable with the so-called "tentative tax" scale at present in force, and used in the maximum Federal tax computations above, since it assumes continuance of the existing credit for state death taxes.

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Table 1

Estate Tax and Gift Tax Rate Schedule to Raise
\$1,000 Million in Average Year on Reformed Base
and Assuming Coordination of the Two Taxes

Bracket of Taxable Net Estate	Proposed Bracket Rates	Present Bracket Rates
0-10	2	2 ^{a/}
10-20	5	4
20-30	8	6
30-40	11	8
40-50	14	10
50-60	17	12
60-70	19	12
70-80	21	14
80-90	25	14
90-100	27	14
100-150	30	17
150-200	33	17
200-250	36	20
250-300	39	20
300-350	42	20
350-400	45	20
400-450	48	23
450-500	51	23
500-600	52	23
600-700	53	26
700-800	54	26
800-900	55	29
900-1000	56	29
1000-2000	57	32 and 35
2000-3000	58	38 and 41
3000-4000	59	44 and 47
4000-5000	60	50 and 53
5000-6000	61	56
6000-7000	62	59
7000-8000	63	61
8000-9000	64	63
9000-10,000	65	65
10,000-20,000	67	67
20,000-50,000	69	69
50,000 and over	70	70

^{a/} This column is not strictly comparable with the "Proposed Bracket Rates" column. The former is for the estate tax alone (the gift tax rates are three-quarters as high at each level). The latter assumes but one rate scale, since the two taxes would be coordinated. Nevertheless the two columns are comparable enough, in a rough way, to indicate the severity of the increase in rates.

Number of Returns.— Although there are approximately 1,100,000 adult deaths annually in the United States, less than 9,000 taxable estate-tax returns of resident decedents were filed during the calendar year 1935.^{1/} Even with allowance for the fact that many people die leaving no property at all, it is obvious that the Federal estate tax touches but a small part of potentially taxable returns.

There were only 2,528 taxable gift tax returns filed for 1934.

If the estate and gift taxes are to play much more important roles, the specific exemptions should be lowered. All net estates (before exemption) of less than \$40,000 pay no Federal estate tax. A similar specific exemption is allowed under the gift tax.^{2/} This amount could reasonably be reduced.

Size of Specific Exemption.— It is sometimes argued that the specific exemption under the estate tax should be high enough so that the widow and minor children and possibly other dependents could live on the income from the amount exempted. This argument assumes not only that the dependents should be cared for during their entire lifetimes (including, for children at least, a time when they have outgrown dependency), but also that the capital should be handed down intact upon a subsequent death.

^{1/} In a prosperous year, and under the existing specific exemption (those returns reflected largely 1934 economic conditions and a somewhat higher specific exemption) the number would of course be larger, but still not much more than 1 or 2 per cent of the total deaths.

^{2/} To be distinguished from the annual exclusion (\$4,000 limit).

So much favor need not be shown. The following standard is 120
generous enough: exempt an amount that would purchase terminable
annuities adequate to care for the children until their majority
(or somewhat beyond) and the widow, ascendants, and incapacitated
children and brothers and sisters until death.

This amount would, of course, vary from one case to another;
no single flat exemption such as the present one would be just
right except in rare cases. Therefore it is desirable to use,
instead of a uniform specific exemption, an exemption that will
vary, depending upon whether any part of the estate goes to a
surviving spouse or dependent children or father or mother. Thus,
if no part of the estate goes to any such heirs, no exemption
would be allowed, except one of \$1,000 purely for administrative
convenience. An exemption of \$30,000 would be granted for amounts
going to a surviving spouse, or to a child who was mentally or
physically incapacitated, or to a brother or sister likewise
incapacitated or to orphans. An amount up to \$5,000 going to a
minor descendant would likewise be exempted. A \$5,000 exemption,
or possibly more, would also be allowed for each adult lineal
ascendant. Such fragmentary data as are available indicate that on
the average these exemptions would fall not far from \$20,000 per
estate.^{1/}

This is the type of exemption structure used in the New York
and North Dakota death tax laws. Since the specific amounts
allowed are deemed to be reasonable, there is no case for setting
an over-all limit on the total of the exemptions in any one estate.

^{1/} Acknowledgment is made of data supplied by Mr. Russell Reagh
of the Treasury.

A still more refined plan would make the exemption to the spouse, etc., depend on his or her age, and thus would require the use of actuarial tables -- the shorter the life expectancy (or time to majority, for minor dependents), the smaller the exemption. In view of the inadequacy of the tables now available, however, this refinement is not recommended for adoption in the immediate future.^{1/}

The wealth already possessed by the widow, child, etc., is another pertinent factor, but in the present stage of development of the estate tax it is probably not practicable to take this into account.

Constant, Vanishing, etc., Exemptions.-The existing specific exemption is constant--it remains the same no matter how large the estate. With a given rate scale the saving in tax because of the exemption is greater, the larger the estate. The point is unimportant, however, so long as the exemption is uniform; if a certain constant exemption, taken out of the top brackets in this way, gives more tax relief to the large estates than is deemed suitable, the rate schedule of the tax can be changed to remedy this defect. If, however, the exemption is to vary according to the nature of the beneficiary, the constancy of the

^{1/} Even with the best tables, injustices will occur, because the tables represent averages--a concept contrary to the idea of relative individual ability to pay. But it is doubtful whether it would be practicable to take into account even such objective data as physicians' reports on state of health in trying to discover, e.g., how long the widow will probably live.

exemption and the fact that it is taken out of the top brackets give certain results that cannot be overcome by simply changing the tax rates. The spread between the saving in tax on account of the spouse, with a \$30,000 exemption, and the saving in tax on account of a child, with a \$5,000 exemption, will be larger than if the exemption were taken out of the bottom brackets; if the exemption is a vanishing one, there is of course no spread at all in estates that rise above the exemption's vanishing point. The constant exemption taken out of the top brackets is the simplest, and any refinement to take care of the spread just noted need be considered only after other, more important refinements have been given due attention (for example, varying the exemption with the life expectancy of the beneficiary).

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Elimination of Double Exemption. - At present the \$40,000 specific exemption can be used twice — once under the gift tax and again under the estate tax. Since it is the same donor in both cases, there is no reason for allowing this duplication. Therefore the Revenue Act of 1939 should provide that the specific exemption at death be reduced by so much of the gift tax specific exemption (not the annual exclusion) as has been availed of. This provision should apply whether or not the gift tax and death tax are coordinated as recommended below. If the specific exemption is cast, as recommended above, in terms of a fixed amount per donee or heir, the same principle should apply. Thus if an exemption of \$5,000 applies to sons, and if the taxpayer gives (above the annual exclusions) \$3,000 to Son A, \$1,000 to Son B, and nothing to Son C, during life, his estate would be entitled to an exemption of \$2,000 for amounts left to Son A, \$4,000 as to Son B, and \$5,000 as to Son C.

Under this plan a widow who had already received the full exempt amount under lifetime gifts would get no exemption at all. If she had spent all the lifetime gifts she might have as much need for the exemption as one who had received no lifetime gifts. It seems reasonable, however, to levy the tax on the assumption that she has not spent the gifts, especially since only amounts given to her above those necessary for support and maintenance are considered gifts.

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Coordination of the Estate Tax and Gift Tax

Gifts during Life and Gifts at Death.—The Federal estate tax and gift tax are essentially taxes on the transfer of property that is given away. Whether the transfer occurs at death or during life should be immaterial in determining the amount of tax due. Two exceptions to this statement -- the interest factor and the savings in income tax -- are discussed below, but otherwise, a fair tax on the giving-away of a piece of property will be the same whether the gift is made during the giver's lifetime (an inter vivos gift) or at his death. Under the present Federal tax system, however, the tax is not the same. A simple example will illustrate the principle.

Savings in Federal Tax by Making Some Gifts during Life.^{1/}

Suppose that an individual has \$1,000,000, of which he wants to give away \$500,000 at death. The remaining \$500,000 he is willing to give away either at death or during his life. If he gives it away at death, it is, of course, added to the other \$500,000, making \$1,000,000 given at death. The estate tax rates are progressive; therefore the tax attributable to this second \$500,000 is much greater than the tax on the first \$500,000. The second \$500,000, in other words, lies in the upper, high-rate brackets of the estate tax. If it is given away before death instead of

^{1/} Savings in state death taxes are not included in these illustrations, but do afford another reason for inter vivos giving.

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at death, it is removed from the upper brackets of the estate tax. It falls in gift tax brackets, but, if the taxpayer has made no other gifts, the gift tax brackets that it falls into are the lower ones.

Moreover, the taxpayer gets the benefit of the \$40,000 specific exemption and the \$4,000 annual exclusion per donee that are allowed under the gift tax, while retaining the use of the \$40,000 specific exemption granted under the estate tax.

By splitting his total gifts of \$1,000,000, making part of them during life and part of them at death, the taxpayer thus saves a substantial amount of taxes.

Lumping Gifts during Life and Gifts at Death to Ascertain Tax Rate.—The only way to eliminate this difference in taxation is to combine the gift tax and estate tax into one tax. The gift tax would be as it now is -- a progressive-rate tax with the cumulative feature, whereby the taxpayer's account is kept open from year to year and the size of the total amount already given away determines the rate bracket into which each additional gift shall fall. Then the amounts that pass at death would be simply counted as still further gifts, so that the rate brackets into which they would fall would be determined by the amount that the decedent had given away during his life. Also there would be no double use of specific exemptions.

Thus if two men, A and B, each left an estate of \$1,000,000, but A had already given away \$500,000 during his life, while B

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had given nothing, the tax at death would be heavier on A's \$1,000,000 than on B's \$1,000,000. To put it another way, A would have had a total of \$1,500,000 to give away while B would have had only \$1,000,000, and, in effect, the extra \$500,000 of A's would be properly taxed at progressively higher rates.

Interest Factor.--It was said above that there were two exceptions to the principle that the time of giving -- whether during life or at death -- should not influence the amount of transfer tax. One exception concerns interest. The present, independent rate schedule of the gift tax is constructed just like the present, independent estate tax schedule except that in each bracket the gift tax rate is one-fourth lower than the estate tax rate. This difference was in part intended to compensate for the interest loss that the taxpayer undergoes when he makes a gift during his lifetime rather than later, at his death -- he loses not only the amount paid out in tax, but also the interest that he might have obtained on the tax money. The difference in tax rate, to take rough account of this factor, could be retained, even when the two taxes were combined, unless -- as in fact will be seen to be the case -- counterbalancing factors destroy the case for such a differential.

Savings in Income Tax.--The second exception springs from the saving in income tax that can be secured by giving during life.

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Inter vivos gifts are often made primarily to lessen income taxes by intra-family distribution of the property. Thus more personal exemption and lower surtax brackets apply. To counterbalance this advantage, it may be fair to tax inter vivos gifts somewhat more heavily, thus tending to offset the interest-factor consideration.

"Tax on Tax", and Annual Exclusion.--Under the gift tax there is no "tax on the tax", in contrast to the estate tax. For example, if a taxpayer has \$1,000,000 and gives \$100,000 away during his life, he pays a gift tax on the \$100,000 -- say, roughly, \$4,000. He then has left \$1,000,000 minus \$104,000, or \$896,000, at death. The estate tax is levied on this \$896,000 and amounts to, say, roughly, \$200,000. The amount actually given to the heirs is thus \$696,000. The estate tax is therefore levied on the amount given away (\$896,000) plus the estate tax itself (\$200,000) and consequently is in part a tax on a tax. This discrepancy could be eliminated by requiring that the gift tax be paid out of the gift. The only disadvantage of this would be that a donor would have to use simultaneous equations, or use a prepared table, to find the gross gift he would have to make in order to assure the donee of a given net amount after tax.

Insofar as an annual exclusion under the gift tax is retained (the present one is \$4,000 per donee) there will be an incentive to give during life rather than at death. Some exclusion is desirable, however, on administrative grounds.^{1/}

(See next page for footnote)

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1/ In contrast to the interest factor and the income-tax-savings factor, the tax-on-tax and exclusion items cause a discrepancy because they affect the tax base, lessening it for the gift tax compared with the estate tax. A certain net gift shows up as a smaller taxable amount under the gift tax than under the estate tax. It is therefore not necessarily a matter of taxing the (net) gift more heavily than the (net) estate, but, instead, of revising the gift tax rate to compensate for the restriction of base.

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Credit against Tax on Inter Vivos Gifts.--In summary, then, under a system that coordinated the two taxes, there would be reasons in tax justice for allowing a reduction in the taxation of inter vivos gifts because of the interest factor and for taxing them more heavily because of income-tax savings.^{1/} The "tax on the tax" factor and the annual exclusion offer reasons for taxing them more heavily. It may be that, under the proposed coordinated system, the net result justifies some credit against the tax on lifetime giving, or, conversely, some credit against the estate tax, but it is so difficult to weigh the factors involved that no credit at all is probably as good as any other arrangement.

The great savings to be made by gifts inter vivos under the existing system are perhaps not generally recognized. If a taxpayer has a fortune of \$5,000,000, it might be thought that he would pay the minimum of transfer tax, under the existing system, by giving slightly more than half during his life and slightly less than half at death. As a matter of fact he achieves the

^{1/} There is a provision of the income tax law whereby property that carries an accrued capital gain can be taken over at death with value at death as the amount to be subtracted from the amount realized, if ever, by sale. If such property passes during life, the amount to be subtracted is the cost or "other basis" to the donor. However, the income tax law should be changed so that gains and losses accrued to time of transfer would be taxed to the transferor or his estate; hence this item will not be considered in the proposed reform of the estate tax and gift tax.

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minimum of tax by parting with \$4,360,000 during life and only \$640,000 at death. This result reflects the tax-on-the-tax factor, the one-fourth differential in rates, and the specific exemptions. ^{1/} Since this differential is supposed to reflect in part the interest factor, which is not taken into account in this illustration, these figures do not give an absolutely fair comparison, but they are nevertheless illuminating.

^{1/} This computation apparently does not reflect the exclusion factor. Montgomery and Magill, Federal Taxes on Estates, Trusts and Gifts, 1936-37, p. 390. Of course the computations change if the property has an accrued gain, and the income tax is taken into consideration. Ibid.: p. 394-5.

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Non-Tax Purposes in Control of Giving. - This discussion has assumed that the tax system should leave the relative inclinations to give during lifetime and to give at death as nearly as possible the same as they would be if there were no death and gift taxes at all. If, however, it is deemed socially desirable to encourage one kind of giving at the expense of another, the rates can of course be adjusted for this purpose. Even in this case, coordination of the kind suggested above is preferable to the existing system, since the degree of pressure exerted in either direction is bound to vary greatly and capriciously from one individual to another when the rates of the two taxes are independent of each other.

States' Revenues. - In general, the states should benefit by the coordination of the two taxes, since only six of them have gift taxes, while all but one have death taxes; thus the existing Federal differential in favor of inter vivos gifts works strongly against them.

The present credit could be retained, its maximum being specifically expressed, as it is, in effect, now, in terms of a hypothetical tax due under the 1926 rates and specific exemption.

Administrative Advantages. - Substantial administrative advantages will be achieved by coordinating the gift tax and the estate tax. At present much of the administrators' and taxpayers' time is absorbed in disputes over whether a transfer made in fact

during life is taxable under the gift tax or estate tax - for example, transfers that the Commissioner maintains are "in contemplation of death." Under the coordinated taxes much, though not all, of the incentive for such disputes (at least on the part of the taxpayer) would end. Moreover, if the taxes are not coordinated, it will be advisable to strengthen still further the sections of the law that check inter vivos gifts designed to avoid estate tax - and as a result further complexities will be introduced.

An administrative disadvantage of the coordination would be that any deficiency or overpayment discovered in gift tax payments would necessitate a revision of an estate tax liability that might already have been discharged. The same problem exists at present within the gift tax, but the trouble, surprisingly enough, seems not to be serious.

Constitutionality. - Coordination of the type here proposed is apparently constitutional.

Rate Changes. - If the rate schedule of the new tax were increased at any time, the increase should not be made retroactive to cover any gifts prior to the change. In some cases the added tax due, especially if death occurred immediately after the rate increase, would exceed the taxpayer's total assets, and even when it did not, it might be so large a proportion of them as to

be distinctly unfair. The Government has no self-evident right to expect the taxpayer to forecast Congressional action on rates and lay aside the reserves necessary to meet future rate increases. Conversely, the Government should not have to pay refunds when rates were lowered.

Accessions Tax

Loophole Created by Tying Up Property. -- There exists under the estate tax a major loophole, of which more and more use is being made each year. It is the kind of loophole that has a particularly bad effect on future revenue, though it is serious enough even for present revenue. It concerns the tying up of property for long periods of time, and can be illustrated by a simple hypothetical comparison.

Suppose that an individual, A, owns some income-producing securities which he leaves to his children, B, B¹, etc., at his death. His children leave them to their children, C, C¹, etc., and the latter in turn pass them on to their children, D, D¹, etc. (the great-grandchildren of the first individual). At each transfer the estate tax applies. Individual A may obviate all but one of these taxes by instead leaving his property in trust whereby his children, B, etc., and each of their children, C, etc., enjoy the income but get no title to the property. Then the only transfer tax due, until the great-grandchildren give away their shares, or die, is the tax at

the death of, or gift by, individual A when the trust is created. No tax accrues upon the death of his children or grandchildren in this case, under the present law.

The two situations are not precisely comparable, because in the first case the children (and the grandchildren, assuming they do get the property intact) have power to consume the property, sell it, or give it away, which they do not have in the second case. The estate tax, however, does not depend on what the beneficiaries do with their property; and if they do not, in fact, dispose of it, the two situations described above are exactly alike in actual results, but with a great difference in tax. The estate tax is supposed, in general, to tax transfers from one generation or person to another. It fails, when property is tied up for long periods in trust.

The problem cannot be dismissed as a mere possibility, since a special study of a number of gift tax and estate tax cases made by the Treasury in January and February, 1938, showed that a surprising amount of property has recently been tied up in this way. Apparently the consequences for the estate tax revenue will be serious within a few years and will grow still more serious thereafter. Perhaps much of the tying-up is motivated by other than tax considerations, but this

^{1/} This is the Harriess study referred to on the first page of the present report.

question is largely irrelevant. Whatever the motive, the decrease in the tax revenue and the unfair distribution of the tax burden remain.

Method of Closing Loophole. - Study of the various ways of closing this loophole reveals that the best device is that used by the British and known as the "principle of aggregation." Under this plan the value of the interest that vests in C, for instance, upon B's death is aggregated or added to the estate of B, and the average tax rate applicable to this entire aggregated amount is levied separately on B's estate and on C's interest--C being responsible for payment of the latter tax, which is therefore an accessions tax, levied as a supplement to the estate tax. Thus if B owns property worth \$1,000,000 and also has a right to the income, for life, of a \$2,000,000 estate, and if C gets this estate in fee simple upon B's death, then under the proposed plan the \$1,000,000 and \$2,000,000 would be added, and the average rate due on the resulting sum, \$3,000,000, would be found. If this rate were 32 per cent, as it is, approximately, under the present law, B's estate would pay a tax of 32 per cent on \$1,000,000, and C a tax of 32 per cent on \$2,000,000.

If C were to get only what B had--i.e., a right to the income from the \$2,000,000 for life--there would be added to

the \$1,000,000, not the full \$2,000,000, but the actuarial value of C's right. The computation of this actuarial value would be nothing new in Federal estate tax procedure, since it must be done under present law when, for instance, an estate contains an interest in property dependent on the length of life of some other person.

State legislation could of course increase restrictions on the tying-up of property, but it is not safe to count on such action. At present the usual restriction is that property cannot be tied up for a period longer than for lives in being plus 21 (in some states 25) years. Thus property can in effect often pass through four generations (father to child to grandchild to great-grandchild) with only one transfer tax under present law. Only one estate tax or gift tax may be due on a given piece of property in more than a century.

The accessions tax should of course cover interests in trusts, etc., created in the past but maturing after the tax was enacted.

Since in some cases the corpus or principal will not be at the disposal of the recipient of the interest (e.g., when he has only a life interest) the accessions tax that he must pay should give generous provisions for payment such as the 3-year period possible under the present estate tax law.

Insurance Exemption

The \$40,000 Exemption.- The Federal estate tax exempts up to \$40,000 of life insurance proceeds not going to the estate of the decedent.

Some life insurance proceeds represent, in part, savings by the insured. There is no reason for favoring this particular kind of savings. Other savings, for example, those invested by the saver himself in Government bonds or placed in savings banks, are no less deserving.

Some life insurance proceeds represent, in whole or in part, pure insurance. The individual has paid in money with the prospect that he will never get it back at all if he lives long enough, but that he will get back much more than he put in (even counting interest on his premiums) if he dies soon enough. Such is the case with the entire premiums on term insurance, and some part of the premiums on straight life insurance. The proceeds are not, from the individual point of view, strictly comparable with a savings account in a bank.

Even though they are not thus comparable, there is no reason why, on the basis of relative ability to pay, the proceeds of pure insurance should be given a privileged place. If A puts in a savings bank the same amounts that B pays out in term-insurance premiums, and if both die shortly afterward, B does in fact transfer a greater amount at death than A does, and has a greater ability to pay.

^{1/} Footnote on next page.

Moreover, exemption of insurance discriminates against the sick and the aged who cannot get insurance.

In view of these considerations, a Revenue Act of 1939 should repeal the exemption of insurance proceeds.

Even if the taking out of insurance is to be subsidized at Governmental expense, the exemption device should not be utilized until the expediency of a direct subsidy or other forms of aid have been explored.

How to Get the \$40,000 Exemption Although Not Insurable.-

An individual can get "insurance" without medical examination and regardless of his age, provided he will at the same time buy of the same company a life annuity. The sooner he dies, the more the insurance company loses on the insurance, but also the more it gains on the annuity. The company doesn't risk a cent. For example, if a taxpayer has \$100,000^{1/} he can turn it over to the insurance company in return for promises (a) to pay him about \$3,500 a year for life (he pays, say, \$40,000 for this annuity) and, (b) on his death to pay the beneficiaries \$100,000 (he pays, then \$60,000 for this insurance). The result is the same as if the individual had kept his \$100,000

(Footnote from preceding page)

In a way, there is a double transfer: from those who outlive their term insurance to those who fail to outlive it, and from the latter to their heirs. That is, the fund on which the decedent draws has been built up in part by those who outlived their insurance.

^{1/} Actually, nearer \$106,000 because of loading, and differences in tables used for insurance and for annuities.

and invested it in 3½ per cent bonds, and then left the bonds to the beneficiaries when he died - but in the latter case there is no insurance exemption from the estate tax.

To cut off this avenue of avoidance, the Revenue Act of 1939 might include some restriction so that where an insurance contract and an annuity contract were taken out with the same insurance company within a short period, the insurance could not be exempted at death (if such an exemption for insurance in general remains).

Exemption Where the Insured Retains No Incidents of Ownership.- If the insured person retains no incidents of ownership in the policy - if, for instance, he can do none of the following: change beneficiary, borrow on policy, surrender or cancel the policy, assign it - then the proceeds are not included in the insured's taxable estate. Perhaps the existing law is in fact broad enough to allow inclusion, but to remove uncertainty the law should be made specific on this point.

The case for inclusion in the taxable estate rests on the same general principles as the accessions tax, explained above.^{1/} Death causes the maturing of a property right which has in the meantime been floating in suspense, so to speak, between the donor and donee, out of the present control of either. The

^{1/} Only insurance taken out since 1918 could be reached.

transfer is similar to transfers taking effect in possession or enjoyment at or after death and to gifts in contemplation of death.

The cost of such insurance is at present a taxable gift. Therefore, if the estate tax and gift tax were coordinated the problem would not be so serious as to insurance taken out after the law was changed, but certainly as to old insurance it would be desirable to include the proceeds in the estate at death, allowing a credit of gift tax against estate tax.

Apparently a considerable amount of insurance has been taken out, with no incidents of ownership retained. A large part of it has been purchased on the combined insurance-annuity plan described above. In the example just given, a gift tax is at present levied on the \$60,000, but, as noted, the beneficiaries receive, tax-free, the \$100,000 at death. Thus \$40,000 escapes transfer tax. This \$40,000, however, is in essence the compounded earnings on the \$60,000. The fact that the gift tax is paid earlier serves to counterbalance the relative smallness of the gift tax base. But on the general principle of reaching property rights that mature at death, the method indicated at the end of the preceding paragraph should be employed.

Powers of Appointment

Avoidance by Use of Power of Appointment.—One type of property ownership or control not adequately reached by the present transfer taxes is that existing when a person has a power of appointment. For example, A wills his property to B for B's life, giving B both the income and a power of appointment, i. e., the right at his (B's) decease to determine who is to take the property next. Under the present law, if B exercises this power of appointment the property passing under it is taxable as part of B's estate, but only if B has what is known as a "general power of appointment." If A specifies to whom B may give the property—for instance, to lawful issue of B, or the cousin of A, or C's minor children—or limits the group, one of which is to receive, though leaving B free to choose which of the group, then the power is not general and the transfer from B is not taxed.

If B has a general power and does not exercise it, then the property will ordinarily pass as directed by A's will (or trust) and there is no tax on the transfer from B. Consequently, if B is satisfied with the way the property would pass under A's will, B can save death tax by refusing or failing to exercise his power of appointment. A grandfather, for example, can direct that his estate is to be divided equally among his children in trust, each child having a life estate and a power of appointment,

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but that if the child does not exercise this power, the property is to pass equally to the lawful issue of the child on the latter's death. This then gives each child the power to cut off his children or divide unequally among them, but enables him to avoid tax if he wishes to do so by letting the property pass according to the grandfather's will. Moreover, it appears that the beneficiary, if the same person as would receive under non-exercise of the power, may himself elect to take in the latter way and eliminate the tax, even though the decedent did exercise the power.

It is difficult to say how much property is now tied up so that the power of appointment is either (a) not general, or (b) such that failure to exercise will pass property to the satisfaction of the life tenant. However, the frequency with which such powers appeared in the gift and estate tax cases covered in the special Treasury study mentioned above gives concern for the future of estate tax revenues. While whole estates may not be so tied up, large parts of them are.

Possible Taxation of Property Passing Under Power of Appointment. - There seems little doubt of the constitutionality of including in the decedent's taxable estate any property over which he had a general power of appointment even though the property passed under provisions of the creator of the power rather than the donee of the power (the decedent). To what extent Congress could tax the transfer when the power is limited has not been decided by the courts.^{1/}

^{1/} Powers created before 1918 could not be taxed.

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If an accessions tax is levied, as recommended above, it should be framed to include property passing under a special power of appointment or under a non-exercised general power of appointment.

If an accessions tax is not levied, the law should be amended to include in the taxable estate all property passing in either of those two ways.

Option as to Valuation Date

Reason for Considering Later Date. - The present estate tax law allows an executor to value the assets of the estate as of date of death or, at his option, one year later. The purpose is to avoid hardship that occurs when the estate shrinks greatly between date of death and date of distribution of the property to the heirs and other beneficiaries. Such a shrinkage is particularly severe on residuary legatees - who are often widows and children -, since, coupled with the payment of fixed bequests plus the tax, it may leave little or nothing for them.

The amount of the tax should not be influenced by changes in the value of the property after it has reached the heirs and other beneficiaries, but consideration should be given to value fluctuations before distribution. The tax is a tax on transfer. Although legal transfer occurs at the moment of death, actual transfer does not. Legally, the tax is an estate tax; but the practical repercussions on the beneficiaries cannot be ignored.

Eliminating One-Sidedness of Present Provision - The present provision, however, is much too favorable to the taxpayer. If the estate's value declines, the taxpayer is relieved, but if its value increases, the Government is not aided. The actual transfer argument noted above applies equally in cases of rising values and falling values. Therefore the tax should go up if values go up. If it were not for legal difficulties, this could be accomplished by taking the tax payable on date-of-death values and increasing or decreasing it by the percentage increase or decrease shown by the estate from date of death to some later date. Unfortunately, the tax must, for legal reasons, be levied on the legal transfer rather than on what was called above the actual transfer. Hence any such plan that would require the estate to pay tax on a value higher than value at date of death must be discarded.

In the face of this limitation the soundest procedure seems to be return to the former practice, abolishing the optional valuation, and trusting that the violent price collapse of 1929-33 will be repeated rarely if at all. This solution at least has the advantage of eliminating the added administrative burden imposed by the use of two valuation dates, with the accompanying necessity of valuing property at time of disposal if disposed of between those two dates.

Transfers for Public, Charitable,
Religious, etc., Uses

Extreme Form of Present Exemption. -- Complete exemption is given under both the estate tax and the gift tax to contributions to public, charitable, religious, etc., bodies. Since the exemption takes the form of a deduction from the gross estate or gift, it comes, in effect, out of the highest brackets.

A method for spreading the contribution proportionally over all the brackets would be desirable if practicable. For example, if a taxpayer leaves \$1,000,000 to non-exempt beneficiaries and \$500,000 to exempt beneficiaries, the tax would, under the restriction just mentioned, be two-thirds of what it would be if the \$500,000 had gone to non-exempt beneficiaries. Under present law it is much less than two-thirds. The proposed method would result in a wealthy man's getting only the same percentage reduction in estate tax as any other taxpayer who disposed of the same percentage of his property to exempt beneficiaries. The device to be employed would be a tax credit. It would be an amount that would bear the same ratio to the tax otherwise due as the exempt property bore to the entire net estate including the exempt property.

Unfortunately, this device may not be practicable for the gift tax. It would necessitate recomputations with rebates or refunds, either each year following a gift or once-for-all at death. This

procedure is not impossible, but further study is needed to ascertain whether the added administrative complexities would be worth the results.

Limiting Amount of Exemption. -- If the exemption is to be limited in amount, probably a percentage limitation is better than any other kind. For example, instead of using "the exempt property" in the ratio formula above, "50 per cent of the exempt property" could be used.

Again, however, the gift tax presents difficulties. Any limitation based solely on one year's gifts would be arbitrary, and harmful in that it might discourage the most efficient way of giving a certain sum. Small gifts scattered over the years would be encouraged at the expense of a large gift in one year. Any reasonable limitation would have to keep the account open until death. This is a troublesome procedure, but if no limitation at all is imposed, while the estate tax has one, there will be considerable pressure to give during life rather than at death.

Further research may, however, find a way to apply these procedures to the gift tax without much difficulty; therefore the matter is recommended, not as one for immediate action, but for further study.

Differences Between Scope of Estate Tax and Gift Tax

Exemption.--Especially if the estate tax and gift tax are coordinated, the scope of the exemption should be the same in both. At present there are some differences.

Deduction of Amounts Actually Paid.--The present estate tax law allows exemption to contributions not actually paid, in some cases, and denies it, in others. The face amount of a charitable, etc., bequest may not actually be paid because the estate experiences financial difficulties and reaches a compromise with the charitable, etc., beneficiary. At the other extreme, a pledge (in distinction to a bequest) may possibly be held non-deductible even though enforceable under State law and actually paid -- but there is some conflict of authority on this point.

Both points should be cleared up by a statutory provision limiting deduction to the amount actually paid, but putting enforceable pledges on the same basis as bequests.

Domestic Institutions.-- All except non-resident aliens may at present claim the exemption (estate tax and gift tax) for a contribution to a foreign charitable, etc., organization. Since the exemption is allowed largely on the grounds that these private organizations are doing what the taxpayers would otherwise have to do, the exemption should be limited to transfers to domestic organizations.

Possible Conditions to Impose on Institutions.--The Congress might consider whether it wants to add certain restrictions concerning the type of institution, the gifts or bequests to which are exempt. Should there be a requirement that individuals outside the donor's family and circle of business associates be given places on the governing boards? Should the records of the institution be made available to the public? Some criticism has developed of the tax privileges accorded private charitable, etc., foundations that give the donor and his family close control of property and (within some limits) the use of its income. We make no recommendations, but suggest that the questions be debated.

Property Previously Taxed

Exemption is granted from the estate tax to property that paid a Federal gift or estate tax any time within five years before the decedent's death. The exemption extends to property that was received in exchange (directly or indirectly) for such property.

Various limitations are put on the exemption, but the general effect is to lighten the estate tax burden on property that passes by gift or inheritance rapidly. The five-year period, however, is arbitrary -- highly so, in that property just one day or more over the five-year line is fully taxable. An exemption graduated with the passage of time would be more reasonable. The exemption

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might, for instance, be graduated so that if the second transfer occurred within 1 year of the first, a 100 per cent exemption would be allowed, but that this would be reduced to 80 per cent, 60 per cent, 40 per cent, and 20 per cent if the period were 2 years, 3 years, 4 years, or 5 years, respectively.

The argument for exemption has pronounced weaknesses as concerns tax justice. Suppose, for example, the following two lines of succession:

(A) Father dies at 60 in 1940, son dies at 40 in 1944, and grandson dies at 50 in 1994.

(B) Father dies at 60 in 1940, son dies at 50 in 1962, and grandson dies at 50 in 1994.

It is at least doubtful that the estate of the son in succession (A) has any claim to complete exemption compared with the estate of the son in succession (B).

Moreover, some administrative difficulty is involved in tracing property through one or more exchanges within the five-year period, to ascertain whether any property in the estate had been obtained by the decedent in exchange for property previously taxed.

Study should therefore be given to the possibility of abolishing entirely, in some later year, the exemption of property previously taxed.

Specific Exclusion

Possible Reasons for Exclusion. - The gift tax law allows the donor a specific exclusion (to be distinguished from the specific exemption) of the first \$4,000 given to any person in any one year. In other words, a donor may give up to \$4,000 a year to each of any number of persons, and pay no gift tax. Only the excess over \$4,000 given to any donee during the year is taxable.

The possibilities of an exclusion are fourfold:

(1) To eliminate a large number of small returns (i.e., those showing either a small number of large gifts or a large number of small gifts) simply for administrative reasons. This purpose is undoubtedly served by the present exclusion.

(2) To eliminate, again for administrative convenience, the reporting of a large number of small gifts (a cigar, as an extreme case) in those returns that should be filed because of the number of large gifts. This purpose is not accomplished by the present law, since the donor, once he has given more than \$4,000 to any one donee in a year, must report all gifts to that donee in that year. Only the excess over \$4,000 is included in computing taxable gifts.

(3) To exempt gifts that are semi-obligatory such as Christmas, birthday, and wedding gifts. The present law tends to do this indirectly, through the \$4,000 exclusion, although this may not cover a few extremely wealthy individuals who feel obliged to give really substantial gifts on such occasions.

(4) To exempt semi-obligatory gifts such as those to support members of the family (and possibly also close friends) whom the transferor has no legal duty to support. In this case the size of the exclusion may have some reasonable reference to a minimum yearly standard of living and thus be analogous in some respects to the personal exemption granted under the income tax. ^{1/} The present exclusion is too large, judged by this standard alone. Moreover, it is not limited to gifts to members of the family and close friends.

Comment on Reasons. - The first and second of the four possibilities above are important. Little weight need be given to the third and fourth, however. Christmas, etc., gifts that are so large or numerous that they are not excluded under the first reason (for administrative convenience) should probably not be deemed so obligatory as to merit exemption. As to the fourth reason (support of relatives and close friends) the exclusion would have to define where this

^{1/} This point has no reference to payments made in support of wife or minor children, since there exists here a legal obligation to support, and hence no gift.

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semi-obligatory zone ended; and the difficulty that will be found in trying to draft such a provision is some indication of the weakness of the proposal.

The present kind of exclusion cares for the first point above (large number of small returns), but \$4,000 a year is probably larger than is needed. It might better be placed at \$2,500 a year.

For the second point (small gifts by donors who must file returns because of large gifts) it might prove feasible, in addition to the \$3,000 exclusion, to grant an exclusion of \$20 per week per donee. This would in large part simply regularize a de facto situation.

Community Property

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In the eight states that utilize the community property system, the husband is regarded as owning one-half of all property acquired during marriage through the efforts either of himself or his wife, or both, and the wife, the other half. Therefore when either spouse dies, there is, of course, no transfer of the half already owned by the surviving spouse. One result is that the present Federal estate tax law does not attempt to tax that half.

Three Kinds of Difference--If a case is supposed where all the property in the family has been earned by the husband, a

1/ Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, and Washington.

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comparison between a community-property-state and a non-community-property state reveals at least three kinds of difference in possible estate tax burden:

1) The difference between the tax on a given amount and a tax on half that amount. Thus, H (husband) dies first; W (wife) is to have all the property. In a non-community property state, the tax is levied on all the family property; in a community-property-state, only on one-half the property.

2) The difference between the tax on a given amount and twice the tax on one-half that amount. Thus, H dies first, and it has been agreed that C (child) will receive all property passing at death of either parent. In a non-community-property state, the tax is levied on all the property, upon H's death, since it all goes to C at that time; in a community-property state, a tax is levied on one-half the property at H's death (H to C) since only one-half of it goes to C at that time, and on the other half at W's death (W to C).

In these two cases, the tax collected in the community-property state is the smaller. In at least one other case, however, it is the larger:

3) The difference between the tax on half the given amount and no tax at all. Thus, W dies first; H is to have all the property. In a non-community-property state, there is no tax; in a community-property state, a tax on the half passing from W to H.^{1/}

^{1/} See footnote on next page.

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From time to time it has been charged that the residents of community-property states enjoy an unfair advantage with respect to the Federal estate tax. The first case above (husband dies first) is commonly cited. The case where the wife dies first is, however, commonly ignored. Taking the situation as a whole, it is however not prima facie evident whether, on balance, the Federal estate tax gets more or less revenue from community-property states than it would if those states had no community-property laws. There is a slight case for supposing a revenue loss, since the difference between the tax on a given amount and a tax on half that amount (case 1) is greater than the difference between the tax on half that amount and no tax at all (case 3), under any progressive-rate tax. So many other factors enter, however, that this factor might prove to be of minor importance. Case 2 is nothing but a variation of case 1.

(Footnote from preceding page)

Except, according to a Federal lower court decision, in Nevada and New Mexico, where there is no tax. See memorandum of June 9, 1938, from Mr. Shaw to Mr. Tarleau. If the wife owns the property, the differences are the same; substitute W for H and H for W in each case. The statement can be generalized by calling the three persons SP (the spouse that, in a non-community-property state, owns the property), S (the other spouse) and C, and substituting SP for H and S for W.

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Whether, when H dies first, W really gets enough to justify the imposition of an estate tax on her community share seems to be a disputed constitutional question. Perhaps a stronger case could be made for an accessions tax, of the type recommended in an earlier section of this report, on W's community share. The imposition of either tax would give the same tax treatment in community states and non-community states, when H dies first, except in case 2, where the total tax would be greater in community states, and this greater tax might be justified on the grounds that half of the property does in fact in this case undergo more transfers in the community-property state than in a non-community state. Even aside from the constitutional question, the present writer finds himself without a decided opinion one way or the other, as long as the wife's community share is taxed when she dies first (case 3).^{1/}

^{1/} In an earlier memorandum the present writer argued that taxation of W's community share when H died first would lead to taxation of H's community share (in addition to W's community share) when W died first. In view of the information supplied, however, in a memorandum of June 9 from Mr. Shaw to Mr. Tarleau, it appears that such a result need not, and indeed very probably could not, follow.

Tenancies by the Entirety and Joint Tenancies

Tenancies by the Entirety:—Under a tenancy by the entirety (which can exist only between spouses), neither spouse can dispose separately of his or her share in the property. The surviving spouse gets the whole property. Therefore, when a husband puts into a tenancy by the entirety some of his own property, he is certainly giving up to some extent, at least, an interest in property. The gift tax Regulations (Article 2, (7)), but not the law, specifies that such a transfer shall be taxed. The size of the taxable gift is to be determined by "adding to the value of her right, if any, under the law of such jurisdiction to a share of the income or other enjoyment of the property during the joint lives of herself and husband, the value of her right to the whole of the property should she survive him, the value of each of such rights to be determined in accordance with the Actuaries' or Combined Experience Table of Mortality, as extended."

This rule seems reasonable, and should be specified in the statute.

Joint Tenancies: - Under a joint tenancy, any one of the tenants can demand to have the property divided and can dispose of his interest independently of the wish of the others. To the surviving joint tenant(s) goes the whole property. If a puts his own property into a joint tenancy, he is obviously

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giving up completely his rights to a fractional part of that property (one-half, if there are only two joint tenants). The gift tax Regulations (Article 2, (8)), but not the law, levies a tax on the full value of this fractional part. This rule, too, seems reasonable, and should be specified in the statute. The principle of the modification introduced by the Regulations concerning bank deposits should also be inserted: "If A creates a joint bank account for himself and B, there is a gift to B when B draws upon the account for his own benefit, to the extent of the amount drawn" (Article 2, (4)).

Real Property Abroad

The Federal estate tax law exempts real property located abroad, but the gift tax law does not. There is no reason for this difference except possibly that gift taxes are rare or light abroad, while death taxes are not.

The estate tax exemption apparently expresses in part a belief in the equity of the principle that real estate should only be taxed at situs and in part a desire to encourage Americans living abroad for business purposes. However, with present high estate tax rates, a person owning or purchasing property abroad, which includes Canada (where each province has its own death tax and the dominion has no death tax) can, even though a tax is levied there, make with profit a double or multiple use of low brackets. In addition the principle

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expounded in Senior v. Braden (55 Sup. Ct. 800) may be extended to trust certificates in foreign real estate, thus in effect making available readily marketable tax-exempt certificates of ownership.

The encouragement that the present law offers to investment in foreign real estate rather than domestic real estate may have undesirable economic and social effects. It would be a more prudent policy, in general, to remove the present full exemption from the estate tax.

How much the present exemption helps American businessmen abroad is not clear. To prevent great damage, a credit on the United States estate tax should be allowed for tax paid abroad on the same property. The credit should bear the same proportion to the total foreign tax on the estate as such real property bore to all the property in the estate taxed by foreign countries. The credit should also be limited so that it would reduce the United States tax by no greater proportion than the ratio borne by the foreign real estate to the total estate taxable by the United States.

Transfers of Federal Government
Obligations by Nonresident Aliens

Transfers of Federal Government obligations by nonresident aliens not engaged in business in this country are exempted from gift tax and estate tax by regulation (not by statute). The reasons for this exemption go back to a time when it was uncertain

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whether it would be possible to tax such transfers in all instances. Subsequent court decisions seem to have indicated, however, that such taxation would be valid. Therefore the statutes should specifically tax those transfers.

Deductions for Support of Dependents

The estate tax law allows, among other deductions from gross estate, deductions of amounts "reasonably required and actually expended for the support during the settlement of the estate of those dependent upon the decedent"—in each case, however, limited to the amounts allowed by the laws of the jurisdiction under which the estate is being administered.

At first glance it might appear that, since the dependents must be supported, to tax the sums used for this purpose would be unjust. The estate, however, ordinarily earns income during administration, and this will go to the beneficiaries (unless it is used for payment of obligations that should come from the capital of the estate, in which case the net worth is increased over what it would otherwise be). The estate during this period has not only the income-producing property that the beneficiaries will eventually have, but it also has the property used to pay the tax (not due till 15 months after death) and perhaps to pay other debts. Thus the income during administration may be larger than later. To require support of dependents from this income involves no injustice.

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The fact that the deduction is now allowed only where state law allows it means that it is in fact allowed in about half the states. At present, therefore, beneficiaries in certain states receive greater advantages than those in others.

The deduction for support of dependents should therefore be disallowed.

Funeral and Administration Expenses

Funeral and administration expenses accrue after death and are to some extent within the control of the administrator. Where the estate is large, there may be a tendency for him to spend more for a mausoleum or prolong administration or incur extra legal fees when he knows that a third or half the cost will in a sense be paid by the Government, through the deductibility of such expenses. State laws regulate, to varying extents, executors' fees and other expenses. Probably the best precaution would be, not to disallow these expenses entirely, but allow them to be taken on an average-tax-rate basis, not out of the highest brackets as at present. However, this is a matter for further research, not for immediate action.

Information Returns

The present statute gives the Commissioner no explicit authority to require information returns from donees and trustees. The regulations stipulate that such returns must be filed, but

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some taxpayers have objected and refused. Although more work would be thrown on trust companies (and a few minutes work on some donees), public policy favors the requiring of information from every source possible. A donor may change the provisions of a trust, making it presently taxable without his knowing it; when the thing is discovered later, he may suffer in penalties and interest from innocent failure to file. Therefore the gift tax law should be amended to permit the Commissioner to require information returns.

Increase in Gift Tax Rates if Death Tax and Gift Tax are not Coordinated

The present gift tax is so light, compared with the estate tax, that there results much more inducement to give during life than would exist if there were no taxes. It is to be recalled that the following federal tax factors are working in favor of inter vivos gifts: (1) Gift tax rates 25 per cent lower than estate tax rates; (2) double use of lower brackets; (3) no "tax on the tax"; (4) annual exclusion of \$4,000 per donee; (5) savings in income tax by greater use of exemptions and lower brackets; (6) double exemptions of gift tax and estate tax. In addition, there are the state death taxes to consider, in so far as they exceed the credit allowed. Against inter vivos gifts there operate only: (1) the interest

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on the gift tax; (2) the taking of the donor's "basis" by the donee when the property given carries an accrued gain.

Therefore, if the death tax and gift tax are not coordinated as suggested above, the gift tax rates should be made the same as the estate tax rates. There is no particular virtue in the sameness; it is somewhat arbitrary, and a closer approach to equality on the average might be found at some other level - for instance, with the gift tax schedule 10 per cent lower (or higher) than the estate tax schedule; but at least it would probably be closer than the existing system to equalizing the tax forces on gifts inter vivos compared with transfers at death.

August 31, 1938.

H.M.Jr: Hello.

Operator: Mr. Haas.

H.M.Jr: Who?

O: Mr. Haas.

H.M.Jr: Oh yes, thanks.

O: Go ahead.

H.M.Jr: Hello.

George Haas: Good morning, Mr. Secretary.

H.M.Jr: Good morning. George, on that daily sheet which you show on the stock market for U.S. England, so forth and so on.

H: Yes, sir.

H.M.Jr: I want you to include that for the same period and also Italy and Japan.

H: Italy and Japan put on the same chart.

H.M.Jr: On the same chart, if necessary shorten the chart, see?

H: Fine.

H.M.Jr: But have them do one in pencil and show it to me.

H: Fine.

H.M.Jr: Will you?

H: Italy and Japan and the stock market of each country.

H.M.Jr: Yes, well you've got on their now -

H: Yes, I've got three countries on there.

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H.M.Jr: Well now, put the three democracies on the top and the three so and sds at the bottom.

H: O.K.

H.M.Jr: All right.

H: That's right. Germany's already there.

H.M.Jr: But they tell me Italy has had a bad drop last week, and I don't know whether she has or hasn't -

H: Uh-huh.

H.M.Jr: But put it on there.

H: Fine, I'll do that. Meantime I'll show you a pencil copy.

H.M.Jr: Yes, show me a pencil, let's keep score on the democracies versus the so and so's.

H: O.K. all right.

H.M.Jr: All right.

GROUP MEETING

August 31, 1938.
9:30 a. m.

Present: Mr. Magill
Mr. Oliphant
Mr. Gaston
Mr. Haas
Mr. Taylor
Mr. Bell
Mr. Upham
Mr. White
Mr. Lochhead
Mr. McReynolds
Mrs. Klotz

H.M.Jr: I have seen the original copy of Kennedy's message. They will bring over a paraphrased copy at four o'clock this afternoon. They sent over a special message, but wouldn't let it out of my hand. To sum it all up, it is very pessimistic - 50-50. They don't think anything will happen before Tuesday.

Taylor: Good. But Thursday?

H.M.Jr: Not saying, but the Hitler crowd are telling themselves that France won't fight.

Oliphant: Won't fight?

H.M.Jr: Won't fight.

Taylor: This lad that was here yesterday didn't talk that way.

H.M.Jr: But England has an agreement with France that France will not declare war without first consulting with England.

White: Declare war or fight?

H.M.Jr: Declare war. I'd like to appoint a committee of Taylor, White, Lochhead, and Oliphant to bring me in, by two, a finished, polished, complete mechanism, so on one hour's notice I can call an exchange control if I want to. I want it by two o'clock, not later. You can consult with anybody down in Federal Reserve that you need. Taylor, you are

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Chairman. I want it by two, finished and complete, so I can just say, "Exchange control - she goes on." Now that doesn't mean you can't have an alternate plan, but I don't want to begin floundering around if we have fifty to a hundred million dollars a day, if there should be war.

Now, the President again told me to see if we couldn't work out something, a plan other than ear-marking the gold so the countries can send gold over here and put it on deposit, to be used in the purchase of war materials. He seems to have in mind the fact that a country could send money over here and have it here, and it would have a good effect. We'll say the Germans - we know that there is this fund. I don't quite see - I mean, he wants to have it public and still, if it's public, why do they have to set up a special fund. I don't quite get it, but he's told this to me twice.

In other words, say England wants to send fifty million dollars over here, as a - "kitty" is the word he used - to buy war materials. This would really be in the British Treasury.

- Lochhead: They can. Under the license you have issued, the Federal Reserve can hold either for the Central Bank or foreign Government.
- White: He is raising a much more significant question here.
- H.M.Jr: Whether the British Treasury could send fifty million over here for deposit, to be used for the purpose of buying war materials.
- White: Whether selected countries could do that.
- Bell: They could; there isn't a thing against it. They did it during the War; they had balances in the Federal Reserve banks and balances in the National banks.
- White: It is really a shaping of a different policy than the Neutrality Act.
- H.M.Jr: All right, there are four of you. Do you (Bell) want to sit on this committee?

Bell: I haven't the time; I'd like to, but I can't.

H.M.Jr: I'd like an answer on what he said; if I could give him an answer on that particular thing by Friday.

Oliphant: The thing to do is to state the implication, which is a very useful thing - the one act which might save the world a war.

H.M.Jr: Anyway, he's asked me this twice, and he may not be aware of the fact that maybe his hands are tied, under the Neutrality Act, but this is the second day he's asked me now, so let's give him something on it as soon as possible.

Gaston: Apparently he wants something he can announce.

H.M.Jr: He's got it in mind - somebody close to him told me. But you fellows have got that, so let's give him something on it.

Oliphant: That is very promising.

H.M.Jr: What?

Oliphant: It is very promising.

H.M.Jr: In the first place, let's get the answer to the question, "Can they buy war materials?"

Oliphant: Can Germany buy war materials?

H.M.Jr: Yes.

Oliphant: That is the one thing we can do, I think, to prevent a war.

H.M.Jr: What?

Oliphant: I think it is the one thing we can do to prevent it.

H.M.Jr: Then let's get a paper out on it.

Taylor: You can use a Government agency, exempted from the Neutrality Act and the Johnson Act. You can set up an account on the Export-Import Bank, for example.

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White: If the matter has any value, Mr. Secretary, time is the essence. Maybe if we get this thing in tomorrow

H.M.Jr: I don't need any

Oliphant: Can we bring it to you as soon as we get it ready?

H.M.Jr: Sooner. I mean, as far as you fellows are concerned, I've got nothing. We'll sit with these fellows an hour or so tomorrow and chew the fat.

(Telephone conversation with Mr. Russell C. Leffingwell, at 9:40 a. m., attached.)

August 31, 1938.
9:40 a.m.

H.M.Jr: Hello.

Operator: Go ahead.

H.M.Jr: Hello.

Russell
Leffingwell: Hello Mr. Secretary.

H.M.Jr: How are you?

L: Oh I'm getting along fine, thank you.

H.M.Jr: Good.

L: I'm having a holiday up in New Hampshire and they told me you had called me up.

H.M.Jr: Oh! Well, what I wanted was this. I'm asking a few people to come down and have supper with me tomorrow night to talk over this international situation, and - I - I kinda wanted to have you there but if you're away up in New Hampshire, that's asking a lot.

L: No, it - it - nothing is asking too much if - if you want me Mr. Secretary, I'll come.

H.M.Jr: Well -

L: If - if - if it'll keep, why of course that's fine, but I - I -

H.M.Jr: Well, it -

L: A call from you to me is - is an order, you know.

H.M.Jr: Well, it - it's just this, that I'd like to talk it over before the thing blows up in my face.

L: I see.

H.M.Jr: You see?

L: I do indeed.

H.M.Jr: And that - that's the whole idea, just to discuss ways and means in case the thing should really go - get much worse.

L: Yes. Yes. Well, that's - that's important indeed, and -

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H.M.Jr: Yes.

L: And I'll be delighted to come, if you'd like me to.

H.M.Jr: Fine. Well, I would very much. You - I don't - my address - have you got my address?

L: Well, I haven't got it at the moment.

H.M.Jr: Well, have you got a pencil?

L: I - I haven't even got that. Wait a second.

H.M.Jr: Well you -

L: I can remember it.

H.M.Jr: Well, it's - when - it's 2211 -

L: 2211

H.M.Jr: 30th Street.

L: 30th Street.

H.M.Jr: 3-0

L: Yes.

H.M.Jr: And it's just off -

L: 2-2-1-1 -

H.M.Jr: Yes.

L: 30th

H.M.Jr: And it's just - be sure to tell the man it's off - it's off Massachusetts Avenue.

L: Yes.

H.M.Jr: Because they usually take you to Georgetown.

L: Oh, I see.

H.M.Jr: 2211 - 30th.

L: 2211 - 30th Street.

H.M.Jr: Well, I was going to have supper at seven-thirty tomorrow night.

L: At seven-thirty.

H.M.Jr: Yes.

L: Thank you very much, Mr. Secretary.

H.M.Jr: Thank you so much.

L: Good day.

H.M.Jr: Fine.

H.M.Jr: All right. Well, you fellows can go on that, if you will. Let's see, the President is having And on this thing, also, this question of war materials, I discussed that with the President, and General Craig is having lunch with me tomorrow, alone, and I am asking him what materials he's short of, and again, the question of, is there some device that if he says he needs this or that, that some agency - could we swap wheat for antimony, or mercury? If we are going to dump wheat, could we swap wheat for mercury? We have been all over it, but let's do it again, because at that time we didn't know we were going to dump wheat.

White: Or could we swap gold for it?

H.M.Jr: Well, I don't know. Anyway, take a look at that. As I say, on this thing, of course, we mustn't mention it out of the room. With the thing so close up it's stupid not to. Certainly this cable from Chamberlain raises Well, it all - all moves are in Hitler's hands. They are all just sitting back - (shakes hands).....

Taylor: There is one other aspect of that thing, which I don't know whether we will - but we can bring that in later - and that is possible liquidation of securities for foreign account.

H.M.Jr: Huh?

Taylor: Possible liquidation of securities for foreign account.

H.M.Jr: Yeah. Well, will you go into that too?

White: Does the S. E. C. have to

Olyphant: Also the foreign

H.M.Jr: movement of capital.

Olyphant: The presence of capital, and movement.

H.M.Jr: No.

Olyphant: You want to talk about taking over foreign holdings?

- Taylor: This isn't a question of taking over, but in case there should be a desire on the part of X country to liquidate its holdings in this country, after they have taken them over, to have a mechanism there which would function.
- H.M.Jr: Yeah. All right. Will somebody tell me how much the Alien Property Custodian's got - how much money is there, there?
- Bell: Oh, I think there is possibly eighteen or twenty million dollars, but a large share of that belongs to American claims.
- H.M.Jr: Not big enough to use. I didn't know but what it was several hundred million.
- Bell: Oh no, it's not more than twenty million dollars.
- H.M.Jr: Well, take a look at this thing. As far as I am concerned, with the exception of our day-to-day things, I've got nothing more important, or as important as this.
- (Nods to Mr. Magill.)
- Magill: Decentralization of the Bureau.
- White: I was wondering, along this line, would there be any value in reexamining, at this time, more or less publicly, the barter arrangements which are now going on between Germany and the United States, and under which almost all, I understand, of the trade is being conducted, and more and more of the trade - so that most of this trade is being conducted under this barter arrangement, which, at most, is a questionable device.
- H.M.Jr: All right.
- White: Shall we examine it?
- H.M.Jr: Sure. Anything else on that subject?
- (Nods to Mr. Magill.)
- Magill: Decentralization of the Bureau.
- H.M.Jr: What Bureau?

- Magill: Internal Revenue, the local Bureau. I had a talk with Gravesyesterday, and the Commissioner is to be back immediately after Labor Day.
- H.M.Jr: He came back on my boat.
- Magill: Did he?
- H.M.Jr: Sure.
- McReynolds: He didn't come back to Washington.
- Magill: You must have left him on Hoffman Island, I guess. We would like to get the order - not the order out, but get the understanding very well established that the rest of the program is going through between the first of January and the thirtieth of next June. I think everything is all right, but I think it would be just as well to get it nailed down.
- H.M.Jr: Well, let's handle it the way we did the last time. Take it to Admiral , and he ruminates on it a week or so, and then he says it's all right. You have to give him a week or two. Why not fix me up something and I'll get it over to him and say after he studies it will he come over and advise me on it. Magill, will you do that?
- Magill: I will. Nothing else.
- Olipphant: There is a memo, appropos of the Arthur Krock speech, if you want it.
- H.M.Jr: Arthur Krock! Do you read Arthur Krock?
- Olipphant: I read Arthur Krock religiously. That is, the answer is perfectly clear. We are perfectly right on it.
- H.M.Jr: Give it to Gaston and let him have it. I don't want it. My father always said, "Never get into an argument with a skunk; you always loose."
- White: What was that end?
- H.M.Jr: You always loose. (Laughter.)
I hope I didn't spoil that.

- McReynolds: It was all right until you mentioned the modification.
- H.M.Jr: Oliphant, if Herbert wants to get out his skunk gun, it is all right, but I'll leave it to the two of you.
- Magill: You can win with an automobile, I notice, up in my country.
- H.M.Jr: All right. What else - Herman?
- Oliphant: Nothing.
- H.M.Jr: You handle it, Herbert?
- Gaston: Oh yes; yes, it's very interesting.
- Oliphant: The Executive Order was based on very clear
- H.M.Jr: Oh, it's just amusing. I read it.
- Oliphant: A grand strain to find something.
- McReynolds: You haven't heard anything from Jim Farley yet?
- H.M.Jr: I'm waiting to have him call up and congratulate me.
- Gaston: I've been getting oral opinions on this effect for the last two or three days; I'm very glad to have some support. We'll check with the technical staff opening. I think Mr. Marrs is going to Chicago this afternoon; I think I'll ask Schwarz to go with him.
- H.M.Jr: Good. I read the piece in the New York Times; I thought it was very good.
- Gaston: They had a nice editorial.
- H.M.Jr: Anything else?
- Gaston: The only other thing of importance I can think of is that this is Mr. Oliphant's birthday anniversary. I'm not a good singer.
- Oliphant: This has never been mentioned - nobody's birthday, to date, has ever been mentioned in here. It's

also Charles Burlingham's birthday.

H.M.Jr: (Shakes hands with Mr. Oliphant.)

(To Mrs. Klots:) Better send Mr. Burlingham a congratulatory telegram.

What other good news?

Gaston: I think that is all this morning.

H.M.Jr: I've been waiting for somebody to congratulate me on Cotton Ed Smith, and Jefty O'Connor.

Oliphant: What happened?

H.M.Jr: Olson didn't mention it, but he's leading the primary. Didn't we get that telegram? Did he let you know?

Upham: Yes, I'll take care of him.

H.M.Jr: All right.

Upham: It's sixth, I think it is.

H.M.Jr: Sixth? All right.

Magill: Who had charge of California for us? Was that Cy?

H.M.Jr: That is why Olson won.

H.M.Jr: George, when I go over those figures with you, do you want Bell present or not?

Haas: Yes. He assembled the figures; my contribution is just the picture making.

H.M.Jr: Are you available at 10:30?

Bell: Yes sir.

H.M.Jr: Will you come in at 10:30?

Bell: What figures are those?

Haas: Those estimates of what they are going to spend during the balance of the fiscal year, broken down by agency.

H.M.Jr: Mrs. Klotz says I have a ten-thirty; make it ten-thirty-five. All right with you?

Bell: Yes.

H.M.Jr: Anybody else interested in those figures? You are invited if you'd like to come. Rate of expenditures, is that it?

Haas: The expenditures by month, by agency, and the total for the rest of this year.

White: Will the total be available?

H.M.Jr: Got to take a look at it first; how do I know what they've got?

Bell: I don't think I've seen them.

Taylor: The pictures are fine; I don't know about the figures.

Bell: I question anybody's ability to make up figures by months, by agencies.

H.M.Jr: Well, let's take a look at it; if anybody's interested - ten thirty-five. Taylor?

Taylor: I'm interested, but I'm supposed to go to this Art Museum thing, which I think I'd better not do today.

H.M.Jr: Well, the meeting is at ten thirty-five, if anybody wants to come in.

Harry?

- White: A slight bit of information of passing interest: The Swiss bankers were privately extended a loan equivalent to about a hundred ten million dollars by the Chilean importers to purchase materials from the United States.
- H.M.Jr: Say that again.
- White: The Swiss banks seem to have a lot of funds available; have opened a line of credit to a maximum of a hundred ten million to be used for the purchase of materials for armaments to Italy. The credit is to extend to the Italian Government.
- H.M.Jr: Get a cable off to Cochran to confirm or deny that, will you, Taylor, for me? I greatly question it.
- Taylor: (Nods "Yes.")
- Lochhead: Didn't that come through Cochran? It was a foreign report. It was from one of the Embassies.
- H.M.Jr: Let's get Cochran to confirm or deny it. If that is true, it's very interesting.
- White: Our exports continue to decline this month.
- H.M.Jr: Exports?
- White: Exports, that is, for the first two weeks in August.
- H.M.Jr: Anything else?
- Lochhead: So far nobody's been trying to buy sterling in this market at all; it is just simply a pause in the selling. That is as far as it's gone.
- H.M.Jr: Cy?
- Upham: The Comptroller of the Currency has about fifty million dollars worth of securities for sale, belonging to closed banks, and his people, who are liquidating those securities are of the opinion that September and October would be a good time to sell substantial quantities of them. That, apparently, got out and he has a letter from the Treasurer of the Westinghouse Electric Company, saying that he thinks prices will be higher after the election, and they'd better wait to sell securities until then. He's not doing anything about it. He's in New York today looking it up.

- H.M.Jr: Who?
- Upham: Diggs. But it seemed to me, in our thinking about the Comptroller's Office, that particular activity ought to be tied in a little more closely with the Treasury.
- H.M.Jr: Are they Government securities?
- Upham: No; I don't know their composition. They are, most of them, probably industrials and municipals.
- H.M.Jr: Of course, if I was a Trustee for anybody, the way I'd act, I'd seldom dump large quantities. Offer them as they became available every day and not try to pick them out.
- Upham: They became available in great quantities when the banks failed to dump them all on the market at one time.
- H.M.Jr: But they wouldn't become available - they must have been available over a matter of months, or years.
- Upham: But during '31 and '32 there were a number of bank failures.
- H.M.Jr: I wouldn't. I'd spread it out.
- Upham: That is what they are doing. Now, they think, would be a good time to speed that up a little more.
- H.M.Jr: I still say, as a Trustee, I would sell, if I had fifty million dollars, I'd say, "All right, it's available; I'll sell five million a week for ten weeks, and average it out. I wouldn't try to take a day or a week or a month.
- Bell: Originally they notified us every day as to how many securities they wanted to sell and we tied that in with our Treasury program. It's been so long since they sold any, I guess they have forgotten that arrangement.
- H.M.Jr: Who's your contractor?
- Bell: *Myra* I guess *Stanger* handled that at that time. It ought now to be tied to Archie's office, I think.
- H.M.Jr: Anything else?

Upham: That's all.

H.M.Jr: Dan?

Bell: You've gotten all the information you want on the wheat subsidy?

H.M.Jr: A man told me he had all the information in his pocket and he forgot to give it to me.

Taylor: You'll have it this morning.

H.M.Jr: Where is it?

Taylor: I sent it in to you the first thing this morning.

H.M.Jr: He was so exhausted after walking home.....

Taylor: I was so weak I couldn't lift it out of my pocket.

H.M.Jr: Have you got all the information?

Bell: I think I've gotten most of it. If you want a little resume I can give it to you.

H.M.Jr: Why not after the ten thirty meeting, let's do it.

Bell: That's all right.

H.M.Jr: All right.

Mac, you've got some stuff accumulated, like Magruder.

McReynolds: I took that Magruder thing in and delivered it to Herbert, because he wanted to put something in the paper.

Gaston: He showed me the statement; I told him it was an entirely proper statement for him to make, but I'd question the propriety of his making it, calling the employees into his office and reading it to them as he did. What he wanted to know, since there's been so many rumors about it, should he not give it to the papers exactly as he read it to the employees, and I said he should.

H.M.Jr: The President said Magruder submitted it to the Treasury before he made that statement.

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- McReynolds: He came in and talked to Gibbons about it and Gibbons worked it out with him.
- H.M.Jr: But as far as we are concerned it's a closed issue?
- Haston: I think so; he's going to give it out to the papers. It's a perfectly clean statement.
- H.M.Jr: What about the T. V. A. marble business? How do I get ahold of that?
- McReynolds: I gave a copy of that to Neil Johnson yesterday morning before you got back.
- H.M.Jr: All right.
- McReynolds: You recall that Chief Usher Crim asked you to get a job for somebody over there. He told me this morning Richardson, who is the chap in the State Department who wants a job, and he told me he'd be delighted to accept the job I'd offered him. He's going in the course of the next two or three weeks, down as a storekeeper's job, down in Tampa, Florida.
- H.M.Jr: Let me write a letter to Crim and tell him I am very much pleased to do it for him. How's Mrs. Crim this morning?
- McReynolds: Fine.
- H.M.Jr: I'm glad she had the courage and thought it was only right.
- McReynolds: Space arrangements, as far as Bell's department, Bookkeeping, Warrants & Accounts, etc., will have, I think, space
- H.M.Jr: in 1940?
- McReynolds: They are gradually moving. Pretty nearly everybody on the third floor is shifting around in order to get the space. Incidentally, we moved a large group of Comptroller's people out of the building. It took a little while to convince them they were really going, but they are out. And Harper's office has been moved down on to the basement floor. There are reports that the division of the big room down on that end - moved it over. And we are spreading the thing out, so they will have

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good office space, and they are now actually out of the halls and it's not so bad, but as fast as those rooms can be fixed up - and Johnny Fox is doing it from day to day, and improving it every day, and in the next ten days, the movement will be completed.

H.M.Jr: Can you and I take a little look around and see?

McReynolds: I don't want to do it this morning.

Klotz: Sounds good.

H.M.Jr: How about the Clinic - Public Health Clinic?

McReynolds: They are building the space for them. As you like construction work you can go down and look at it now. You said before the first of January you wanted them out, but they will be located

H.M.Jr: Oh, NO. - the first of August.

McReynolds: You told me so far as the Clinic was concerned, you had to have their present space before the first of January.

H.M.Jr: Mac, that is a pure figment of your imagination.

McReynolds: Procurement is working on that thing. They had to rebuild the room in that old building where they are going, and that is under way.

H.M.Jr: And they are making my cuspidors bigger than they were yesterday.

McReynolds: That's all right - go right ahead and break it.

H.M.Jr: By January first! Mac, I don't think - Mac, now listen, when can I take a look at the new Clinic construction, and Mrs. Crim in her space? Did Budget get more room?

McReynolds: No, no we didn't bother the Budget.

(Telephone conversation with Gordon Rentschler at 10:06 a. m. attached.)

August 31, 1938.
10:06 a.m.

H.M.Jr: Hello.

Gordon Rentschler: Hello, Henry. Did you have a good holiday?

H.M.Jr: Fine. How are you? Hello.

R: Hello.

H.M.Jr: I say how are you?

R: Oh, I'm all right now. I'm fine.

H.M.Jr: Are you working?

R: Oh, yes. I'm on the job now, regularly. Loaf a little bit in the morning but ordinarily get here every day.

H.M.Jr: Well, the reason I'm calling you is this, I'm asking a few people to come down tomorrow night and talk over this international situation, see?

R: Yes.

H.M.Jr: And I wondered if you'd be available.

R: Oh surely, I'll come down.

H.M.Jr: Well, I'm not advertising the meeting.

R: Oh, no, I realize that.

H.M.Jr: And it would be seven-thirty at my house.

R: Seven-thirty at your house. I'll be delighted to be there, Henry.

H.M.Jr: Do you know where it is?

R: Well, it's the same place, isn't it?

H.M.Jr: Yes, 2211 - 30th Street.

R: 2211 - 30th Street.

H.M.Jr: Yes, and tell the taxi man it's off Massachusetts.

R: Yes.

H.M.Jr: So he doesn't take you over to the graveyard or over into Georgetown.

R: All right, Henry.

H.M.Jr: All right.

R: Well, I'll be there at seven-thirty.

H.M.Jr: O.K.

R: I don't suppose they're dressing.

H.M.Jr: Oh, no.

R: How did you find things over there? Lots to talk about.

H.M.Jr: Lots to talk about.

R: They're not so good.

H.M.Jr: Well, it - it's changed a lot since I left there, and I don't think it has got any better.

R: Yes, I'm afraid that's so.

H.M.Jr: Yes.

R: That's what our advices all say, and I don't like it. I'll be down Henry and be at your house at seven-thirty.

H.M.Jr: Right.

R: All right, fine.

H.M.Jr: Thank you.

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H.M.Jr: O. K.

McReynolds: Here is a letter to Ickes releasing the three million two from the Cost Guard. The only thing about that is that the boys have written into the letter a suggestion that if they want to give back the three million two, we've got contracts ready to sign and we can start spending it immediately.

H.M.Jr: Now listen, Mac, I'm going to hold this up, until I - when I get through with all these things, and with Bell this morning, and if Bell has time we're going to ask him to come in and I want to talk with Bell, this whole business about when does Ickes' money expire, how much has he okayed, as of the fifteenth of August, and how much has he at present. I don't want to be on record on something which, maybe after I've talked to the three of you, we may want to put something up to the President, as to the possibilities of having a dead-line. General Hines told me yesterday he had twenty-one or twenty-two hospitals. He said I got that when he heard he did the same thing for the Army. How many extensions has the President given me on the fifteenth of August?

Bell: Well, I don't know, but I think the President has given Ickes a general extension.

H.M.Jr: I think, as Secretary of the Treasury, and Director of the Budget, you and I ought to know. The question - it comes down to the question of a fiscal policy. If there is so much money unallocated, does the President want to consider the possibility of putting it away and not using it, and before I sign that, asking for additional money

McReynolds: You are not asking for additional money.

H.M.Jr: What am I doing?

McReynolds: Turning it back.

H.M.Jr: I thought you said I am asking for it back.

McReynolds: In view of the commitment made to Ickes when he made the three million two allotment, that we would turn this back, we are merely turning it back. I told the boys - they came in and found that Mr. Gibbons was wrong in telling you that they couldn't complete their arrangements to spend this money in

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the Coast Guard. As a matter of fact, on the fifteenth of August, all but about two thousand dollars — I said, "You can't do it; you can't. On Assistant Secretary Gibbons' recommendation, or statement, to the boss, he went and committed himself to Ickes."

H.M.Jr: What was the matter with Gibbons?

McReynolds: Well they didn't have the ways, about the tenth of July — they didn't have their titles clear, and you remember, Steve told you that — when you heard they had turned down Public Health on some allotments, Steve told you, "Here is three million two that Coast Guard can't possibly spend."

H.M.Jr: Did Ickes give us that for Public Health?

McReynolds: He did. You told him that you had asked him to give it to us for Public Health, so that actually we have now thirteen million two instead of ten million. We've got three million two for Public Health, plus that, for you would give him back an equal amount from Coast Guard. This is merely giving him back the three million two. In the course of giving him back the three two, you are merely reminding him that those contracts were ready in the Coast Guard, and are now ready if he wants to spend it, if it's available.

H.M.Jr: And are they going to finish Bethesda?

McReynolds: Yes. A million, hundred sixteen thousand on that (Brox) possibility, which was something I wanted to think about, but I think you're all right in signing that.

H.M.Jr: Well, I think Parran ought to be tickled.

McReynolds: Well, he was sore because he didn't get the seven.

H.M.Jr: Parran's sore! Tell him not to come around to me about it.

McReynolds: No, he really was glad. He thought he'd lost it all.

August 31, 1938

10:30 a. m.

Present:

Mr. Taylor
Mr. Bell
Dr. Haas

Dr. Haas: (Referring to attached charts) These are cash deposits and cash receipts and are not budgetary figures. To get some idea, the difference is on receipts. These total up to \$5,972,000,000, whereas the Budget is within \$5,000,000,000. But this is the type of things you need to indicate economic spending, irrespective of how the books are kept.

HM, Jr: Whether or not spending did cause the depression?

Dr. Haas: No. I think this may have been the proper thing to do, but while it was being done tightening should not have taken place at the same time.

HM, Jr: What is the red line?

Dr. Haas: Maybe I had better start with the black line. The black lines are the deficit or surplus. We put the surplus this way when there was an excess of receipts over expenditures, you have this line (pointing to chart). The red line is the 12-month average and the average put in the center month, so it ends here. (pointing to chart).

HM, Jr: Are these trial balloons?

Dr. Haas: Yes; estimates.

HM, Jr: These are estimates?

Dr. Haas: The July figure had not come in. Here was a trial balloon. See how it worked out? Did not quite make it. Here's on expenditures. They spent less than estimated.

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H^m, Jr: Which is the green?

Dr. Haas: Estimate. The difference between the two is the difference between the estimate and actual. Same thing down here: receipts were very close. Here you have a balanced basis, on cash.

H^m, Jr: Last September?

Dr. Haas: September and November.

Mr. Bell: The September income taxes gave you that. At that point.

Dr. Haas: Actually at that point he had a surplus, but he was looking at the red line, which puts us on an annual basis. And here is the pick-up in expenditures. Started about this period, which was the time it was balanced, and started going up and receipts started going down. That's the depression brought them down. So now, if these estimates work out, you are going up at quite a rapid pace.

This next chart, I have taken total expenditures and broken them down by agencies, so the sum of all these charts would equal this figure here. The first one is Works Progress, and here's Hopkins' trial balloon. He says he is going to spend an even \$170,000,000 a month. Then these balloons down here, the boys in Dan's office gave him another \$500,000,000 to carry him through the rest of the year. To do that means \$125,000,000 per month, so you don't know what is going to happen.

Mr. Bell: In the budget picture it isn't the case at all. These lines should come up and these should come down. In the budget we had 1 1/2 billion -- 1 billion 7 approximately -- appropriated to Hopkins and National Youth and then we had to put in something for the last five months, so we figured he would spend around \$175,000,000 a month throughout the 12 months, which made about 2 billion 2, so we put the difference in the supplemental items in the budget. Hopkins, however, took all his money available and divided it by seven, which is probably what he will obligate, but does not mean a cash expenditure.

This all was based on a maximum of 2,800,000 people

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and he now has 3,050,000 on the rolls. I asked Harrington why it was they were increasing their rolls when business is increasing so fast. He said, "It's unanswerable. I have tried to get Hopkins for the last three weeks to stop taking anybody and, he said, they won't do it."

Dr. Haas: From the standpoint of pure business stimulation, you still need a little -- not time to cut down.

HM, Jr: Not to cut down, but allow people to go off. They lose 5% a month as a turnover.

Dr. Haas: Now Ickes. Their estimates showed -- of course this is the most flexible; Hopkins goes down very quickly and up very quickly -- these estimates look as though they go up very quickly if he meets it, but in July he's off. The peak of it comes next year.

This is agricultural aid, including Commodity Credit Corporation, and what the way the boys handled C.C. C. was to estimate the net amount which would go out and they think this year it will be a total loss -- not total, but they feel there will be heavy losses on the cotton loan, which is really a net expenditure.

Mr. Bell: Just a subsidy.

HM, Jr: That's right.

Mr. Haas: Here they were above their estimate, but the explanation of that is they were slow in getting out payments for the last fiscal year and they carried over into this fiscal year. Jesse Jones got back more than he expected. What he ought to do is sell some of his own assets.

Mr. Bell: Sell some State securities, such as for the San Francisco Bridge.

Dr. Haas: Here's a sharp increase in trust accounts. Those include a lot of things -- Unemployment Trust Fund is there; Railroad Retirement, and District of Columbia, all that sort of thing.

Now, down here, here's interest -- these large

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quarterly payments, distorted picture. This is every other Government expenditure which is not included in any other charts, departmental mostly, and the bonus was put in here.

Now this chart, Mr. Secretary, is what might be used as a statistical control chart. For example, Works Progress estimated they would spend 1 billion 860 in July. You can see how they are coming pretty close to it; over here it gives you a closer picture of how much they are off. Here they were about 1% over. Same thing with Public Works. They are under. You can see exactly how much they are under. They are 15% under. R. F. C. is down.

HM, Jr.: I would keep it up. I think it is excellent.

Dr. Haag: It worked well in Farm Credit when you had 12 banks; kept them on their toes. This thing is statistically controlled on the basis of these three. In other words, you can't call anybody up when you see expenditures are going down, but for your own information you will know the deficit is working less than the estimate or that receipts at 3.9% higher than estimates.

HM, Jr.: But the deficit is about 17% less than the estimate.

Dr. Haag: Yes. Not the budget estimate, but the Departmental. We are having another chart on the Budget.

Mr. Bell: You don't have a monthly breakdown of the budget made on a yearly basis.

HM, Jr.: Well, we ought to make one.

Dr. Haag: You made one last year.

HM, Jr.: I would like to have one.

Mr. Bell: It isn't worth much. Those figures aren't worth much.

HM, Jr.: But it's better than keeping your head in the sand.

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Mr. Bell: Of course, we can have a much better estimate from the total standpoint than from individual agencies. Of course, I work these things out when I make the estimates and tie them in with the budget, but I would have to separate some of the stuff that does not go into the budget.

HM, Jr: Here is the thing I would like to do, George: (1) sometime within the next ten days or so, I would like to go before the President and say, 'Now, look. We are running along here now. We have July and August figures. Here's the thing. You want to keep this up at this rate or don't you? But I would like you to take a look at it and would like to bring it to your attention once a month.'

Mr. Taylor: These are your charts to talk over and I think George has given you the picture.

HM, Jr: I would like to say 'Mr. President, this is worth an hour a month and here's the picture. Now, what have you in your mind?' Well, Hopkins is taking on more people. Here are the employment figures. Do you want this thing to continue or do you want them to stop at this point?' That would be the one thing.

Now, what about Mr. Ickes. 'Up to date, so much under allotment. You have postponed so much more. Are you going to continue, as these things come in, to postpone?'

What's the deadline under the law for Ickes?

Mr. Bell: No applications after September 15th, I think it is.

HM, Jr: Will be accepted?

Mr. Bell: Yes. They can file any before Sept. 15th. Of course, he has more than 1 billion and they took that other date out -- the 15th of October. I will check that. They have plenty of time under the law.

HM, Jr: What I want to do -- he is extending these things every day and I will simply say 'Mr. President, take a look at these things. Even if you don't do any

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more, Ickes estimates -- he's just going to hit this thing up there. Haven't we got enough of that kind of stuff and don't you want to say right now no more approvals?' I mean no more extensions. 'Don't you want to stop making approvals?'

I think it is up to us. I would like to do it with him once a month and I would like to ask him 'Will you give us some time at Hyde Park; tell us when we could come up and we would like to put it before you.'

To make it simple for him, I think he ought to have Mr. Ickes there. Let's do it all right above board.

Mr. Taylor: Certainly better if they are there.

HM, Jr: And have Ickes and Hopkins there. With that in mind, I would be working on this thing. This figure proves that if we never voted any money, the expenditures started to increase without any additional appropriations. The point I am trying to get at, if the President had not voted any money to Mr. Ickes, if you would look over your business recovery period, you will find we began to turn the corner here in June.

Dr. Haas: June, 1938.

HM, Jr: Here. And that deficit figure had six months' head start. We asked for \$200,000,000 extra for Hopkins?

Mr. Bell: \$250,000,000.

HM, Jr: But the President only signed that bill the end of June, so this thing had nothing to do with all that and it is going to come exactly as I said it would and I want to show it to the President.

Mr. Bell: You said Ickes would not spend anything until after business recovered.

Mr. Taylor: Just what you said last Spring.

HM, Jr: You contended the one billion was not necessary.

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Mr. Taylor: These charts are just what you were saying last Spring.

HM, Jr.: That was my feeling and I have nothing to substantiate it.

The National Resources Board are crowding me. They want a fiscal authority set up, me as Chairman, Director of the Budget, Chairman of the Federal Reserve Board, and a member of the National Resources on. They want a fiscal committee. So what I want to do is this: I am going to see Franklin Delano and say, Here's this thing. You take a set of these charts and after you have seen them, I want you to make a recommendation, because the committee consists of Merriam, Dennison, a fellow named Ruml, and this economist David Cushman Coyle, Mitchell, and the fellow we had on cement, Blaisdell.

Mr. Bell: Ickes is one.

HM, Jr.: But he never attends. He doesn't know what's going on. So I want to know is this simply a bureau in Ickes' Department or an independent group, and before I tie myself up with you fellows, here is the thing; what would you do about it?

But I would like to ask the President. He will be at Hyde Park, he said, for ten days beginning the 8th. He might see us on the 11th, which would be a Monday. And I would like to lay this before him. We want half a day. And I think it's worth all of a half a day, and you, Haas, could have all the business charts. I don't mind, I would like to do it right out in the open. And we get the employment chart. I would just as lief show it to Ickes and Hopkins before we go up. My attitude would be, 'Here, Mr. President are the figures. What do you think?' Dan? You concur?

Mr. Bell: Yes, I do.

Mr. Taylor: As you say, while they may not be completely accurate, it certainly seems to me this is the most complete and easiest way of presenting the thing that we have seen.

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Mr. Bell: My point is, these estimates, you can't finance on this basis.

HM, Jr: Oh, no! No!

Mr. Bell: And I would say that this one of Ickes should be extended out here further, probably, which makes it worse, of course. But I think you will find, not as much as you did in 1933, but you will find that they are just forward one more month.

HM, Jr: Let's have our differences in the room before we go up to see the President and make it as near right as we can. In 15 minutes he can get this picture. He can simply say -- I am not going to force him -- he may say no; we are not ready. But does he know? Lots of times Hopkins goes ahead and does things, but the President does not know about it.

Could you, Bell, in view of this proposed interview, get for us a statement how much was let as of the 15th of August and, second, how much has the President postponed beyond the 15th?

Mr. Bell: Yes.

HM, Jr: And then next week we can have another dress rehearsal.

But I am very pleased with this, George. It's a swell job.

I can see from Bell's standpoint he could not make a budget and I could not finance it, but that is not what I want. I just want to get trends.

Dr. Haas: This total figure for agriculture adds up to this 1 billion 192 millions, agricultural aid.

HM, Jr: I said yesterday 1 billion 1. That does not surprise me. But that isn't enough, George. They need another billion!

Well, that's that! We will have another rehearsal next week.

Dr. Haas: This one you have not seen. You asked also to get expenditures and have them estimate employ-

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ment for each agency. The only way the boys in Dan's office could figure, to get comparable figures from each agency, was to estimate man months from each agency, so this is what this is. This is Works Progress and shows how many man months and also on the next one, which is Public Works and Civilian Conservation Corps and all other Government employees the curves will look just the same as the expenditure curves, but we are unable to give a true picture as one agency pays a lower average salary scale. It shows some information.

HM, Jr: If it is not so good, I don't want it. But I would like to lay this before the President -- let's see, that would be the 10th, 11th, 12th, the 12th of September, and that also would give us the first feel on how he feels on this whole thing. I would just as lief have Eccles there and would rather have Eccles do his talking there than in the papers.

Mr. Bell: Yes; that's right.

HM, Jr: Because I personally can't see how the National Resources Board fits into this thing, but let's see.

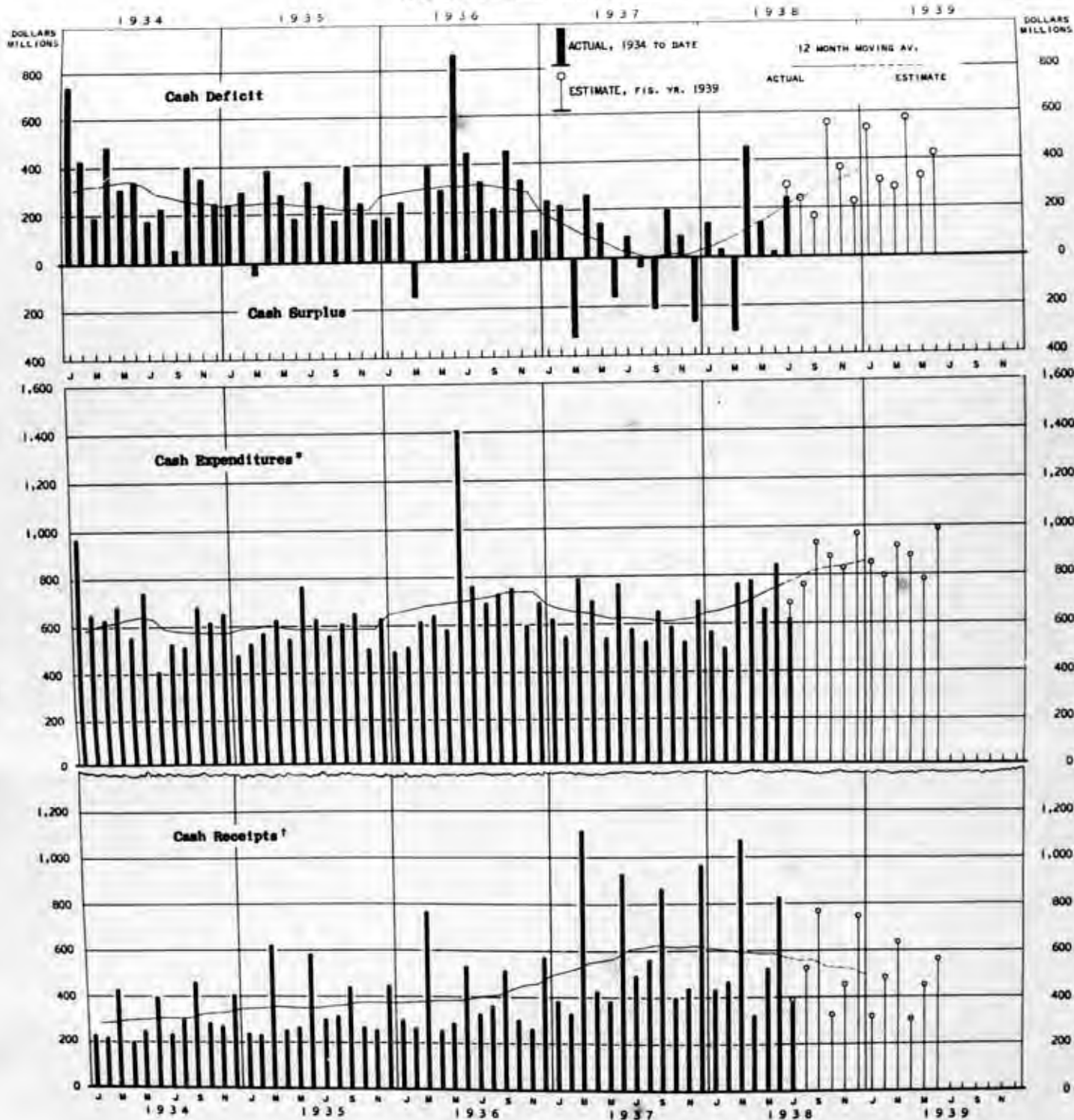
Mr. Bell: They are in almost everything. They figure that this whole economic picture fits into the resources of the country some place and they have got to have this whole picture in order to develop their program. In order to fix up a program, they have to know what the other branches are doing and how they are feeling. That's the way they feel about it.

HM, Jr: All right.

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NET CASH DEFICIT AND CASH EXPENDITURES AND RECEIPTS, MONTHLY
Daily Treasury Statement Basis

(With Twelve Month Moving Averages)

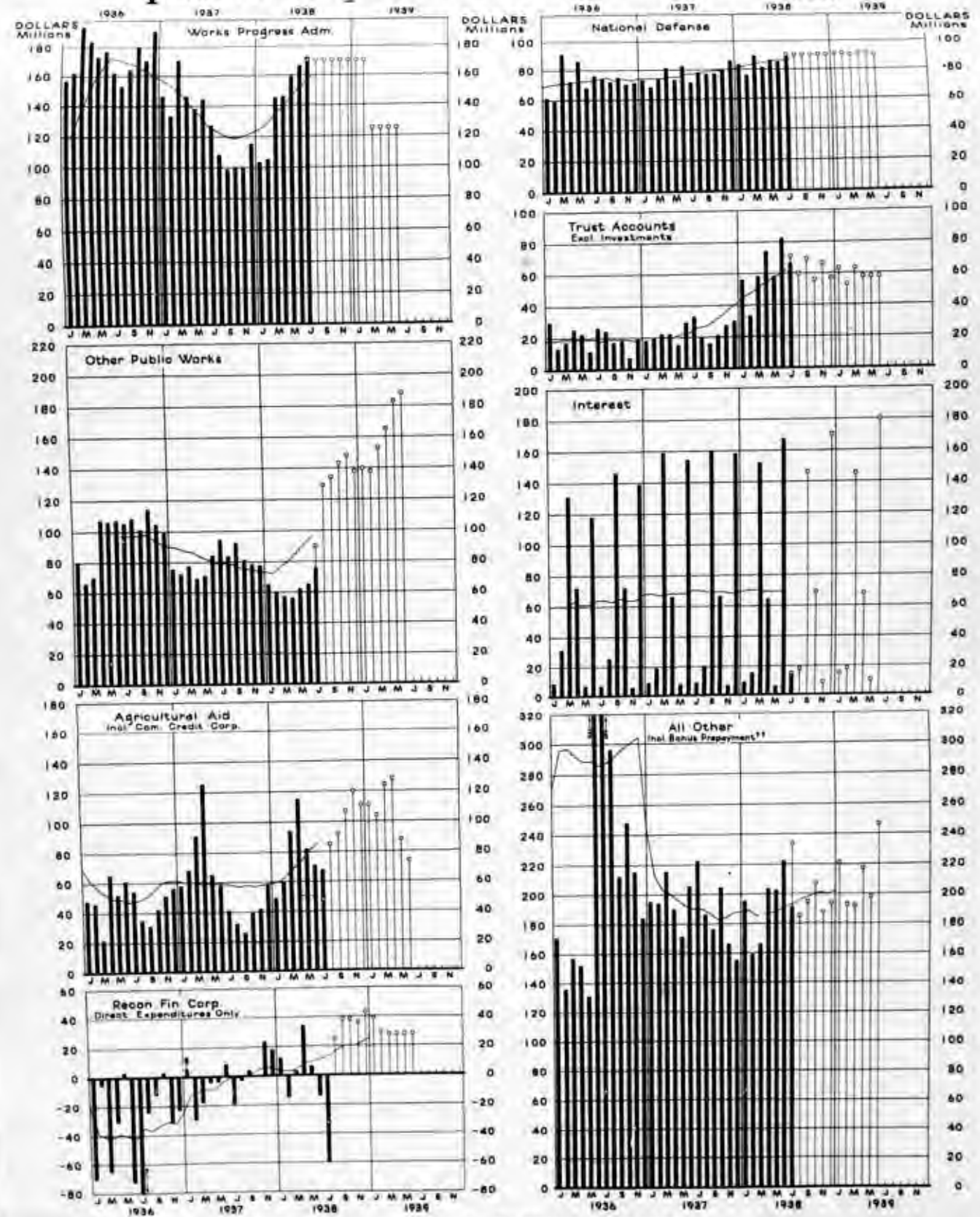


*EXCLUDES DEBT RETIREMENT AND BOOKKEEPING TRANSFERS TO TRUST ACCOUNTS. BONDS INCLUDED ON BASIS OF BONDS CASHED AND CHECKS PAID. ESTIMATES AS REPORTED TO ACCOUNTS AND DEPOSITS BY THE VARIOUS DEPARTMENTS AND AGENCIES, JULY 1938

†INCLUDES TRUST ACCOUNTS; ESTIMATE AS OF BUDGET SUMMATION, JULY 1938

MONTHLY FEDERAL CASH EXPENDITURES BY CLASSES

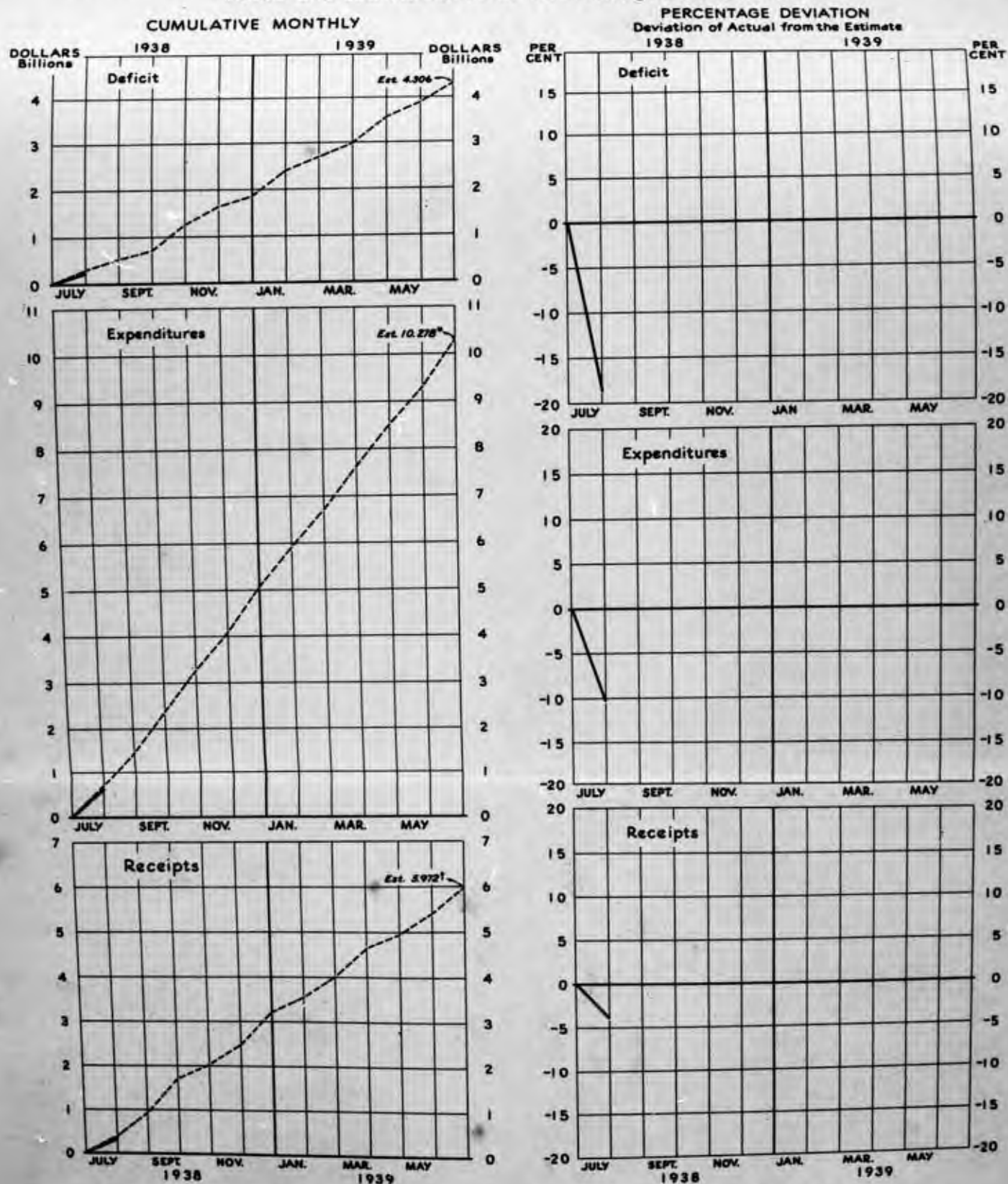
Actual, 1936 to date
Estimate for 1939*
12 Month Moving Av.
Actual
Estimate



* Excludes debt retirement and bookkeeping transfers to Trust Accounts
 ** As reported to Accounts and Deposits by the various departments and agencies, July 1938
 ** Bonus Bonds Cashied and Checks Paid

CUMULATIVE CASH DEFICIT, EXPENDITURES AND RECEIPTS

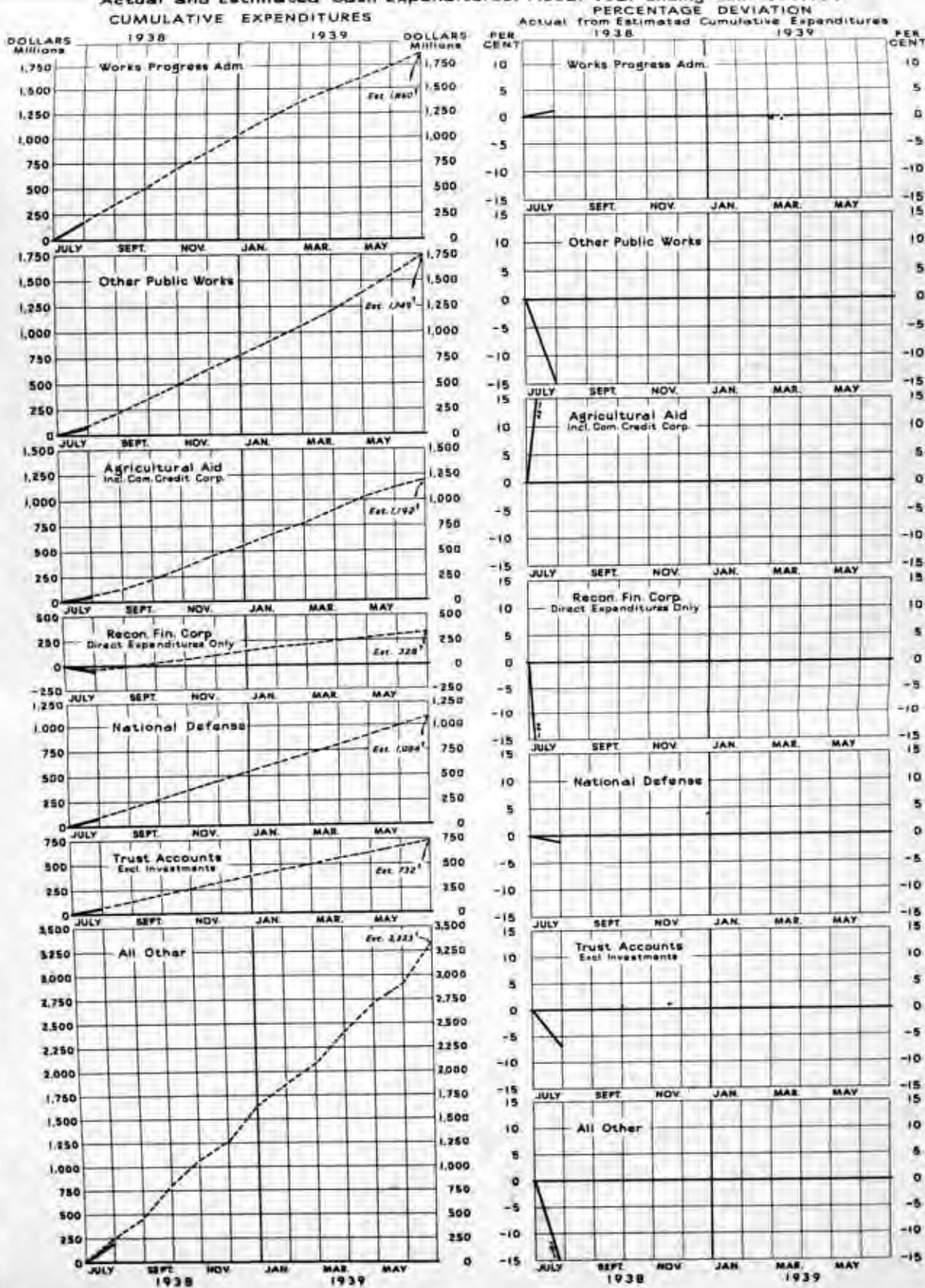
Actual and Estimated, Fiscal Year Ending June 30, 1939



*As reported to Accounts and Deposits by the various departments and agencies, July 1938. Excludes debt retirement and bookkeeping transfers to Trust Accounts.
 †Budget summation estimate plus Trust Accounts.

CUMULATIVE FEDERAL EXPENDITURES BY CLASSES

Actual and Estimated Cash Expenditures: Fiscal Year Ending June 30, 1939



¹ Excludes debt retirement and bookkeeping transfers to Trust Accounts
² As reported to Accounts and Deposits by the various departments and agencies, July 1938

WHEAT EXPORT POLICY

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SECTION 32 MONEY (DISPOSITION OF WHEAT)

August 31, 1938

(This is a continuation of the meeting of August 31, at 10:30, when Mr. Taylor, Mr. Bell and Mr. Haas were present to discuss various charts prepared by Mr. Haas. The same group remained for the following discussion.)

HM, Jr.: All right. Do you (Bell) want to talk about this?

Mr. Bell.: If you want me.

HM, Jr.: Please.

Mr. Bell.: There is available in 1939 for Section 32 purposes, \$144,000,000 and there was reserved out of that for a cotton subsidy \$65,000,000, leaving a balance of \$79,000,000. In July, just before I left, Wallace went to the President and outlined a program for operating under Section 32, most of which is around relief purposes. It's going to take all surplus stuff off the market and turn it over to relief agencies. So we gave him \$74,000,000 of the \$79,000,000. We still have \$5,000,000 in reserve.

While all the discussions that we had were around relief purposes, the letter of the President, in turning it over to Wallace and telling him to go ahead on the program, did not confine it to relief. So he has \$74,000,000 for general purposes under Section 32 not confined to any one section.

They have now, I don't know how much Surplus Commodity Credit Corporation has, a balance, but they have on our books upstairs \$40,000,000 on requisition and they have with our disbursing officer \$4,000,000, or a total of \$44,000,000. And Surplus Commodity Credit has more than \$12,500,000 balance, I know, because Jump told us yesterday that the Secretary was drawing back from that Corporation \$12,500,000 to be used in connection with this wheat subsidy.

What they are going to do now is have the Corporation borrow \$30,000,000, which has already been approved

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by R. F. C., from R. F. C. and use that as a revolving fund to buy wheat and, as I understand it, the Corporation will get some broker or brokers to sell this wheat on the world market outside of the United States and if there is any loss or any difference between what the Corporation pays and what it sells it for, why it will be made up out of Section 32 money. The reason they are using the Corporation is because the Corporation can act as a revolving fund. Whenever they sell the wheat, the proceeds will come back into the Corporation, but if Section 32 money bought the wheat and sold it, the receipts would have to come back into the Treasury and could not be used again. So all Section 32 loses is the loss -- makes up the loss and the other can revolve and revolve. That's just about the story.

HM, Jr: I see. I see. I misunderstood what Taylor said. What I was all excited about was I figured they had used up all the Section 32 money and were committing us for Section 32 longer than July 1, 1939. Taylor says I am wrong.

Mr. Taylor: They tentatively allocated it, but then changed it.

HM, Jr: That's their business. But I was thinking they were borrowing the money with the expectation that Congress would vote it for them -- make it available after July 1, 1939. That is what I was excited about. And you would be too!

Mr. Taylor: Right!

Mr. Bell: The Corporation is a Delaware Corporation and in its charter has almost everything except the kitchen stove.

Mr. Taylor: They have every power in the world except to order out the Army and Navy.

Mr. Bell: And I don't believe Herman Oliphant will find anything wrong. The Solicitor of Agriculture and the General Counsel of R. F. C. and the Attorney General have all passed on it.

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HM, Jr: That's a different thing. I misunderstood.

Mr. Bell: I think it is all right. From the standpoint of Wallace's authority, it is all right.

HM, Jr: Is he going to publish how much he loses?

Mr. Bell: That will come out eventually. In the Budget eventually. Here's a pretty good press statement on it.

HM, Jr: I have it. What else?

Mr. Bell: That's all.

HM, Jr: All right. We'll call it quits.

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INFORMATION FOR THE PRESS

United States Department of Agriculture Agricultural Adjustment Administration

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Release - Immediate

August 29, 1938.

ACTING SECRETARY WILSON ANNOUNCES 1938-39 WHEAT EXPORT POLICY

Acting Secretary of Agriculture M. L.

Wilson announced today a wheat and flour export sales policy for the 1938-39 marketing season, designed to enable United States wheat farmers to maintain their share of the world export trade.

The export sales policy is expected to result in United States exports during the current season of approximately 100 million bushels. The export plans fit into the general wheat program of the AAA. They supplement the acreage allotment provisions of that program, and in no way replace the need for production adjustment measures.

The United States policy will be made effective through purchases by the Federal Surplus Commodities Corporation from domestic producers and others and resale to exporters, with losses on these resales, if any, to be made up from Section 32 funds, which sets aside an amount equal to 30 percent of the customs receipts for programs for the removal and disposal of farm surpluses. The FSCC has arranged to borrow \$30,000,000 from the Reconstruction Finance Corporation, and this sum will be used as a revolving fund in the exporting operations. First purchases were made on August 27. In the actual sale of the wheat the FSCC plans to pursue a merchandising policy similar to that which has been adopted by the Canadian Wheat Board. In carrying out the program, the facilities of the regular wheat and flour trade, including farmer cooperatives, will be used.

308-39

- 2 -

"The wheat export program announced today has been adopted as a necessary means of meeting a special situation," Acting Secretary Wilson said. "That situation is the fact that, up to the present, the major exporting nations are not cooperating in a general program for meeting the world wheat surplus problem.

"The program will also supplement the 1939 AAA wheat acreage allotment in bringing about a better balance in the wheat supply situation. The United States crop this year is now estimated at 956 million bushels, the second largest crop on record. The supply, including the carryover of 154 million bushels, is estimated at 1,110 million bushels, the largest supply this country has had since 1932-35. The estimated world crop is the largest on record.

"This export program does not remove any of the necessity for wheat producers to work through acreage allotments to bring about a better balance in the wheat supply situation. Even with wheat exports of 100 million bushels, the United States wheat carryover on next July 1 may exceed 300 million bushels.

"This export program is for a specific limited objective of 100 million bushels. This is all that the program aims to do. Exports of 100 million bushels would be approximately 18 percent of the estimated world trade in wheat for this season. This compares with about 20 percent of the world trade that the United States obtained during the past season and with an average share in world wheat exports of approximately 25 percent during the years 1920 to 1929."

Operation of the Program

In the actual operation of the program an offer and acceptance method will be used, under which exporters of wheat and flour will make offers for wheat or flour based upon the prices prevailing in the export market. These offers may be less than the domestic price paid for the wheat by the FSCC. The difference between the resale price of wheat or flour to exporters and the price paid to domestic holders, will come from Section 32 funds.

It is impossible to determine how much per bushel will be required to move the wheat into export, as this will depend upon the price of wheat prevailing in this country and the price at which it can be exported.

Types of wheat exported will depend almost entirely upon demand. There are adequate supplies of all types of wheat in the United States this year. Normally, United States wheat exports are comprised chiefly of hard red winter wheat produced in the Southwest, soft white wheat produced in the Pacific Northwest, and durum, produced chiefly in the Dakotas and Minnesota.

The program will operate entirely in cash wheat and it is not contemplated that any wheat will be bought or sold on the futures contract markets.

Wheat will be purchased by agents of the FSCC in various parts of the country, and will be sold to exporters ready for loading for ocean shipment. Such purchases will be made in various parts of the country, the offers of exporters are all to be made to the office of the Corporation in Washington, D. C., and offers will be accepted in the Washington office.

The program will be under the immediate direction of F. R. Wilcox, director of the AAA Division of Marketing and Marketing Agreements and Vice President of the FSCC; and J. W. Tapp, Assistant Administrator of the AAA and President of the FSCC.

"The Federal Surplus Commodities Corporation will purchase wheat and flour at the interior or at ports," Mr. Wilcox said. "Offers to export will then be received from exporting firms, including flour millers; and the Corporation will accept or reject individual proposals. In each instance the exporter of either wheat or flour will be required to conduct his operations under a bond which will guarantee exportation of the wheat or flour purchased from the Federal Surplus Commodities Corporation.

"In the case of flour, it is expected that the millers will obtain outlets for their flour in the usual way and then arrange for sale and repurchase for export with the Corporation to fill such business as can be obtained upon terms satisfactory to the millers and to the Corporation. It is anticipated that the Federal Surplus Commodities Corporation will be in the market continuously for an indefinite period for the purchase and resale of both wheat and flour."

Federal Surplus Commodities Corporation
Summary of Commodities Procured -
July 1, 1937 to August 31, 1938

(Figures in thousands)

Commodity	Unit	7/1/37	5/12/38	5/19/38	5/26/38	6/2/38	6/9/38	6/16/38	6/23/38	Total fiscal year ending 6/30/38*	7/1/38	7/7/38	7/14/38	7/21/38	7/28/38	8/4/38	8/11/38	8/18/38	8/25/38	Total 7/1/38 to 8/31/38
		to 5/11/38	to 5/18/38	to 5/25/38	to 6/1/38	to 6/8/38	to 6/15/38	to 6/22/38	to 6/30/38		to 7/6/38	to 7/13/38	to 7/20/38	to 7/27/38	to 8/3/38	to 8/10/38	to 8/17/38	to 8/24/38	to 8/31/38	
Apples (Dried)	Pounds	14,774	-	-	-	-	-	-	-	14,557	-	-	-	-	-	-	-	-	-	-
Apples (Fresh)	Bushels	5,658	2	-	-	-	-	-	-	5,625	-	-	-	-	-	-	-	-	-	-
Autocots (Dried)	Pounds	2,990	-	-	-	-	-	-	-	2,990	-	-	-	-	-	-	-	-	-	-
Beans (Dried)	Pounds	53,840	100	2,090	60	-	-	-	-	56,800	-	-	-	-	-	-	-	-	-	-
Beans (Snap)	Bushels	-	-	9	6	-	670	120	1,200	33	5	4	8	9	3	4	1	1	1	36
Beets (Fresh)	Bushels	-	-	-	-	-	-	-	-	11	6	7	18	13	9	5	6	5	5	74
Butter	Pounds	9,992	514	665	1,451	1,734	687	192	8	15,035	6	7	18	13	9	5	6	5	5	74
Cabbage	Bushels	676	214	38	58	3	-	-	-	990	26	40	31	45	62	36	30	66	81	437
Cane syrup	Gallons	-	-	-	-	-	-	54	133	237	107	-	-	-	-	-	-	-	-	107
Carrots	Bushels	-	-	-	-	-	-	-	-	-	1	2	11	7	7	6	7	10	12	63
Celery	Crates	193	3	-	-	-	-	-	-	196	-	-	-	-	3	11	7	3	2	26
Cereal (Whole wheat)	Sacks	-	-	-	-	-	-	-	408	408	-	-	-	-	-	-	-	-	-	12
Cheese	Pounds	-	-	-	-	-	-	-	3,446	3,446	-	-	-	-	-	-	-	-	-	17
Corn	Sacks	-	-	-	-	-	-	-	-	-	-	-	-	-	-	1	4	3	-	8
Cotton fabric	Yards	656	92	-	-	236	-	12	129	1,133	-	-	-	-	-	-	10	49	1	60
Cottonseed oil	Pounds	9,780	-	-	-	-	-	-	-	9,780	-	-	-	-	-	-	-	-	-	16
Eggs (Shell)	Cases	270	-	-	-	-	-	-	-	270	-	-	-	-	-	-	-	-	-	17
Fish	Pounds	-	-	-	-	-	-	-	3,677	3,677	-	-	-	-	-	-	-	-	-	18
Flour	Barrels	-	7	3	125	-	915	-	1,649	2,699	-	-	-	-	-	279	-	-	-	279
Maplefruit	Boxes	272	48	38	42	19	10	-	-	401	-	-	-	-	-	-	-	-	-	20
Maplefruit juice	Cases	-	5	-	-	-	-	444	52	552	-	-	-	-	-	-	-	-	-	21
Maples	Tons	8	-	-	-	-	-	-	8	8	-	-	-	-	-	-	-	-	-	22
Milk (Dry skim)	Pounds	8,642	-	-	7,940	-	-	5,000	-	21,582	-	-	-	-	-	-	-	-	2,681	2,681
Milk (Fluid)	Quarts	9,013	482	495	478	497	510	514	511	12,497	497	515	523	528	525	538	530	531	522	4,709
Onions	Pounds	3,000	-	-	-	-	-	-	-	3,000	-	-	300	25	8	11	22	16	12	394
Oranges	Boxes	1,730	50	31	14	10	11	54	57	1,932	2	46	59	57	38	46	49	55	50	404
Paper bags	Bags	8,175	-	-	8,400	-	-	5,250	-	21,825	-	-	-	-	-	-	-	-	-	27
Peaches (Dried)	Pounds	2,534	-	-	-	-	-	-	-	2,534	-	-	-	-	-	-	-	-	-	28
Peaches (Fresh)	Bushels	-	-	-	-	-	-	-	8	8	2	4	-	-	-	-	-	-	-	6
Pears (Fresh)	Boxes	318	-	-	-	-	-	-	-	318	-	-	-	-	-	-	-	-	-	31
Peanut (Canned)	Cases	927	-	-	-	-	-	-	-	862	-	-	-	-	-	-	-	-	-	31
Peanut (Dried)	Pounds	6,000	-	-	-	-	-	-	-	6,000	-	-	-	-	-	-	-	-	-	32
Peanut (Fresh)	Bushels	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	-	3	-	3
Potatoes (Sweet)	Bushels	440	-	-	-	-	-	-	-	440	-	-	-	-	-	-	-	-	-	33
Potatoes (White)	Bushels	4,331	7	-	-	-	2	-	-	4,315	-	466	483	120	44	167	266	142	219	1,907
Potato starch & fl.	Pounds	2,842	-	-	-	-	-	-	-	2,562	-	-	-	-	-	-	-	-	-	36
Prunes (Dried)	Tons	24	-	-	-	-	-	-	31	55	-	-	-	-	-	-	-	-	-	37
Prunes (Fresh)	Tons	-	-	-	-	-	-	-	15	15	-	-	-	-	-	-	-	-	11	38
Rice (Milled)	Pounds	75,990	560	1,000	1,600	-	900	-	-	73,190	-	-	-	-	-	-	-	-	-	39
Tomatoes	Pounds	-	-	-	-	-	-	-	-	5,300	-	-	-	-	-	-	-	-	-	40
Tomatoes (Canned)	Cases	50	-	-	-	-	-	-	-	50	-	-	-	-	-	-	130	25	-	145
Tomatoes (Fresh)	Bushels	-	-	-	-	-	47	170	64	282	3	-	-	1	-	7	12	22	-	73

U.S. Navy Department, Division of Research and Statistics.

September 2, 1938.

Weekly figures reported by Federal Surplus Commodities Corporation are based on telegraphic reports and are unrevised. Fiscal year totals have been revised to include all contract cancellations and other adjustments.

August 31, 1938

5:20 pm

Steve Early called up and said that the United Press said they had a hot tip that I am resigning to head up some movement. He said, "What is there to it?" and I said, "I don't know anything about it. It's furthestmost from my mind." He said, "Well, I will deny it with both feet."

August 31, 1938.

MEMORANDUM FOR THE SECRETARY:

In accordance with your request yesterday, I have gone over with Mr. Graves the matter of completing the decentralization of the tax-settlement work of the Bureau of Internal Revenue along the lines of the experimental installation made under your instructions at Los Angeles effective March 1.

Three field divisions have now been established, as follows:

Divisions:	Area	Personnel assigned	Proportions of total business	Date established
Pacific	California, Oregon, Washington, Idaho, Montana, Utah, Nevada, Arizona, Alaska, Hawaii	73	14%	July 1, 1938
New York	New York State	106	21%	Aug. 1, 1938
Chicago	Illinois, Indiana, Wisconsin	68	11%	Sept. 1, 1938
	Total	247	46%	

The Pacific Division has complete jurisdiction of all contested cases after protest against the decision of the internal revenue agent in charge. The New York and Chicago Divisions have jurisdiction only of cases appealed to the Board of Tax Appeals. They will assume complete jurisdiction on January 1, 1939.

Holting has developed in the operations under the new system to alter my original opinion that the plan is a sound one, and greatly superior to the old arrangement. Those who are responsible for the work on the Pacific Coast and in New York are confident that it will (1) expedite the closing of cases; (2) be more convenient and less expensive to taxpayers; (3) lose no revenue justly due the Government; and (4) add nothing to administrative costs. I occur in these conclusions.

The plan has been well received by the public and has been widely and favorably commented upon as a forward step in tax administration. I believe that we are warranted in proceeding with the installation of the system in the remaining sections of the country as rapidly as the necessary arrangements can be made. As I have said, the New York and Chicago Divisions will assume complete jurisdiction over cases in their respective territories on January 1, next, and Mr. Graves advises me that, if a decision is reached promptly, it would be entirely practicable, from an administrative point of view, to begin the establishment of the necessary additional divisions at that time, and complete the program by June 30. I hope that this can be done.

Mr. Graves has supplied me with a schedule showing the additional divisions which would be necessary, the relative amount of business falling in each one, the approximate personnel which would be required, and the date when it could be practicable to set up each division, as follows:

Division	Area	Estimated personnel	Proportion of total business	Date to be established
Cleveland	Michigan, Ohio, Kentucky	56	10%	Jan. 1, 1939
New England	New England States	34	6%	Feb. 1, 1939
Philadelphia	Pennsylvania, New Jersey	66	12%	Mar. 1, 1939
Texas	Texas, Louisiana, Mississippi	39	6%	Apr. 1, 1939
Atlanta	South Carolina, Florida, Georgia, Alabama, Tennessee	25	4%	May 1, 1939

Memo. for the Secretary-3

Division	Area	Estimated personal	Proportion of total business	Date to be established
Middle Atlantic	Delaware, Maryland, District of Columbia, North Carolina, Virginia, West Virginia	40	7%	May 1, 1939
St. Paul	Iowa, Nebraska, North Dakota, South Dakota, Minnesota	25	4%	June 1, 1939
Kansas City	Arkansas, Oklahoma, Missouri, Kansas, New Mexico, Wyoming, Colorado	30	5%	June 1, 1939
	Total	311	54%	

I feel strongly that when these additional field divisions are established they should be given jurisdiction immediately over all contested cases, whether before or after petition to the Board of Tax Appeals, as was done in the case of the Pacific Division.

In view of the importance of an early decision, I would suggest that promptly upon Commissioner Belvering's return we arrange a conference with him for the purpose of discussing the completion of the decentralized plan along the lines proposed.

ENG/mff

Under Secretary.

TREASURY DEPARTMENT

INTER OFFICE COMMUNICATION

DATE August 31, 1938

TO Secretary Morgenthau

FROM M. A. Harris

3:45 P. M.

U. S. Treasury bonds remained firm throughout the morning but during the noon hour prices turned lower, with the longer issues leading the way. At the official close of the market losses ranged from 2 to 8/32nds but right after the close a better tone developed and I understand that at the moment prices have improved 1 to 4/32nds so that losses for the day range from 2 to 4/32nds for the short and intermediate issues and from 4 to 6/32nds for the longer issues.

Mr. Matteson stated that as far as he could find out the weakness was due more to potential sellers than to actual sales and at the same time practically no buying interest was shown in the market.

Treasury notes remained generally quiet with prices at the close 1 and 2/32nds lower.

August 31, 1938

HM, Jr called the President this morning at 9:30.

The President said, "How are you?" and Mr. Morgenthau said, "Fine!"

The President then said, "What's new?" and HM, Jr replied, "I have a little news this morning. We put Sterling to bed last night at 4.86. It broke through 4.86 this morning. It went down early to 4.85, but since then it has come back to 4.85 $\frac{1}{2}$ and the feeling seems to be a little bit better. For whatever it is worth, I just thought I would pass it on to you."

Continuing, HM, Jr said to the President, "Moffett was kind enough to send me Kennedy's cable, which is an interview with Chamberlain. It is pretty pessimistic. I guess it is on its way over to you."

"I am having my crowd get all these exchange regulations ready," he told the President, "so that if we should push the button in case there was war and want to put in exchange control, I want to be ready at a moment's notice. If we had war and they started dumping \$50,000,000 a day on us, we want to be ready to do something to stop it."

At this point the President said, "As I said yesterday, in the event of war it would help if outside of our general statement they could send us money for their own use to buy things from us -- a purchasing kitty -- that would not appear anywhere else." The Secretary answered, "I am working on it."

Continuing his remarks, the President said, "Psychologically it would have a great effect in Germany, Italy and Scandinavia if they had their own accounts over here, not in the general fund, and marked for use to buy general supplies, wheat, cotton, etc."

The Secretary then remarked, "I invited General Craig to come over here tomorrow, because I want him to know a little bit about our problems and discuss some of his problems, such as what raw materials they would be short of which came from overseas." The President commented, "I am not worried much about that. Most of the

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raw materials come from places where we can get them without any trouble; in other words, from friendly countries. It might be possible, for instance, using Commodity Credit Corporation, to have them pay us in raw materials."

The Secretary concluded the conversation by saying, "What I am doing here -- I think the situation is serious enough so that we should all be on our toes."

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Meeting in the Secretary's Office, 2:00 p.m., Wednesday,
August 31, 1938.

Present: Secretary Morgenthau, Assistant Secretary Taylor,
Messrs. Oliphant, Lochhead, Cairns, Bernstein, and
White.

The meeting was held in accordance with the Secretary's request made at the 9:30 staff meeting that some proposal be drafted to carry out the President's suggestion with respect to making it possible for a "kitty" to be set up in this country by certain foreign governments.

Mr. Oliphant presented three proposals: the first making provision for extension to the original members of the Tripartite Accord of certain privileges with respect to the withdrawal of earmarked gold and the sale of that gold for dollars and use of the dollars for purchasing of goods needed in war times, other than arms and ammunition. The Secretary had several comments and suggestions to make with regard to the draft.

The second draft contained the proposal suggested by Mr. Taylor, which would set up special accounts for specified governments with the Export Import Bank to be used for the purchase of materials. The Secretary commented on the relative merits of each proposal.

A third paper presented to the Secretary was a proposal to invoke Section 338 of the Tariff Act against German imports, the fact of discrimination already having been declared by the President on previous occasions as indicated in the draft. The Secretary said he did not think it ought to be handled that way, but that it might be an excellent thing for the President to reveal to the German Government that they would invoke Section 338 of the Tariff Act if Germany resorted to force or entered Czechoslovakia. The rest of the men agreed with the Secretary that would be much the better way of handling it.

The Secretary requested that the men work over the drafts and prepare them in form of a proclamation or statement. He said since time was of the essence it had better be done as soon as possible. The hour was set for 3:30 for the presentation of the next drafts and the Secretary telephoned the President and obtained an appointment for four o'clock.



THE SECRETARY OF THE TREASURY
WASHINGTON

Aug 21

1st draft

2.00 P.M.

215

MEMORANDUM FOR THE PRESIDENT:

Responding to your request for an arrangement for a "kitty" to be held by certain foreign governments in this country, to be used in the event of war, obviously one of the most effective things which you could do at this juncture to prevent the impending catastrophe of war would be the immediate announcement of your intention to seek a change in the Neutrality Act, permitting you to discriminate among belligerents in order to carry out the purposes of treaties to which the United States is a party. As further steps in this direction we could do the following new things without further congressional action:

(1) Announce an arrangement among the three original parties to the Tripartite accord under which each government would be assured that the gold which it had on earmark in another country could be freely withdrawn and exported at any time.

(2) That such gold could be freely converted into the currency of the country in which the gold is earmarked for purchasing any supplies useful during a war other than arms and ammunition.

(3) If desired, we could go further and provide that, for a limited time and for the limited purpose stated in (2), the gold could be converted into currency of the country in which the gold is ear-

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marked at the rate between that currency and gold prevailing today, or, if earmarked hereafter, at the rate prevailing at the time of earmarking.

If preferred, the United States could do any or all of these three things, acting alone.

In addition to all the foregoing or in the alternative, we could, acting alone, arrange for any nation we selected to have an account in the Export-Import Bank and by this means do all the things mentioned in (1), (2) and (3) above.

Aug 31, 1938
2. P.M.



THE SECRETARY OF THE TREASURY
WASHINGTON

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MEMORANDUM FOR THE PRESIDENT:

You can forthwith proclaim the imposition of additional duties of 50% ad valorem on the products of Germany and on articles imported in German vessels. These additional duties would go into effect in thirty days. You have already repeatedly proclaimed the fact on which this act would rest. The law and the situation are as follows:

Section 338 of the Tariff Act of 1930 (U.S.C. title 19, sec. 1338) provides that, whenever the President shall find as a fact that any foreign country discriminates against the commerce of the United States, he shall, when he finds that the public interest will be served thereby, impose additional duties not to exceed 50% ad valorem, or its equivalent, on any products of such discriminating country or on articles imported in a vessel of such country. Such additional duties will be applied thirty days after the date of the proclamation.

If the foreign discrimination continues after the issuance of a proclamation imposing additional duties, the President may issue a further proclamation prohibiting the importation after thirty days from the date of the proclamation of products of the discriminating country or articles imported in its vessels.

The Trade Agreements Act of 1934 (U.S.C. title 19, sec. 1351) provides that rates of duty established pursuant to trade agreements shall apply to products of all foreign countries, but that the President may suspend their application to the products of any

- 2 -

country because of its discriminatory treatment of American commerce. Pursuant to this provision of law, you advised me in a letter dated December 2, 1935, published in Treasury Decision 48035, of December 3, 1935, and in several subsequent letters which were also published in Treasury Decisions, that you found as a fact that Germany discriminates against the commerce of the United States, and that trade-agreement rates, therefore, should not be applied to products of Germany.

Under present conditions, it would be competent for you to determine it to be in the public interest, in view of the already ascertained discriminatory treatment of American commerce by Germany, to impose the additional duties provided for in section 338 of the Tariff Act of 1930 mentioned above.

The Export-Import Bank has today opened special accounts for the Governments of _____ and _____ . Through these facilities the governments of these countries will be enabled to convert into dollars the proceeds of gold on earmark for their accounts in this country and to utilize the amounts standing to their credit with the Export-Import Bank for the purchase of various raw materials and finished products which these nations may wish to acquire in this country.

In addition, the Export-Import Bank will be authorized to arrange for the export of gold now or hereafter placed under earmark by these governments; for the conversion of such gold into dollars for making the purchases mentioned above; and for a period of a year to arrange for the sale of such gold at the Treasury buying rate prevailing today, or if the gold is earmarked hereafter at the Treasury buying rate prevailing on the date such gold is earmarked.

Tripartite Document

TREASURY DEPARTMENT

Washington, D. C.

FOR IMMEDIATE RELEASE.

1938.

By authority of the President, the Secretary of the Treasury makes the following statement:

Supplementing the arrangements which have been made in pursuance of the Tripartite accord, the Government of the United States has advised the British Government and the French Government of the following additional steps which this Government is taking in order to carry out one of the fundamental objectives of the Tripartite accord, namely, "to foster those conditions which safeguard peace and will best contribute to the restoration of order in international economic relations":

1. Great Britain and France will be allowed at any time freely to withdraw or to export any gold which either of such governments, directly or through any agency designated by them, holds under earmark in this country.

2. This Government will at any time desired by Great Britain and France purchase such gold with dollars at the rate specified in Section 42 of the Provisional Gold Regulations issued under the Gold Reserve Act of 1934, for the purpose of enabling Great Britain and France to utilize the dollars thus obtained to purchase supplies in this country.

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3. The United States will also, for the limited purpose stated in item No. 2 above, and for such period of time as may be fixed by the United States for consummating any purchase for which any such credit is established, purchase the gold thus earmarked by the governments of Great Britain and France in this country at the rate now stipulated in Section 42 of the Provisional Gold Regulations, and, for such gold thus earmarked hereafter, at the Treasury buying price for gold prevailing at the time of the earmarking of the gold.

August 31, 1938.
2:47 p.m.

Admiral Peoples: How do you do, Mr. Secretary?

H.M.Jr: Hello, Admiral.

P: How do you do, sir?

H.M.Jr: How are you?

P: Oh, fine. I'm glad to get back in harness again.

H.M.Jr: Admiral.

P: Yes, sir.

H.M.Jr: Two things.

P: Yes, sir.

H.M.Jr: Mrs. Morgenthau and Mrs. Roosevelt have interested themselves in the landscaping for the Poughkeepsie post office.

P: Yes.

H.M.Jr: Some man came - locally came to see Mrs. Roosevelt and he said he didn't have an - didn't have enough time, or enough information to bid. I think the bids are in now. I wish you'd look into it and hold it up long enough until I get the facts.

P: Absolutely, sir.

H.M.Jr: See?

P: Yes, sir.

H.M.Jr: He said that the local people haven't had a chance, that there wasn't enough advertisement, and Mrs. Morgenthau has mailed the stuff to me, but I didn't by any chance want it let until I got the facts. I ought to have them tomorrow.

P: Yes, sir.

H.M.Jr: That's number one. Number two - I have a letter from Arthur Carpenter who used to be manager of the Warm Springs Foundation, and he has - let me just get this thing correct - he has - what he calls a restaurant called the Moore's Diner in Reading, Pennsylvania.

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P: Reading Pennsylvania. The Moore's Diner?

H.M.Jr: Yes.

P: Yes, sir.

H.M.Jr: M-o-o-r-e.

P: Yes, sir.

H.M.Jr: He's written a letter to L. C. Colman, of your Division - Procurement Division.

P: Yes.

H.M.Jr: On August 30th. What he wants is - he says he hasn't had enough notice to vacate, see? And that he can't start by September 21, and can't we give him more time.

P: Yes, sir.

H.M.Jr: He doesn't want to interfere with the construction.

P: Yes, sir.

H.M.Jr: But if he could stay there up to - get off say a week in advance of the time they want to really break ground why he'd be satisfied, but they've given him so little notice.

P: Yes, Mr. Secretary.

H.M.Jr: And all he wants is just to stay there as long as he can until they can get another location.

P: Yes, sir.

H.M.Jr: But he wrote a letter to you or Mr. L. C. Colman.

P: Yes, sir.

H.M.Jr: And it's dated August 30th, and it's signed Arthur Carpenter.

P: Yes, sir.

H.M.Jr: He's a former infantile patient.

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P: Yes.

H.M.Jr: Used to be manager of the Warm Springs Foundation.

P: Yes, sir.

H.M.Jr: See what you can do on that, will you?

P: Yes, indeed, Mr. Secretary.

H.M.Jr: I think that's a reasonable request.

P: Yes, sir.

H.M.Jr: He doesn't want you to hold up construction but he would like to stay there up to the - get off a week in advance if they are going to break ground. That gives him time to find a new location. It's one of these, you know, dining car restaurants, you know.

P: Well that's a very reasonable request.

H.M.Jr: I think so.

P: Yes, sir.

H.M.Jr: Thank you so much.

P: I'll dig up the facts and give you a little memorandum on it, sir.

H.M.Jr: Yes, and if you would, communicate directly with Arthur Carpenter, or have your man do it, would you?

P: Write direct to him.

H.M.Jr: Yes.

P: Yes, Mr. Secretary.

H.M.Jr: And send me a copy.

P: Yes, sir.

H.M.Jr: You'll find a letter addressed to L.C. Colman of the Procurement Division.

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P: I'll check it up right away, sir.

H.M.Jr: Thank you so much.

P: Not at all, Mr. Secretary. Thank you, sir.

August 31, 1938

5:10 pm

Present:

Mr. Oliphant ✓
Mr. Taylor ✓
Mr. Lochhead
Dr. White
Mr. Bernstein
Mr. Cairns
Mrs. Klotz

HM, Jr.: This is triple and quadruple confidential. The President even asked Mr. Hull not to tell anybody in the State Department.

Taylor, Oliphant and I called on the President, about 4:15, as a result of his two telephone conversations with me yesterday where he suggested the possibility of setting up an account, different from the so-called earmarking, where countries might send their money for safe-keeping.

We gave the President a copy of a document suggesting the setting up of these special gold accounts in the Export-Import Bank. (See "A" attached.)

Also gave the President copy of "B" (attached) which was the method by which the Governments might turn over to the Export-Import Bank certain American securities.

Also gave the President copy of "C" (attached) an amendment to the Tripartite Agreement.

The President was simply delighted with these and said that "I gave you the germ of an idea and you come back with three golden kernels" and, he said, "This is a great improvement over my suggestion."

We pointed out to him that using the Tripartite would be more advantageous, because it would simply include

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England and France whereas if we used the Export-Import Bank, Japan, who had \$17,000,000 on deposit with us, could ask for this facility, and due to the conference I had with the State Department, in connection with a wheat loan to China, where they said we would have to make a similar offer to Japan, I am sure the State Department would object to using the Export-Import Bank and limiting it to England and France.

The President listened very closely. He said he felt that using the Export-Import Bank would be a little more dramatic because it would be something new, which I agreed with, but I said I felt that under the circumstances the Tripartite would be better.

In reading through the Tripartite draft, it came to my attention for the first time that we were offering these countries a fixed gold price for twelve months. That was not in the first document that I received. I did not let on that it was news to me, but I was very much surprised because it made all the difference in the world and by giving them a guarantee for twelve months at \$35.00 an ounce, we were really offering them something.

Then I said to the President, We have another one we would like to show you which you could show to the Germans and tell them that in case they went into Czechoslovakia this is what you might do. He said, "I don't want to look at it. Before I look at it, let me tell you what I have in mind."

He said, "I want you to tell me how, in case Germany goes to war, I can immediately impound every German ship in every American port and," he said, "that will save a lot of argument. At this place he paused and told a fifteen-minute story on how he handled the Crown Princess Cecelia at Bar Harbor and how he made German Captain Miller salute and how he told him (Capt. Miller) he would move down to Boston or he (Roosevelt) would take the ship over. After he told this story, with great relish, he then took a look at this memorandum of increasing duties by 50%. (See "D" attached.)

We said the suggestion was that this be shown to the Acting German Ambassador with the suggestion that if they did go into Czechoslovakia we might be forced to use this -- and in showing the document to the President I said, "I am going to show you something which I know has been worrying you greatly for a long time." He cross-examined Herman Oliphant as to German goods in German vessels, German

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goods in foreign flags or English goods in German vessels. He was amazed that this Act included all of these classes of goods.

After he expressed his approval of these documents, I asked him how he would suggest that I proceed and he suggested, on account of shortness of time, that I go over to see Cordell Hull. So, with a very meek voice, I suggested would he mind telephoning Cordell that I was coming and would he see me, which he agreed to do. After he put in the call for Cordell Hull, I again meekly suggested that he ask Cordell to come over to his office so as to put a little pep into it, so he called Cordell Hull and asked him to come on over. He didn't tell Cordell what it was about or that we were there. He said, "I have hatched a chicken. Do you want to come over and look at it?"

Before Hull came in, it was agreed that the Tripartite arrangement should be submitted to the British and French with a statement that if this was pleasing to them we contemplated issuing it.

Also before Hull came in, the President said he was still thinking about his plan, which he could not get anybody to help him on, for helping the Democratic Governments in the event of war; that is, his plan for a three-cornered arrangement, using coffee from Brazil as an example, whereby credits by such three-cornered arrangement could be built up in this country for the Democratic belligerents.

Cordell Hull came over and the President read him the memorandum, in great detail, about the Tripartite, interpolating as he went along, stressing particularly the advantage of doing this before war. Hull said couldn't he have time to think about it overnight and then went on to say that he thought there was such a thing as doing too much at this time. With the recent speech of the President, himself, and the trade treaty going through in a day or two, and this coming on top of that, we are apt to get the American people up on their toes over the European situation and he said that within about 40 days he had talked to him about the Austrian debt and put the heat on and was preparing a new note. So I said the difference between the Austrian debt and this was that the Austrian debt decision rested with the Germans and this decision rested with us and, I

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said, I don't know how you feel, but my own personal opinion is that I have grave doubts as to whether the English will do anything, and Cordell agreed.

Sometime during the course of the conversation the President said he thought it was a three-to-one bet that we would not have a war. I said I felt it was fifty-fifty, which surprised him and he remained silent for quite a little while.

At one point during the conversation with Secretary Hull, the President emphasized that these steps would be desirable in order to show to the German Government exactly where the sympathies of this Government lay.

Hull's attitude was to resist our doing this at this time.

When the President got into the tariff matter, he first said that Hull should send for the German representative and tell him that we might put this into effect if they went into Czechoslovakia. The last thing the President said was that he, not Hull, would send for the German representative. In rehearsing how he would put it to the German charge, he at one time said, 'It's a hundred-to-one shot that I will do this if you go into Czechoslovakia' and another time he said, 'I hope you won't force my hand'.

After Hull got up, I turned to the President and said, "When do you want to see us again?" Hull said, "Any time you people are ready, let me know." I said, "Mr. President, don't you want to set a time tomorrow morning to see us?" and the President set the time at 11 o'clock.

The President said to Hull, "Please don't show this to Moffett or anybody down the line, as this would be a Treasury matter and the State Department would not be supposed to know about it." On the other one, the tariff thing, Hull said he was not going to discuss it with anybody, but he did want to think that over again, but the President cautioned him not to consult with anybody and, he said, that lies in the discretion of the President. Hull thought a minute and said he would not discuss that with anybody.

(The President evidently did not feel it necessary

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to caution me not to talk to anybody in the Treasury.)

My own feeling is that if we are going to do anything, the time to do it is in the next 48 hours, as I think that the offer we are making under the Tripartite would be most reassuring to the British and the French and I think if the President decided to do both, that it would give the German General Staff and Dr. Schacht something to think about, and if this is a fifty-fifty question everything that we can add on the scale for peace is just that much to the good. But time is the essence! And it ought to be out in the papers, the latest by Saturday and the President ought to send for the German diplomatic representative not later than Friday.

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Taylor's Document

The Export-Import Bank has today opened special accounts for the Governments of _____ and _____ . Through these facilities the governments of these countries will be enabled to convert into dollars the proceeds of gold on earmark for their accounts in this country and to utilize the amounts standing to their credit with the Export-Import Bank for the purchase of various raw materials and finished products which these nations may wish to acquire in this country.

In addition, the Export-Import Bank will be authorized to arrange for the export of gold now or hereafter placed under earmark by these governments; for the conversion of such gold into dollars for making the purchases mentioned above; and for a period of a year to arrange for the sale of such gold at the Treasury buying rate prevailing today, or if the gold is earmarked hereafter at the Treasury buying rate prevailing on the date such gold is earmarked.

(COPY of document taken to White House 4:00 p.m. 8/31'58)

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In the event that the Government of _____ should acquire control of certain American securities the Export-Import Bank would be glad to establish a special account for the Government of _____ to which the proceeds of the sale of any American securities would be credited. The credits so established would be available for the purchase of various raw materials which these nations may wish to acquire in this country, or at the request of the Government of _____ the dollars standing to its credit will be converted into gold at the prevailing Treasury buying rate and earmarked or freely available for export at the option of the Government of _____.

TREASURY DEPARTMENT

Washington, D.C.

67-1000
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FOR IMMEDIATE RELEASE.

1938.

By authority of the President, the Secretary of the Treasury makes the following statement:

Supplementing the arrangements which have been made in pursuance of the Tripartite accord, the Government of the United States has advised the British Government and the French Government of the following additional steps which this Government is taking in order to carry out one of the fundamental objectives of the Tripartite accord, namely, "to foster those conditions which safeguard peace and will best contribute to the restoration of order in international economic relations....."

1. Great Britain and France will be allowed at any time freely to withdraw or to export any gold which either of such governments, directly or through any agency designated by them, holds under earmark in this country.

2. This Government will at any time desired by Great Britain and France purchase such gold with dollars at the rate specified in Section 42 of the Provisional Gold Regulations issued under the Gold Reserve Act of 1934, for the purpose of enabling Great Britain and France to utilize the dollars thus obtained to purchase supplies in this country.

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3. The United States will also, at any time during the next twelve months and for the limited purpose stated in item No. 2 above, purchase the gold thus earmarked by the governments of Great Britain and France in this country at the rate now stipulated in Section 42 of the Provisional Gold Regulations, and, for such gold thus earmarked hereafter, at the Treasury buying price for gold prevailing at the time of the earmarking of the gold.

MEMORANDUM FOR THE PRESIDENT:

You can forthwith proclaim the imposition of additional duties of 50% ad valorem on the products of Germany and on articles imported in German vessels. These additional duties would go into effect in thirty days. You have already repeatedly proclaimed the fact on which this act would rest. The law and the situation are as follows:

Section 338 of the Tariff Act of 1930 (U.S.C. title 19, sec. 1338) provides that, whenever the President shall find as a fact that any foreign country discriminates against the commerce of the United States, he shall, when he finds that the public interest will be served thereby, impose additional duties not to exceed 50% ad valorem, or its equivalent, on any products of such discriminating country or on articles imported in a vessel of such country. Such additional duties will be applied thirty days after the date of the proclamation.

If the foreign discrimination continues after the issuance of a proclamation imposing additional duties, the President may issue a further proclamation prohibiting the importation after thirty days from the date of the proclamation of products of the discriminating country or articles imported in its vessels.

The Trade Agreements Act of 1934 (U.S.C. title 19, sec. 1351) provides that rates of duty established pursuant to trade agreements shall apply to products of all foreign countries, but that the President may suspend their application to the products of any country because of its

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discriminatory treatment of American commerce. Pursuant to this provision of law, you advised me in a letter dated December 2, 1935, published in Treasury Decision 48035, of December 3, 1935, and in several subsequent letters which were also published in Treasury Decisions, that you found as a fact that Germany discriminates against the commerce of the United States, and that trade-agreement rates, therefore, should not be applied to products of Germany.

Under present conditions it would be competent for you to determine it to be in the public interest, in view of the already ascertained discriminatory treatment of American commerce by Germany, to impose the additional duties provided for in section 338 of the Tariff Act of 1930 mentioned above.

Copy of document taken to White House 4:00 p.m. 8/31'38

August 31, 1938.
5:30 p.m.

H.M.Jr: Hello.
Herbert Gaston: Hello.
H.M.Jr: Yes.
G: Lyle Wilson had gone home but I talked to Salisbury, the Daily News editor, and he told me, yes they had had such a rumor, one of their men brought in a story that was told to him by somebody. He didn't know who - to the effect that you were going to resign - to head up some sort of a Jewish international movement.
H.M.Jr: I see.
G: And -
H.M.Jr: There's no money in that.
G: Uh-
H.M.Jr: There's no money in that.
G: No - no money in that. And I told him that you had never heard of it, it was the bunk.
H.M.Jr: Yes.
G: So I imagine that may be the same thing that Kip was talking about.
H.M.Jr: Uh-huh. Kiplinger.
G: Yes.
H.M.Jr: Yes. Well, what else should we do?
G: Well, I - I think calling it out of Press is all right, but I don't like to do it through any of the rest of them -
H.M.Jr: No.
G: Put ideas in their heads.
H.M.Jr: No.

G: I think I'd just better sit tight now.

H.M.Jr: All right. No.

G: Evidently the AP didn't hear it or didn't think enough of it to - to

H.M.Jr: No.

G: I'll tell you what I'll do. I'll see if any - I'm afraid all the boys have gone, and my -

H.M.Jr: Well, if - what's his name - jumps on it, and he said he was going to, I should think that that would end it.

G: Yes, I think so, and especially after my talking to the fellows direct.

H.M.Jr: Yes.

G: They - they wouldn't be calling my office now - somebody may be calling me later in the evening about it.

H.M.Jr: Well -

G: And I'll be here.

H.M.Jr: All right, I'll see you tomorrow and you can charge - you can charge that one off.

G: Yes, all right.

H.M.Jr: O.K.

G: O.K.

H.M.Jr: Thank you.

TREASURY DEPARTMENT

INTER OFFICE COMMUNICATION

DATE August 31, 1938

TO Secretary Morgenthau

FROM Mr. White

Subject: The sterling situation

Summary

1. There is increasing comment in the British periodicals and press indicating a growing expectancy that the pound is likely to decline.
2. There is a widespread belief in British circles that the economic situation justifies a lower sterling rate with reference to the dollar.
3. It is our belief that:
 - (a) The total economic situation does not clearly justify a lower sterling rate at this time though there are some arguments that might reasonably be advanced in favor of it.
 - (b) Any significant decline in sterling below the traditional parity at this time may create monetary disturbances throughout the world that would have far more serious disadvantages to England -- and to the rest of the world -- than any possible trade gain that England might obtain from a moderate drop in sterling-dollar rate.
 - (c) Our own business situation is such that any significant worsening of our trade position, such as would be caused by a substantially lower sterling rate and by the adverse effects of instability of foreign currencies, might seriously jeopardize our recovery to the detriment of the whole world as well as of the United States.

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(d) For these reasons we believe that no attempt should be made at this time to adjust the sterling-dollar rate but that the subject should, if necessary, be reconsidered after some months have passed.

(1) Delay would prevent acute monetary instability from being injected into the present political crisis in Europe. Declining sterling rate will accentuate capital outflows and increase the loss of gold England may suffer in the coming months.

(2) Though the trend in England's balance of payments on non-capital items was unfavorable to her, particularly during the last half of 1937 and first quarter of 1938, it is too soon to conclude that it will continue at that unfavorable level. In fact, the largest item in her unfavorable balance of payments -- namely, excess of imports -- has been growing less unfavorable during the past four months. Furthermore, the wholesale price exchange aspect of her competitive position has become decidedly more favorable to her during the past six months.

(3) The possibility of a reversal in her trend is heightened by the approaching trade agreement with the United States which contains concessions favorable to some reduction in the British import excess; and by the further fact that the United States gives signs of emerging from the recession, which emergence should aid Great Britain's balance of trade.

(4) The adverse balance of payments which England has developed to an increasing extent during the past year has taken place at a time when her exchange rate has been around \$4.95. The rate now is around \$4.86. In other words, some adjustment in rate has already taken place within the past month. This adjustment in rate has been enhanced by the relative price movements which have become more favorable to England's balance of payments.

Altogether, we conclude that so far as the underlying British economic situation is concerned, we would be justified in taking the position that

Secretary Morgenthau - 3

England should await further developments before attempting to alter her exchange rate. England is now losing not more than £5 million per month on her balance of payments, exclusive of capital movements, a loss which the British Fund can easily stand for some time to come. Even were the current international monetary and political situation much less precarious than it is, England would not be justified in lowering sterling now.

(5) The reported loss by the British Fund of some \$50 millions of gold during the past few days does not alter the situation sufficiently to nullify the above considerations. Practically the whole of the loss represents an outflow of capital -- only partly British funds -- stimulated by the political uncertainties and by the general talk of a prospective lower sterling. The best way to check that outflow would seem to be a demonstrated determination not to let sterling decline below current levels. It is important to note that a substantial part of that outflow does not constitute a net loss to England. A large part came from France and newly mined gold.

All the gold leaving England during the past couple of weeks is not to be interpreted as a loss from her monetary stock. A substantial portion, how much we do not know, represents gold that had been placed on earmark or in vaults, and does not serve to weaken her metallic reserve position though it does reduce the amount of gold she might be able to get hold of through legislation in the event of war.

If the sterling rate is maintained -- and the British can maintain it if they wish for many months to come -- there is more likely to be an inflow of capital into England than an outflow unless, of course, the war scare does not subside. Prior to the recent decline in sterling and to the recent acute crisis England had been gaining capital on balances. If the present war scare does not subside but continues at anywhere near its present intensity, a moderate drop in the sterling rate will not offset capital funds fleeing from England through fear or expectation of an exchange profit but will strengthen those motives and likely add to the outflow. A sustained loss of gold by England at current rates of outflow would doubtless force her to establish some form of restrictions on gold exports before many months have passed. But to attempt to check large flights of capital by a moderate decline in exchange rates is obviously ineffectual.

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The Sterling Situation

1. Sterling has been permitted to decline from \$5.02 in February to \$4.86 in August. Despite that decline there is a widespread belief in British financial circles and also within the government that the economic situation in England necessitates a lower sterling rate with reference to the dollar. Figures as low as \$4.50 are frequently mentioned though the more responsible persons speak in terms of a smaller decline.
2. The following arguments might be advanced by the British in justification of a lower dollar-sterling:
 - (a) England has been experiencing an adverse balance of payments exclusive of capital movements of substantial proportions while we on the other hand have been gaining a large amount of gold despite an outflow of capital of some \$400 million during this year.
 - (b) British exports are dropping while her rearmament program calls for sustained imports.
 - (c) England no longer has a balanced budget and her rearmament program combined with the possibility of a deepening recession will still further unbalance her budget.
 - (d) England cannot afford to lose much gold through an adverse balance of payments on non-capital account because she is the resting place for a large amount of short-term capital. She therefore needs to conserve her gold supply to make her less vulnerable in the event of a flight from sterling.
 - (e) England must reserve its gold stock as part of her national defense program.
 - (f) In her efforts to prevent sterling from weakening England has already given up, she claims, some \$450 million of gold.
 - (g) Since the recession in England is concentrated largely in her export industries any improvement in her international competitive position is an important means of checking the recession.

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These appear to be an imposing array of arguments justifying a lower sterling-dollar rate.

How much weight should we attach to them?

3. Examination of the British balance of payments over the past few years indicates that until recently her adverse balance on non-capital items has been increasing.

(In millions of pounds)

1935	+ 32
1936	- 18
1937	- 52
1938 estimate for first six months only	- 45 to 55

The revenue from shipping (which in 1936 amounted to \$425 million increased to \$650 million in 1937) has suffered a fairly sharp decline in 1938. The figures on this item are not yet available but the reduction in the volume of world shipping and the decline in freight rates has probably caused a drop of \$50 million in British revenues from shipping during the first six months. Income from overseas investments, also a large item (\$1,100 million in 1937) has doubtless declined somewhat during the first six months of 1938. How much we do not know, but we estimate that it is in the vicinity of \$25 million. The excess of merchandise imports which has always been large in England has increased about \$65 million during the first six months of this year over comparable period last year.

Altogether our estimates indicate an increase in England's adverse balance of payments in the first half year over that of last year of somewhere between \$125 to \$150 million. This is to be compared with a favorable trend in our own balance of payments on non-capital items which has taken place during the first half year. During the first six months of 1938 we had an inflow of gold of \$170 million despite a net capital outflow during that period of over \$350 million.

4. The British foreign trade balance has been increasingly unfavorable since 1935, but the trend turned in the second quarter of 1938. In 1935, the trade was unfavorable by £275 millions. In 1937, the unfavorable balance reached the highest level since 1926, £432 millions, or \$2,160 millions.

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In the second quarter of 1938, however, the balance of trade showed a lower unfavorable amount than the same period of the previous year.

United Kingdom - Excess of imports

(In millions of pounds)

	1935	1936	1937	1938
1st quarter	£ 59	£ 78	£ 90	£ 109
2nd quarter	66	85	102	96
3rd quarter	64	81	107	
4th quarter	<u>90</u>	<u>107</u>	<u>135</u>	
Total	279	351	434	

In contrast, the balance of trade of the United States has been extraordinarily favorable in the past twelve months. For the year ending June 30, 1938 the favorable balance of trade of the United States was more than \$1 billion in contrast with an unfavorable balance of \$124 million from July 1, 1936 to June 30, 1937.

United States - Excess of exports

(In millions of dollars)

	1936	1937	1938
1st quarter	\$- 3	\$-113	\$321
2nd quarter	- 6	- 44	310
3rd quarter	- 24	99	
4th quarter	67	312	

But a comparison of those two years is not the appropriate one for us to use for this problem. Both years were distinctly abnormal in opposite directions. The year ending June 1938 shows a large increase in excess of exports partly because of the low level of exports in 1937 due to the special agricultural condition, while the very low level of imports in the year 1938 was due to a sudden and sharp recession in the United States. Furthermore, the exchange wholesale price aspect of our international competitive position was substantially less favorable in the fiscal year ending June 1937 than it was in the subsequent twelve months.

Therefore, the increase in the fiscal year ending June 1938 does not represent the trend to be expected in the future (barring war of course). On the contrary there is reason to believe that our export excess during the next twelve months will be substantially less than it has been during the past twelve months.

Secretary Morgenthau - 7

4. In addition to her own balance of payments on non-capital account she must take cognizance of the movements of the balances of other sterling countries. Sterling countries keep their working sterling balances in England and an adverse balance to non-sterling countries developed by sterling countries would result in an outpayment to be made by London. There is, however, no unusual adverse balance of payments developing in the total of sterling countries. The important thing, of course, is the balance of payments for sterling with non-sterling countries anticipated during the next six months or a year. British Malaya and the Argentine have already experienced curtailed export balances. The Malayan situation is more apt to improve than grow worse in the next year with recovery in the steel and automobile industries here. As for Argentina, her sterling balances have already been reduced to low levels. Australia, South Africa, New Zealand, India and Sweden have not yet experienced any significant deterioration in their balance of trade nor in their economic condition. Besides recent events have doubtless already led to a substantial reduction of their sterling balances.

5. The United Kingdom's balance of trade with the United States became sharply unfavorable in the fall of 1937, but since February 1938 there has been a steady improvement in United Kingdom's position. In the year ending June 30, 1938 our favorable balance of trade with the United Kingdom amounted to \$440 million, which is indeed extraordinarily high. In the second quarter of 1938, however, the excess of our exports to the United Kingdom has receded to a rate of \$25 million per month, compared to \$38 million per month for the year.

Net export balance of trade of United States
with United Kingdom (In millions of dollars)

	1936	1937	1938
1st quarter	\$54.7	\$49.4	\$125.6
2nd quarter	41.9	46.0	76.2
3rd quarter	61.0	89.3	
4th quarter	82.3	147.2	

It should be noted, furthermore, that the unfavorable balance of trade of the United Kingdom with the United States during this period was incurred under a sterling-dollar rate of about \$4.97. In the second quarter of 1938 the pound had already begun to decline and by August had reached \$4.86. This adjustment of 2+ percent in the exchange rate will doubtless change the balance of trade in a direction more favorable to the United Kingdom. And, as already indicated, the last quarter of 1937 and the first half of 1938 were months of sharp recession in the United States.

In addition the trade agreement between the United Kingdom and the United States which will probably go into effect in September or October will grant more concessions to British

trade than will be granted to United States trade. This factor too will throw the balance more favorably toward the United Kingdom during the coming months.

6. One argument in favor of a lower sterling dollar rate which British financial writers have emphasized is the decline in British exports. It is true that British exports have been declining during 1938, but so have ours. While British exports in June were only \$20 million less than in January 1938, United States exports in June were \$57 million less than in January, although the seasonal trend both in British and United States exports for the first six months are not greatly different. However, it must be admitted that the export industries play a more important role in the total economy of England than our export industries do. (See table on page 9 for statistics on exports of the United Kingdom and the United States.)

7. The two important sources of Britain's income on the balance of payments are income from shipping services and income from investments abroad. Both of these items have been increasing since 1935, although the income from shipping declined in the first six months of 1938 with the decline in the volume of world trade and the decrease in freight rates. No accurate information is available as to the income from these two sources in 1938 but we estimate that income from shipping declined \$50 million in the first half of 1938 compared with 1937 and income from investments abroad declined \$25 million.

United Kingdom - income from shipping and investments abroad

(In millions of dollars)

	<u>Estimated net national shipping income</u>	<u>Estimated net income from overseas investment</u>
1935	\$350	\$ 925
1936	425	1,025
1937	650	1,100
1938 - estimate first six months	275	525

There is no reason to assume that the decline will continue. Since business conditions throughout the world seem to have stopped declining, and have even improved in the United States, there is reasonable hope that these sources of income will be maintained or will increase during the coming twelve months. If war breaks out, of course the picture will be completely changed.

Secretary Morgenthau - 9

Exports of United States and of United Kingdom, compared
January-June and July, 1937 and 1938

U. S. Exports

	(Millions of dollars)		Percentage Change 1937 to 1938
	<u>1937</u>	<u>1938</u>	
January	\$222	\$289	+ 30 percent
February	233	262	+ 12 "
March	<u>256</u>	<u>276</u>	+ 7 "
1st quarter	711	827	+ 16 "
April	269	274	+ 2 "
May	290	257	- 11 "
June	<u>265</u>	<u>232</u>	- 12 "
2nd quarter	824	763	- 7 "
July	268	228	- 15 "

U. K. Exports

	(Millions of pounds)		Percentage Change
	<u>1937</u>	<u>1938</u>	
January	£ 44	£ 46	+ 4 percent
February	45	43	- 5 "
March	<u>50</u>	<u>47</u>	- 5 "
1st quarter	139	136	- 2 "
April	50	42	- 16 "
May	50	45	- 9 "
June	<u>51</u>	<u>41</u>	- 18 "
2nd quarter	151	128	- 14 "
July	54	42	- 22 "

Secretary Morgenthau - 10 -

8. The index of the exchange rate wholesale price aspect of the international competitive position of the United Kingdom has steadily improved in recent months. The combined index has risen approximately four points from November 1937 to June 1938, the latest month for which the figures are available. Preliminary figures for July indicate a continuation of that trend. In contrast, the index of our position has not risen since November, and what is more significant for the problem in hand, has declined four points since February, while England's position since February has substantially improved.

Exchange -- Wholesale price aspect of international "competitive position" of United States, United Kingdom, 1928 = 100

(Average of all indices)

	United States	United Kingdom
1937		
November	105	95
December	106	95
1938		
January	108	95
February	109	96
June	105	99

A shift of that magnitude in this important aspect of the international competitive position of England with respect to that of United States is an additional important reason why England should wait before lowering sterling any further. Even if the trend noted above does not continue the changed position is sufficient to modify to some degree the trend of Great Britain's balance of trade as compared with ours. This, taken together with the lower rate for sterling in the past month and the impending trade agreement would seem to constitute ample justification for our position that England should postpone an adjustment of the sterling dollar rate for at least some months to come.

9. With regard to other pertinent economic factors the British situation is more favorable than ours. (a) Though England is operating under a deficit her budget position is very much more favorable than ours. (b) Her industrial activity has declined but that decline is extremely mild compared with the one we have experienced. (c) The increase in our unemployment in the last year is incomparably greater than occurred in England. (d) So far as we are able to ascertain there appears to be no evidence that British costs of production are rising. The prices of her import goods have fallen; her cost of living has fallen, interest rates remain low, and there has been no general increase in wage rates. There has been some increase in wages, and costs in industries producing largely for the rearmament program, but the bulk of those are not very significant for her export market.

10. Admittedly England cannot permit her gold holdings to suffer a serious sustained loss, both because of her position as sterling banker and because of her war needs. But it is exactly because of this reason that England ought not to permit sterling to decline at this time. No step we believe could be calculated to increase the danger of a loss of gold by way of capital movements and flight into gold more than would a decline in sterling under present conditions.

A moderate decline in sterling would not suffice to alter the balance of payments soon enough to significantly reduce any outflow of gold due on non-capital account. Such outflow of gold as reflects a flight from sterling into dollars would not be checked by a moderate decline. On the contrary, such a drop might well serve to accentuate that flight: if the flight from sterling is due to the fear of war, then a moderate decline will not check it; if, on the other hand, it is induced by the expectation of lower sterling, then weakness in sterling can only aggravate the outward movement.

Therefore, from the point of view of conserving gold resources, a moderate decline in sterling appears to be the worst thing England can permit. A steep decline could, it is true, alter the balance of payments on non-capital account within a few months and even possibly induce a flight to sterling provided we and other affected countries did nothing to counteract such an attack. But the repercussions on the rest of the world of such a drastic change would introduce economic disruption far more serious than any that exists now.

11. It is claimed that Great Britain has already given up \$450 million in an effort to protect sterling. It is possible that Philipps was referring to the gross loss and not the net loss. It appears to us that this figure does not make allowance

Secretary Morgenthau - 12

for the flow of gold from France into England and the acquisition of newly mined gold by the London market. The bulk of the loss of gold which England has sustained has gone into private hoarding in London and cannot be considered as a loss to England's war chest. Much of the gold now hoarded in England can be retained in case of war, just as was done in the United States in 1933.

In any event, it seems, we repeat, most unreasonable to expect a moderate decline in sterling to check a loss of gold caused by fear of war or lack of confidence in any currency.

11. Any alteration of the dollar sterling rate which results in a significant increase in British trade cannot help but adversely affect our trade. It is hardly to be doubted that all sterling countries, as well as several non-sterling countries, would follow sterling down with a resultant worsened situation for us.

Our own economic situation is in such a precarious state that it is highly desirable from our own point of view to prevent any bearish effects at this time. We have been experiencing a recovery during the past two months but a continued sharp decline in our exports coupled with increased currency uncertainty, and a world-wide flight into gold may prove a sufficient drag to neutralize the improvement we are experiencing in our domestic situation.

12. For sterling to be kept below the old parity in the present unsettled economic and political situation would, we believe, be seriously disruptive, and might even check chances of world recovery. For many months past the traditional range of sterling (4.84 to 4.88) has been regarded as a natural stopping place in the event of a sterling decline. Should sterling break through that lower limit, people may lose confidence not only in sterling but in all currencies, and a flight from all currencies into gold might occur that would deplete England's stock of gold much more than the present unfavorable trend in balance of payments on non-capital account.

If sterling declines:

(a) Other sterling currencies will almost certainly go with it.

(b) Increased pressure would be placed upon practically all currencies in the world. The franc, the belga, the lira, would probably follow sterling, while the guilder and the Swiss franc would certainly not be strengthened.

Secretary Morgenthau - 13 -

(c) Japan and Germany would be stimulated to resort on a greater scale to various devices for maintaining their markets.

(d) There would be pressure here to raise the dollar price of gold.

(e) It might create a public demand for a revision of the Trade Agreement.

The consequence of such unsettlement in the international monetary sphere cannot aid world recovery and may initiate a resumption of a downward trend.

13. In the light of the above probable consequences it is difficult to understand how Philipps could regard with equanimity a decline in sterling at this time to 4.80. If his views reflected a real intent on the part of British authorities it appears to us that they must have an ulterior political objective in mind.

REB

GRAY

London

Dated August 31, 1938

Rec'd 11:10 a. m.

Secretary of State,
Washington.

845, August 31, 1 p. m.

FOR TREASURY FROM BUTTERWORTH.

STRICTLY CONFIDENTIAL.

I had a short talk with Sir Richard Hopkins today (last paragraph my 839, August 30, 6 p. m.) who stated that he had conferred with the Governor of the Bank of England prior to seeing me and that Montagu Norman had indicated that as yet he had been unable to obtain anything of a definite nature from the Bank of France; but that he would "go back at them today". Hopkins offered to get in touch with me as soon as he had obtained a tangible reply which he hoped would be in a day or two. He seemed anxious to make it evident that the delay was not caused at this end.

KENNEDY

VWC

KLP

PARTIAL PARAPHRASE OF TELEGRAM RECEIVED

FROM: American Embassy, Paris

DATE: August 31, 1 p.m.

NO.: 1375

FROM COCHRAN

At five o'clock this afternoon I visited the Bank of France. Only about 350,000 pounds at 178.32 were yielded by the French control by 5 p.m. as the Paris market has been comparatively quiet today. My contact in the Bank of France had learned from his colleague in the Bank of England that losses of British authorities up until early afternoon had equalled approximately \$25,000,000 and that the pressure on the pound had lessened. British officials are determined that the pound should not be permitted to go below 4.85, at least in the present circumstances, and they are prepared to resist strongly at this point.

French financial papers note breaking of 4.86 rate but confine stories principally to quoting British press.

Statements of French Minister of Finance past two days deny plans for any "gold" loan and give impression that no new financial measures will be suggested prior to bringing out of 1939 budget about September 15 but may be incorporated therein. Revaluation of Bank of France gold stocks is again being suggested by certain writers.

BULLITT

EA:DJW

PARAPHRASE OF TELEGRAM SENT

TO: American Embassy, Paris

DATE: August 31, 4 p.m.

NO.: 601

TO COCHRAN FROM MORGENTHAU.

A. G. Frost, Consul General at Zurich, under date of August 5, confidentially reports that Swiss Banks have extended credits of 500 million Swiss francs to Italian firms for eventual use of the Italian Government for the purchase in this country of munitions and materials. Will you please discreetly investigate this report.

HULL

EA:DJW

RECEIVED

SEP 1 1944

THE NATIONAL ARCHIVES
COLLECTION OF DOCUMENTS
RELATIVE TO THE HISTORY OF THE UNITED STATES

REB

PLAIN

London

Dated August 31, 1938

Rec'd 4:30 p. m.

Secretary of State,
Washington.

RUSH

848, August 31, 6 p. m.

FOR TREASURY FROM BUTTERWORTH.

The demand for dollars has again been large. Contrary to the ticker report the rate opened at 4.85 5/8 and was quickly bid down to 4.85. The tactics of the British authorities have been somewhat different today and helpful in checking the pound's tendency towards rapid depreciation. The gold fixing of 330 bars at 143S. 3 1/2D. was called parity but actually was at a slight discount and after fixing contrary to the normal practice of selling post-fixing gold, each individual transaction being virtually a separate arrangement, gold was in effect on tap. This had the desired effect of strengthening the pound to close at 4.85 3/4.

In this connection it might be worthy of note that I was informed by an entirely reliable source of a private

REB

2-#848, From London, Aug.31,6p.m.

private letter recently written by Siepmann of the Bank of England in which inter alia he stated that during this year they had found it convenient to operate increasingly by means of the gold market and that whereas there were only seven days during this year that they had not dealt in gold it was perhaps surprising how relatively small their foreign exchange transactions had been. This informal and somewhat casual observation has interesting implications.

The city is alive with rumors of varying shades of credibility about the Czech-German situation and its members in general are in a high state of low fever. The attitude of the population in general is one of unconscious fatalism.

KENNEDY

KLP

REB

PLAIN

London

Dated August 31, 1938

Rec'd 5:20 p. m.

Secretary of State,
Washington.

RUSH

849, August 31, 6 p. m.

FOR TREASURY FROM BUTTERWORTH.

This morning's financial dailies and also the DAILY TELEGRAPH carry a news item quoting Reuter under Washington dateline that "United States Treasury quarters indicated yesterday that no deliberate efforts by the stabilization fund were likely to peg the sterling dollar rate to its old parity though the usual cooperation with foreign governments would continue." The statement is cited as indicating that "fluctuations in sterling would be permitted to continue within limits which both Governments felt essential to a safety margin."

Today's press gives the general impression that while the passing of the old parity has produced fears on the part of foreign holders of sterling especially in the present political crisis, depreciation below that
level

REB

2-#849, From London, Aug.31,6p.m.

level is accepted in the City as desirable provided (repeat provided) some new anchor is forthcoming to give long range confidence in sterling.

Headlines announcing the passing beyond the old parity appeared in practically the whole press. With the exception of the "FINANCIAL NEWS" this morning's press is not critical of the authorities' action in allowing the decline. The comment in the City column of the "DAILY TELEGRAPH" is that "The day's movement must not be taken necessarily to indicate any change in the policy of the authorities" while "THE TIMES" City Editor refers to the "sentimental milestone of the old parity" and attaches no special significance to its passing. "It does not reflect any change in policy on the part of the authorities as there was a disposition to infer in some quarters yesterday" nor any inadequacy in the Exchange equalization account's resources. "Nor is it true that a cheaper pound is welcomed for its own sake. Any competitive export advantage that might normally be obtained by a cheaper pound would be more than counter-balanced by the disturbing effects of renewed mistrust of sterling on world trade. . . . The present

REB

3-#849, From London, Aug. 31, 6p.m.

present decline of sterling has been endowed with exaggerated importance simply because of the comparative stability of earlier months. It is still primarily the expression of continental political anxieties that is to say of extrinsic rather than intrinsic factors."

This writer it should be noted has recently referred on several occasions to the transitory nature of the present trade balance influences affecting sterling.

The "FINANCIAL NEWS" on the other hand which with the "STATIST" has been the most emphatic in asserting the over-valuation of sterling heads its leading editorial "4.86 -- and now what?" This editorial begins by stating that yesterday's fall below 4.86 brings to a head the question of British monetary policy. "The danger is that speculation against the pound which died down as the rate neared the old parity may be encouraged by this demonstration that 4.86 $\frac{2}{3}$ is not the rock bottom dollar rate to be envisaged." The editorial refers again to the trade balance situation which it alleges will persist in weakening sterling and says "Hitherto our import surplus has been financed partly out of oversea's investments partly by an increase in
our

REB

4-#849, From London, Aug. 31, 6p.m.

our short-term liability. But should we now use up in addition a large part of our reserves for the dual purpose of maintaining the sterling exchange and financing the import surplus which must then continue undiminished? 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 over-valued) 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 United States 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

REB

5-#849, From London, Aug. 31, 6p.m.

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 by the United States which in the past has profited in addition by a persistent under-valuation of the dollar vis-a-vis sterling and the franc. That under-valuation has now become too pronounced to be sustained by further sacrifices on the part of this country. The June issue of the Federal Reserve Bulletin showed that the position is perfectly well appreciated in American banking circles. The political prospect will be immensely improved if in fact the United States Treasury has ceased to attach particular significance to the old parity and is prepared to permit fluctuations in sterling to continue within limits agreed by the two Governments in cooperation." In Einzig's Lombard Street Column in the same paper the authorities are sharply criticized in that they "should have chosen the middle of a political crisis as the moment to allow the pound to break through the old parity level" and suggests that "it

REB

6-#849, From London, Aug. 31, 6p.m.

"It is perhaps not too late to correct the mistake by staging a recovery to well above 4.86 and maintaining the rate above that level in spite of the adverse pressure." The "FINANCIAL TIMES" in its leading editorial describes the Czechoslovakian crisis as the last straw which broke the resistance put up for the past ten days at around 4.87 and states that "it has evidently been decided that it is not desirable to lose more gold in order to maintain sterling at a point which is after all only of historical interest." It further asserts that there will remain after the passing of the present crisis "the over-valuation of sterling which has been an accepted fact for years and bear speculation is likely to be encouraged by the fall below the semi-sacrosanct parity level. For this reason it is unlikely that the authorities regard yesterday's fall as a momentary matter to be corrected once the movement of hot money has been checked. They must know that the defence of sterling against the bears will be considerably more difficult below 4.86 $\frac{2}{3}$ than above that level. . . . In any case the two alternatives to depreciation--a drastic deflation of prices and costs

in

REB

7-#849, From London, Aug. 31, 6p.m.

in this country or an unlimited loss of gold--are both out of the question at the present time. It is to be assumed that Washington appreciates the position and that whatever methods and degree of control are to be applied when the present abnormal strain has been passed will be operated in harmony."

The "NEWS CHRONICLE" in its financial column stresses the psychological results of the failure of the authorities to make a prolonged stand at the old parity and says "one must (* * *) suppose that now that parity has been passed the pound is likely to fall appreciably further yet."

KENNEDY

NPL