

CONFIDENTIAL

Bank of England

14th February 1939.

Dear Mr. Governor,

Twelve months ago Mr. Cobbold gave you his impressions of the economic position of this country during the second half of 1937. I now bring that review up to date by discussing developments during 1938; and, in the hope that it will be of interest to you, I enclose a memorandum on Sir Robert Kindersley's latest estimate of our Overseas Investments.

On the whole, considering the disturbed state of international relations and - until the summer - the depressed state of business in the United States, it can be said that employment and output in this country have been maintained at a relatively satisfactory level. The last two quarters of the year were dominated by political uncertainty, but it is widely held that the economic recession evident in the spring reached its low point in the summer and that, had political conditions been more favourable, there would have been a visible upturn.

The number of persons in employment averaged in 1938 some 90,000 less than in 1937, but at the end of the year, in spite of an increase of 166,000 in the number of unemployed, more persons were in employment than there had been twelve months earlier

CONFIDENTIAL

Page 2.

Mr. Risto Ryti.

14th February 1939.

earlier. Industrial output in the first quarter of the year was equal to, but in subsequent quarters some 10% less than, that in the corresponding quarters of 1937. This decline is due in the main to diminished activity in iron and steel manufacture, coal mining, the textile trades and building. In engineering and chemicals and in certain trades concerned largely or entirely with supplying the home market (e.g. food, distribution, public utilities and entertainment) activity increased.

The first quarter of the year was a time of heavy output in the iron and steel industry. By March, however, stocks of semi-finished steel had begun to accumulate and the shortage of supplies (which the reduction of import duties a year earlier had been intended to decrease) had given place to a growing surplus. Production was slowed down and the duties were restored. Some recovery occurred in the autumn, but orders were confined to pressing requirements in anticipation of reduced prices in the new year. It is not surprising, therefore, that the output of crude steel fell short, by a fifth, of the record output in 1937. Price reductions of from 6% to 9% now made for the first six months of 1939 appear to have given some impetus to new business and stocks are not excessive.

Of

CONFIDENTIAL

Page 3.

Mr. Risto Ryti.

14th February 1939.

Of the great industries dependent to an appreciable extent on overseas markets, engineering undoubtedly made the best showing. Armaments were certainly an important feature in increasing activity but commercial work was also plentiful and machinery was one of the few important items in which exports were greater than in 1937. Motor vehicle production was rather less, aeroplane production considerably greater than in the previous year. Merchant shipbuilders were somewhat less busy than in 1937, but busier than in any other year since 1930. Even so, more than a fifth of the work-people attached to the industry were without employment. As the year advanced ships were being completed faster than orders were coming in and unless demand improves there will be less work in 1939. Naval construction, however, continues at a high rate. Freights were fairly steady at a level rather below that of 1937, but British shipping laid up in the United Kingdom and Ireland, which a year ago amounted to not more than 100,000 net tons, increased during the year by some 250,000 net tons. Owing to the nature and intensity of foreign competition and to the importance to this country of its mercantile marine, the shipping industry has prepared a memorandum with a view to invoking Government assistance.

Coal

CONFIDENTIAL

Page 4.

Mr. Risto Ryti.

14th February 1939.

Coal output, which had expanded in each year since 1933, fell by about 5% in 1938. The decline was shared equally between industrial and domestic demand on the one hand and export and bunkers on the other.

Overseas demand for textiles was poor, especially for cotton goods; and the weakness of raw cotton prices was an unsettling influence. Production averaged probably not more than two-thirds of capacity. Woollen and worsted manufacture was checked by similar conditions but it had the advantage that raw material prices, after falling, became steady at the lower level. The industry as a whole was working at about three-quarters of capacity. In recent months the home trade in cotton and woollen goods has improved and Government orders have increased. Rayon output was some 10% lower than the record reached in 1937. The various sections of the cotton industry are now within measurable distance of agreement on the terms of an Enabling Bill, designed to provide legislative authority and Government assistance for the elimination of surplus capacity and the establishment of minimum prices. An Export Development Committee is also proposed.

Since the spring (but more noticeably since September) there have been signs that building, other than on Government account, has fallen away. A reaction from the

activity

CONFIDENTIAL

Page 5.

Mr. Risto Ryti.

14th February 1939.

activity of recent years was, of course, at some time inevitable; and, indeed, in Outer London and the South East, where boom conditions developed earliest, has been evident since mid-1936, progress elsewhere helping to maintain the total output. The present decline affects both domestic and commercial construction and can be attributed largely to the general feeling of uneasiness.

The farmers have been considerably embarrassed by a fall in agricultural prices and by lack of rain during early summer. The difficulties of the dairy farmer were met, in part, by increasing the wholesale price of milk, and of the barley grower by increasing the subsidy payment. Wheat growers were, in any event, adequately protected by a variable levy on flour milled or imported. Some pressure is now being brought to bear on the Government for guaranteed minimum prices for farm products.

The railway companies have also approached the Government for legislation. Faced with a marked decrease in their revenue from merchandise traffic they ask that they be relieved of their statutory obligation to accept all traffic offered to them at rates fixed and published in advance and subject to statutory control. To this obligation, imposed on them at a time when the attitude of the State was that the

consumer

CONFIDENTIAL

Page 6.

Mr. Risto Ryti

14th February 1939.

consumer must be protected against a virtual monopoly, they ascribe their inability to withstand the competition of road transport, which is not so restricted. The Transport Advisory Council will report to the Government after having examined the claims of the interested parties.

Although Central London again compared unfavourably with the rest of the country, the total value of retail sales again increased a little. This, in conjunction with a continued growth of small savings at an undiminished rate, supports the conclusion that earnings have not fallen. Wage-rates, it may be mentioned, were more than 3% higher than in 1937 and over 11% higher than at the low point of 1933. On the other hand, industrial profits are falling short (but, so far, not markedly short) of the very high level of 1937. There was a tendency for wage rates to fall as the year came to a close.

Overseas trade was smaller in value than in the previous year, but well above 1936. A contraction of 9% in the value of imports was due more to a fall in the prices of food and raw materials than to reductions in quantity; that in exports (10%) to a smaller volume of trade at similar or even higher prices, the brunt of the decline being borne by the textile trades and iron and steel manufactures. At the same time certain exports, notably of machinery and vehicles,

increased

CONFIDENTIAL

Page 7.

Mr. Risto Ryti.

14th February 1939.

increased in value. The entrepôt trade was also smaller than in 1937.

The growth in the excess of imports which was so noticeable a feature of 1937, in consequence of the simultaneous demands of rearmament and industrial recovery, continued during the early months of 1938, when imports were swollen not only by defence requirements but also by special purchases of foodstuffs by the Government. During the later months of the year, however, imports were smaller in value than in 1937 and during the whole twelve months their excess over exports was as much as £43 million less than in the previous year.

Before turning to the commodity, stock and foreign exchange markets I may perhaps refer to the important subject of the national finances. The provisions of the 1938/9 Budget were outlined in a memorandum sent to Dr. Suviranta in June. Since then the estimate of £90 million to be spent out of borrowed money on defence has been increased to £113 million.

Until September, expenditure as a whole seemed to be running somewhat lower than had been anticipated, but subsequently there has been a slight increase in the rate of spending on defence. Up to the 31st December last defence expenditure amounted to £255 million, of which £17 million was

out

CONFIDENTIAL

Page 8.

Mr. Risto Ryti.

14th February 1939.

out of borrowed money. A year before the corresponding figure was £173 million, all out of revenue. Total expenditure by the end of the financial year (including the £113 million for defence financed by borrowing) should not differ much from the revised estimate of £1,058 million. The Government has already raised sufficient funds by the issue of £100 million 2½% National Defence Bonds 1944/8 in May 1937 and £80 million 3% National Defence Loan 1954/8 last June to cover their defence expenditure out of borrowed money up to the 31st March 1939.

It is more difficult to judge the Revenue figures as the bulk of income tax, surtax and motor vehicle duties (together about 45% of the total) is not received until the last quarter of the financial year. At present it appears that receipts will fall a little short of the Budget estimate of £945 million, owing to the poor yield from estate duties, due mainly to the decline in security prices, and from stamp duties, due to the decline in Stock Exchange and business activity.

Influenced in the first half of the year by depression in the United States and in the second by the condition of Europe, the general state of the commodity markets was inevitably weak or hesitant. Most prices, nevertheless, remained well above, and none of importance fell beneath, the low points of 1932 and 1933. Wheat and barley, however, together with cocoa and some kinds of oilseeds came within a
short

CONFIDENTIAL

Page 9.

Mr. Risto Ryti.

14th February 1939.

short distance of those points, and tin and rubber were supported only by drastic restrictions of output. Raw materials recovered to some extent in the second half of the year in sympathy with the improvement of industrial activity in the United States: but grains, of which there was a heavy surplus, remained weak throughout.

In July the Government obtained wide powers to accumulate stocks of food and petroleum under the Essential Commodities Reserves Act. They also obtained retrospective authority for various purchases already made. Partly because of this provision, stocks of many commodities in this country are greater than a year ago.

The volume of business done on the London Stock Exchange during 1938 was less than in recent years but prices, although tending downward, fell appreciably less than in 1937. The price of British Government securities, for example, fell $5\frac{1}{2}\%$ against 12% in 1937; of industrial debentures 3% against $4\frac{1}{2}\%$ and of industrial equities $16\frac{1}{2}\%$ against $18\frac{1}{2}\%$. Dominion and Colonial Government and Municipal securities did not fare badly. Foreign Government Bonds on the other hand had a bad year.

Successive developments in the international political situation were, of course, the main factors depressing markets. The German demands upon, and ultimate occupation of,

Austria

CONFIDENTIAL

Page 10.

Mr. Risto Ryti.

14th February 1939.

Austria led to a weakening of prices in February and March. After the Anschluss there was a rally which lasted until the end of April, when trouble in Czecho-Slovakia caused renewed weakness. Another rally followed in June, but came to an end early in July. During the remainder of the year, prices continued their downward tendency. In September, at the time of the crisis, prices for a few days were quoted at more or less nominal levels: and by voluntary agreement among the leading jobbers (with the consent of the Stock Exchange Committee and the prior knowledge of the Government broker), minimum prices were fixed and remained in operation for two days for all gilt-edged stocks, including Home Municipal and Dominion and Colonial Government securities.

According to our estimates, New Capital Issues in 1938 totalled £131 million (of which £28 million for overseas), as compared with £180 million in 1937. Taking the disturbed conditions into account, the declines in Stock Exchange prices and new capital issue activity do not appear to me to have been unduly great.

The international and financial crises gave rise to violent fluctuations in foreign exchange markets which became increasingly sensitive to reports and rumours of political decisions. Throughout the year the markets were dominated by politics rather than by economics and the commercial trends of currencies were overshadowed by movements of short-term capital.

Sterling

CONFIDENTIAL

Page 11.

Mr. Risto Ryti.

14th February 1939.

Sterling weakened steadily, chiefly as the result of bear speculation and of a flight of foreign capital from London to New York arising from fears of a European war. The capital movement reached its peak in the days preceding the Munich Agreement. After a temporary reaction sterling turned weak once again, owing partly to fears that the trade balance would be adversely affected by the acceleration of rearmament and partly to a belief that sterling was overvalued in terms of the dollar.

The hoarding demand for gold and, more especially, gold coin, intensified during the first nine months of the year; but war fears caused considerable dishoarding in September. By the end of the year the market in gold coin had died away to almost nothing and the small premiums quoted were hardly effective.

The silver market on the whole was steady, although there was a flurry earlier in the year when the expropriation of the properties of foreign companies by the Mexican Government led to fears of a possible American boycott of Mexican silver. The range of 2 3/16d. in the cash price of silver was the narrowest since the war, the prevailing features of the market being the scarcity of spot sellers and the periodical carrying over of a bear account which were reflected in the consistent premium in the spot price over the forward quotation.

CONFIDENTIAL

Page 12.

Mr. Risto Ryti.

14th February 1939.

quotation. The U.S.A. Treasury continued to buy foreign silver although in March their price was lowered from 45 cents to 43 cents.

Looking back over what has been in many respects a disappointing year, I am struck less with the recession that has undoubtedly occurred than with the resistance which economic activity in this country has shown, and continues to show, to adverse factors. The signing in November last of the Anglo-American Trade Agreement, which reduces or stabilises the tariffs on an important part of the trade between the two countries, is a source of some encouragement, as is also the improvement of conditions in the United States.

Yours sincerely,

M. Merata

Mr. Risto Ryti.