Confidential

W. Eccles -

October 3, 1940.

To Mr. Goldenweiser

From Mr. Alvin H. Hansen

Subject: Introductory Statement on Research Project.

Following are four reports relating to the study which we have undertaken in the Defense Program and its impact upon the American economy with special reference to problems of concern to the Board of Governors of the Federal Reserve System.

The first is a Progress Report detailing the topics under investigation, the memoranda which have been prepared, and the interdepartmental conferences which have been held on various problems.

The second is a Preliminary Report stating in summary fashion some general conclusions relating to the Defense Program and its aftermath. In this statement I have discussed the general situation confronting our economy at the point when the Defense Program begins; the magnitude and timing of the Defense Outlays, together with the probable effect of these outlays on the national income, output and employment; the probable tax receipts and deficits during the next two fiscal years; the probable flow of corporate, institutional and individual savings which may be available for private outlays on plant, equipment and housing, and for investment in new Government issues; the appropriate methods of financing defense expenditures, whether borrowing from banks, from the public, or from taxes; the danger as we get on with the defense program of running headlong into general inflation, and the various means of meeting this situation; post-war slump and how to deal with it; and finally, long-range fiscal policy, with special reference to a thorough reorganization of the Federal-State fiscal setup and machinery for developing a flexible tax program.

The third is an outline of problems--some immediately pressing and others of a long-range character--about which the Board ought, in the near future, to reach definitive conclusions with respect to policy and lines of action.

The fourth is a special memorandum on proposed changes in our gold policy, in two parts, the first (A) dealing with general aspects and the second (B) dealing with alternative formulations of future gold policy.

These reports should be considered as tentative as they have not all been read by all the senior members of the Board's research staff.

PROGRESS REPORT ON RESEARCH RELATING TO THE DEFENSE PROGRAM AND ITS IMPACT UPON THE NATIONAL ECONOMY

Enclosed herewith, in a separate memorandum, is a brief statement indicating tentative conclusions with respect to the Defense Program and its effect on the economy.

The present memorandum is intended to give a summary statement of areas under consideration and the lines of investigation that have been started. It lists the various memoranda which have been prepared bearing on the economic problems relating to defense, and makes a short resume of inter-departmental conferences which have been held dealing with various aspects of the subject.

A. Topics Investigated

The specific topics investigated may be outlined as follows:

1. The magnitude and timing of the Defense Program.

2. The probable effect of the Defense Program upon the national income, employment and output.

3. The probable magnitude of private investment in plant, equipment and housing, and the probable expenditures on automobiles and household equipment at various income levels.

4. The probable volume of business profits; of corporate, institutional and individual savings at various income levels.

5. The probable magnitude of tax receipts (assuming different tax structures) at various income levels.

6. The probable Federal expenditures and deficits under the Defense Program.

7. The probable volume of Federal borrowing from commercial banks, savings institutions, corporations and individuals.

8. The prospect with respect to commodity price inflation (industrial, agricultural and food prices) under varying conditions.

9. The danger of bottlenecks with special reference to steel, railway equipment and skilled labor.

10. The prospect with respect to wage increases and labor unrest.

11. Control of Inflation: rationing, priorities and other direct measures of control; consumption taxes; Keynes plan for compulsory saving and deferred payment; excess reserves and direct monetary controls.

12. The impact of the war on foreign trade and post-war trade policy.

13. Gold and exchange policy of the U. S., especially in view of Germany's access to the gold and foreign balances of virtually the entire European continent.

14. Problems relating to the post-defense slump, particularly post-defense Federal budget, the fiscal capacity of the States, the Federal-State fiscal relations, variable grants-in-aid, social security programs (including old age, unemployment, food stamp plan, health, education), Federal works programs, housing.

15. Long-range proposals with respect to expansion, full utilization of resources, anti-depression policy, flexible tax structure, flexible program of public works, a Fiscal Authority Planning Agency.

B. Memoranda Available

Under the various topics the following memoranda have been prepared (some quite independently of the present research program) and are available (except where noted).

I. Magnitude and Timing of the Defense Program.

1. Present and Prospective Plans for National Defense (Sherrard).

2. Revised Estimates of Present Defense Program (Sherrard).

II. Outlook for National Income, Employment and Output.

1. Private Durable Goods Expenditures at Higher Income Levels (Terborgh).

2. The Business Outlook for Fiscal Years 1941 and 1942 (Divisions of Business Review and Industrial Economics, Department of Commerce).

3. Immediate Prospects for Trade in War or Peace (Gardner).

4. National Income under Conditions of Full Employment (Barton).

5. The Magnitude of the Recovery Problem (Salant).

III. Business Profits and Savings.

1. Data on Corporate Profits at Various Income Levels (Edmiston).

2. Estimates of Savings at Various Income Levels (Hersey). (Not yet completed)

IV. Federal Tax Receipts.

1. Tax Receipts at Various Income Levels (Edmiston).

2. Economic Effects and Estimated Yields of a set of Tax Proposals designed to raise revenue without restricting consumption (Krost).

3. Probable Yields of an Excess Profits Tax (Colm).

4. Data on Consumption versus Other Taxes, 1932-39 (Krost).

V. Federal Expenditures and Deficits, and Federal Financing Under the Defense Program.

1. Financing National Defense (Krost).

2. Budget Outlook and Treasury Financing (Edmiston).

3. Estimated Distribution of Government Bonds under the Defense Program (Piser).

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4. Present Situation in the Capital Markets with Special Reference to the Defense Program (Burr).

VI. European War Finance.

1. Notes on British Government Finances, 1934-1941 (Jaszi).

2. German Armament and War Financing (Kindelberger).

VII. Commodity Price Inflation.

1. Pay Roll Taxes as a Device for Restricting Consumption (Krost).

2. Direct Methods of Price Control (Despres).

3. Present Banking and Credit Situation (Thomas).

4. Prospective Banking Developments (Commercial Loans, Deposits, Velocity, etc.) at Various Income Levels (Thomas). (not completed)

5. Banking Legislation for a Defense Program (Hersey).

6. Program for Price Stability (Garfield and Gehman).

7. Progress of Price Program (Gehman).

8. A Federal Policy of Stock Piles of Strategic Commodities (Gehman).

9. Outlook for Farm Prices (Report of Conference with Stine's section, Bureau of Agricultural Economics).

VIII. Bottlenecks.

1. Steel Requirements under the Defense Program (Bassie).

2. The Janeway Report on Railway Car Equipment (Terborgh).

3. The Defense Program and Housing (Foster).

4. Estimates of Available Manpower (Barton).

5. Labor Supply and the Defense Program (Barton).

6. Recent Developments in the Labor Aspects of the Defense Program (Barton).

7. Report on Labor Conference, August 28 (Barton).

8. Labor Policy and National Defense (Reynolds); (not completed).

IX. Gold and Foreign Trade Policy.

1. Gold, Blocked Balances and Exchange (Gardner).

2. A Pan-American Trade Bloc (Upgren).

3. The Future Position of Germany and the United States in World Trade (Upgren).

4. The Resources of Germany and the United States (Upgren).

5. Western Hemisphere Bloc (Hansen).

6. Gold Policy (Hansen).

7. Our Future Gold and Trade Policy (Hansen).

8. Gold, Blocked Balances and Export Controls during the War (Despres).

X. Federal-State Fiscal Relations (Krost); (nearly completed).

C. Conferences with other Government Agencies

Inter-departmental meetings of research workers from various agencies have been held dealing with various aspects of the Defense Program and its impact on the economy. These may be divided into the following areas: (1) Taxation and Fiscal Policy, (2) The Impact of the Defense Program on the National Income and Employment, (3) The Defense Program and the Labor Supply, (4) Gold and Foreign Trade Policy, (5) The Defense Program and Prices.

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I. Conferences on Taxation and Fiscal Policy.

1. National Income and Taxation (July 24).

Present at this conference were Colm and Means (Budget Bureau), Blough, Sheere and Shoup (Treasury), Heer (Federal Security Agency), Coe (Defense), Gilbert (Commerce), Despres and Hansen (Federal Reserve Board).

Discussion was devoted to appropriate methods of financing the Defense expenditures: taxation of various types versus borrowing from the public and from banks.

2. Federal State Fiscal Relations (September 4).

Present were Frank Bane, Ostrander, Vichery and Niebyl (Defense), Colm, Means (Budget), Eleanor Dulles, Coy (Security Agency), Blough, Coe (Treasury), Bean (Agriculture), Blaisdell, Altman (National Resources), Dewey Anderson (T.N.E.C.), Despres, Krost, Hansen (Federal Reserve).

The conference considered the current Federal-State fiscal relations, the fiscal incapacity of the States, the problem of variable grants-in-aid, and the means of implementing a study of the whole problem. It was the consensus of the meeting that it would be desirable to have a study made this autumn by the Fiscal Division in the Budget Bureau. (Subsequently I had a conference with Mr. Smith, Director of the Budget, who expressed himself as favorable to the proposal). It was also agreed that it would be desirable in the near future to have a National Commission set up to study the whole problem along the lines of the recent Royal Commission in Canada.

II. Conference on Defense, National Income and Employment (August 1).

Present were Means and Colm (Budget), Paradiso (National Resources), Meehan, Gilbert (Commerce), Levin (Defense), Loring Wood (Labor), Howard Myers, John Webb and Alan Sweezy (W.P.A.), Garfield, Thomas, Goldenweiser, Hansen (Federal Reserve). (Bean of Agriculture, unable to be present, made available a preliminary report).

The meeting considered the problem of estimating the probable impact of the Defense Program on income and employment. Following the meeting, personal exchanges of information have been made growing out of discussion at the conference.

III. Conference: Defense and Labor Supply (August 28).

Present were Lubin, Nathan, Tolles, Martin (Defense), Howard Myers, John Webb (W.P.A.), Loring Wood, Boris Stern (Labor), Stocking, Hollander (U. S. Employment Service), Weiss (Wages and Hours), Somers (National Resources), Hetzel (C.I.O.), Boon (Machinists), Shishkin (A.F. of L.), Barton, Goldenweiser, Hansen (Federal Reserve).

The conference considered training programs, prospective labor scarcities by industries and occupations, competitive bidding for skilled labor, priorities as a method of dealing with labor shortages, prospective wage demands and labor relations in connection with the Defense Program.

IV. Conferences on Gold and Trade Policy.

1. Conference on Foreign Trade (July 18).

Present were Pasvolsky, Hawkins (State), Wheeler (Agriculture), Fox (Tariff), Gardner and Hansen (Federal Reserve).

Conference considered the problems relating to a Western Hemisphere bloc, the degree of self-containment of this bloc, and of a German dominated European Continent, including Northern Africa and the Near East. Projected researches in the various divisions were outlined.

2. Conference on Gold Policy (August 30).

Present were Eddy (Treasury), Gilbert (Commerce), Ezekiel (Agriculture), Gardner, Goldenweiser and Hansen (Federal Reserve).

The new problem, created by the ability of Germany to lay hands on large amount of gold held in the conquered or dominated countries, was considered and alternative proposals for dealing with this situation,

V. Conferences on the Defense Program and Prices.

1. Conference on the Defense Program and Agricultural Prices (August 6).

This conference was held at Stine's office and included about 10 research workers in this field. The current situation with respect to the loan price, the Government loan stocks, current crops, exports, domestic consumption and carry-over were considered with respect to cotton, wheat and corn. Other commodities considered were meats, poultry products, animal and vegetable fats, dairy products, fruits and vegetables. In general the conclusion was reached that, barring general price inflation, the agricultural price index could not be expected to rise by more than 10 to 15 per cent with a national income of $90 to $100 billions. In the case of cotton, it was believed that an income of this magnitude might raise domestic consumption to 9.5 million bales. Cotton exports after the war might not exceed 2 million bales. With respect to wheat, it was believed that

domestic consumption might be lifted slightly to 700,000,000 bushels at high income levels, 100,000,000 short of the annual production. With respect to corn and meats, it was thought that, at $90 to $100 billion income level, the current large carry over of pork-lard products might be lifted with some improvement in prices. Farm income from other meats could be expected to rise considerably with a rising national income. This would come from both increased production and higher prices. Prices are currently very low for poultry products, animal and vegetable fats. Only moderate price increases can be expected. A considerable increase in the prices of dairy products, fruit and vegetables can be expected.

2. Conference on Steel (and other metals) Prices (August 12).

Present were Durand, Winslow (Tariff), Wallace, Humphrey (Defense), Gehman, Conklin, Thomas, Hansen (Federal Reserve).

Discussion related to possible bottleneck in steel capacity, and to copper, manganese and other metal prices; the extent to which tariff reductions might be used as an instrument of price control; rationing; price controls.

D. Future Study

As the Defense Program unfolds, continual revision of the estimates relating to its impact on various aspects of the economy will have to be made. Gradually the picture will become clearer and more accurate judgments can be arrived at. With respect to policies, it will be necessary to dig very much deeper than has been possible in the exploratory studies thus far made.

PRELIMINARY REPORT ON
THE DEFENSE PROGRAM AND THE NATIONAL ECONOMY

1. Recovery from the deep depression of 1932-33 proceeded with fits and starts but, on the whole, at a fairly satisfactory rate until 1937. The speed of the recovery, up to this point, was clearly one of the most rapid in our history, and probably about as rapid as the economic organism could digest. The recovery was, moreover, one of the longest in American experience.

In 1937, however, the recovery was checked at what was little better than a half-way point. Indeed, a major depression was allowed to develop until well into 1938. By late 1939, however, stimulated by the war, the 1937 level was recovered, but no new ground conquered. In broad outlines, the recovery made satisfactory progress until August, 1937, and since then has been operating at about 70 per cent of reasonably full capacity.

A combination of circumstances produced the depression of 1937. A part of these could have been avoided, but in considerable measure it was a normal reaction from a prolonged upswing. With respect to the mistakes made, account should certainly be taken of them for future reference, and every effort made to avoid them. Some (for example the labor difficulties) were related to fundamental changes which the American economy was undergoing. But whatever the causes, once the down turn was started, it was a mistake to permit the acceleration by introducing a contractionist policy at just the point when vigorous expansion should have been undertaken. If a bold program of

Federal expenditures had been undertaken in September, 1937, when danger signals were sufficiently in evidence, the precipitous stock market crash of October could have been averted, and the recovery pushed forward after only a moderate and wholesome (in terms of the cost-price situation) set-back. Federal expenditures should have been shot up, in fiscal 1938, $2 to $3 billion dollars in excess of 1937 level--or, in other words, to $10 or $11 billions. We may remind ourselves that $12 billions is the figure contemplated in the current fiscal year. Had the defense program, or something equivalent, been started in the autumn of 1937, the national income could have been rapidly lifted to $90 or $100 billions by 1940.

Despite the fairly good showing made in the recovery up to 1937, the fact is that neither before nor since did the administration pursue a really positive expansionist program. Until 1936, public works outlays fell far short of the level of the Twenties, and since then have only slightly exceeded that level. For the most part, the Federal Government engaged in a salvaging program and not in a program of positive expansion. The salvaging program took the form of refinancing of urban and rural debt, rebuilding the weakened capital structure of the banks, and supporting railroads at or near bankruptcy. The R. F. C. poured $10 billion dollars into these salvaging operations. The Federal Government stepped into the breach and supported the hard pressed State and local governments--again a salvaging operation. One has only to consider the items accounting for the increase in recent

years in the Federal budget to see how true this is. Unable to carry the relief burden and to continue a normal program of public works, the local units turned to the Federal Government. $13.8 billions of the Federal deficit of $18.7 billions, from 1934-39 inclusive, is accounted for by the single item of unemployment relief. Other items which greatly relieved the fiscal position of local governments were the agricultural program, involving expenditures of $3.2 billions, and public works (largely as grants in aid or as substitutes for diminishing local outlays) amounting to $5.4 billions in the same period.

That a salvaging program of this magnitude was necessary was of course due to the unprecedented depth of the depression reached by early 1933. An important lesson that we can learn from this experience is the waste of funds for salvaging purposes which must be incurred if a depression is allowed to cumulate until the national income is cut in two. Under such circumstances, the economy dries up like a sponge. Vast governmental expenditures, designed to float the "sponge" to a high level of prosperity, are instead absorbed by the sponge itself. The expenditures seemingly run to waste. This is the salvaging process. Only when the economy has become thoroughly liquid can further funds float it to higher levels. A deep depression requires vast salvaging expenditures before a vigorous expansionist process can develop.

2. The current defense program offers, however, an opportunity to complete the recovery movement halted by the 1937 depression.

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We are currently a long way from full employment. The national income for 1940 will probably be about $73.5 billion, slightly above the 1937 level. The Federal Reserve index of production will average about 120 compared with 113 in 1937 and 110 in 1929. Employment will average about 46 million, compared with 46.6 million in 1937 and 47.9 million in 1929. We have currently a labor force estimated at from 55 to 57 million. There are thus 9 to 11 million unemployed. While some part of this number are more or less unemployables, on the other side it should be remembered that there are probably 2 to 3 million surplus workers now counted as employed in agriculture, who would eagerly seek jobs in urban industries whenever opportunity afforded. Moreover, the World War experience indicated that there is a vast potential labor supply which can readily be drawn into the labor market--when labor scarcity becomes intense. Thus, in 1918, 44 million were employed, including those drawn into the armed forces, while the normal labor force was only 41 millions. Three million potential workers, not normally in the labor market, had been drawn into employment. This indicates that the potential increase in labor resources is greater than indicated by the formal and somewhat artificial figures with respect to the so-called normal labor supply.

3. With respect to plant and equipment, the possibilities for expansion, as Terborgh showed in the July issue of the Federal Reserve Bulletin, is enormous in the non-continuous process industries. Two or even three shifts could, if necessary, be introduced. This

would provide greatly expanded output without any large capital outlays. The situation is most critical in steel, a continuous process industry. Here we are already operating at over 90 per cent capacity. Exports to Britain, the defense requirements, railroad equipment purchases, together with the increased demand for consumers' durables, notably automobiles, as the national income rises--all these converge upon the steel industry.

Steel thus threatens to become our most serious bottleneck. Our steel ingot capacity is about 12 per cent above 1929. A projected trend based on iron and steel production from 1899 to 1929 indicates a peace-time consumption of these products, at full employment, of about 30 per cent in excess of the 1929 output. Taking account of fundamental changes in the uses of steel and other factors, this figure is probably too high. War-time consumption of steel is, however, quite a different matter. Steel ingot capacity on January 1, 1940 was around 72.8 million gross tons. Considering the military requirements, nearly 80 million tons will be needed at a $90 billion dollar level. Thus already in 1942 we shall encounter a shortage unless steel capacity is enlarged. At full defense effort it is estimated that the requirements would be 105 million tons, about 50% in excess of current capacity. Coke consumption is moreover currently running at 63,000,000 tons. At peak levels last winter the output of coke was about 60,000,000 tons. Last autumn, when the steel industry was running at over 90 per cent capacity, coke output was inadequate to meet the

steel requirements, and the extra coke needed was supplied from stocks.

4. How rapidly we shall encounter bottlenecks in certain types of skilled labor, and especially in steel capacity, will depend upon the magnitude and speed of the defense program and the stimulus it gives to income and employment. The Secretary of the Treasury estimates total military expenditures, during fiscal 1941, at $5 billion. In view of the greatly enlarged army program (which offers easier opportunity for quick expenditures) it is not impossible that $4.5 or possibly $5 billion might be reached. It must be recognized, however, that defense expenditures are currently running at the rate of only $2-1/2 billions. Hence the expenditures would have to rise steadily to at least a $7 billion rate by the end of fiscal 1941 in order to reach a total of $4.5 billions for the year. Should spending at the rate of $7 billions be reached by July 1941, it would appear possible to achieve a total defense expenditure of $10 billions in fiscal 1942. But if this rate were averaged for the year, the rate of expenditures would have to rise to about $13 billion by July 1942. If this level were reached it would appear possible to spend $18 billion for defense in fiscal 1943.

The international situation might, of course, easily become so menacing that we should be compelled to push on as rapidly as possible to a full defense effort with expenditures of $18 billion or more in 1943. This, however, would involve a drastic increase in the defense program as now contemplated. The present program involves:

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(1) A navy of 3,000,000 tons (approximately 3 times the size of our present effective navy).

(2) Full equipment for an army of 1,200,000 men, and, in addition, equipment of critical items (not readily obtainable on short notice through commercial channels) for an additional 800,000 men. Housing facilities for 800,000 draftees, and for 200,000 national guardsmen.

(3) An air fleet of 35,000 planes including fighting, bombing and training planes, with production facilities for an output of 50,000 planes per year.

To raise the navy, army and air force to this level would entail an "expansion" cost of $18.5 billions. Pay and subsistence of draftees during training are not included in "expansion", but are accounted for under "personnel and operation" in the table given below. In this latter item are also included the expenses of training 40,000 air force personnel annually. In a certain sense all these items, at least in the earlier years, really constitute a part of expansion, and if they were so included the total cost of lifting the armed force to the contemplated strength would approach $25 billions.

The army expansion program is expected to reach a peak in fiscal 1942 and to be practically completed in 1943. The navy expansion program it is thought would reach a peak in 1943 and would be completed by 1945. In the meantime, however, the operating expenses, including personnel and replacement, will rapidly rise. The program now laid out, as nearly as it can be pieced together with respect to magnitude and timing, is given in the table below:

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DEFENSE PROGRAM
(In Billions of Dollars)

Fiscal Year (Ending June 30)	Grand Total	Expansion	Operating Expenses, Including Personnel and Replacement
1941	4.5	2.4	2.1
1942	10.0	6.5	3.5
1943	9.0	5.0	4.0
1944	7.5	3.2	4.3
1945	5.5	1.0	4.5
1946	5.5	0.5	5.0
1947	5.5	-	5.5
1950	6.0	-	6.0

If the present program were carried out without revision upward, a tapering off in defense expenditures would thus begin in fiscal 1943. It is rather difficult to believe that an upward revision will not occur. In the event, however, of a negotiated peace--say next spring--in which England emerged as the undisputed sea power, we should probably feel relatively safe even though Germany were left in command of the European continent. The present defense program might, therefore, appear adequate while, on the other side, the situation would not be sufficiently safe to warrant its abandonment or curtailment. Under these circumstances, the model given in the table above might be substantially realized.

Two other eventualities are however equally, or perhaps even more, probable. On the one side Germany may conquer England. In this event it would appear certain that we shall step up our defense expenditures with utmost speed, perhaps reaching $12 to $15 billions in 1942, and $20 to $25 billions in 1943. This would put us definitely on a war

basis so far as expenditures are concerned. On the other side, England may withstand the attack and continue the war indefinitely. This outcome presents two alternatives for us. Either we shall speedily enter the war, or we shall continue to give maximum support to England short of war, meanwhile rapidly increasing our own military strength. In the former case our expenditures might rapidly rise to $30 or $40 billions. In the latter case we might spend $10 to $12 billions in fiscal 1942 and $18 to $20 billions in fiscal 1943.

Whatever the various alternative outcomes (excluding entrance into the war) the expenditures in fiscal 1941 are not likely to fall below $4 or to exceed $6 billions. The probable range is of course wider for fiscal 1942. We may perhaps set the minimum for that year at $8 billions, and the maximum at $15 billions. The range of possibilities for 1943 is, of course, enormous, perhaps from $5 to $25 billions. If we actually enter the war these upper limits will of course be exceeded by a wide margin.

5. It is scarcely worth while to attempt any estimates of the effect of the defense program on national income for 1943. But some tentative figures may be suggested for fiscal 1941 and 1942.

The defense expenditures will enlarge directly the total income stream by a certain amount. Moreover, there will be certain repercussions upon private investment in plant and equipment induced by the general expansion. A considerable part of the increase in plant and equipment required for the production of military equipment will be financed directly by the Government. Moreover, in view of the short

amortization period allowed, the capital outlays for new plant and equipment, even though privately financed in the first instance, will within a few years be recovered in the prices charged, and so, in effect, would be financed by the Government. Nevertheless, the general expansion of income will doubtless induce a considerable amount of investment in plant and equipment which will be financed quite independently of the defense outlays.

In 1940, with a national income of $73 or $74 billions, capital outlays on plant and equipment amounted to about $7.5. At a national income of $90 billions, it is expected that expenditures on plant and equipment might rise to $11.0 billions; and at $100 billion income level to $13.5. As indicated above, however, a considerable amount of these outlays, relating to the defense effort, will be financed directly or indirectly by the Government. In so far as this is the case, one would be guilty of double counting if one added to the stimulating effect of the defense outlays the plant and equipment expenditures directly or indirectly financed out of defense outlays.

In the current year housing and nonprofit construction is running at about $2.4 billions. At a national income of $90 to $100 billions, this might rise to $3.5-$4.5 billions. This assumes that the defense effort will not arbitrarily curtail construction. Automobile purchases are running at $2.7 billions this year, and might rise to $3.5 - $4.0 billions. Household durables are running currently at $5 billions and would rise to $6 - $7 billions at a $90 to $100 billion income level.

Past experience indicates approximately a 1 to 1 ratio between increases in expenditures on durable goods, public and private, and increases in nondurable consumption expenditures. At a $90 billion income level possible increases in private consumers' durables, as indicated above, are estimated at about $3 billions. Private producers' durables we may perhaps estimate at $2.5 billions, exclusive of the part financed directly or indirectly by the Government. We assume outlays on military equipment (operating expenditures excluded) in 1942 of $6.5 billions. Non-military public construction (Federal, State and local) may be expected to fall by say a billion below the $3.6 billion level of 1940. Public and private durables (including defense equipment) on these assumptions would thus run about $11 billions in excess of 1940. This would leave, at a $90 billion national income, $6 billions as the increment of nondurable consumption above the 1940 level. This appears excessively modest, but on the other hand the estimates suggested for private durables may be too high.

Assuming the current defense program, it would therefore appear that a national income of $90 billions by calendar 1942 is a conservative figure. No important price rise is assumed. Wholesale prices might move to an index of say 85, an increase of about 10 per cent above the current price level.

Various studies (Bean, Paradiso, Salant) indicate approximately an increased employment of 1 million for every $3 billion increase in national income at approximately stable prices. On this basis, 5.5 million additional workers might be absorbed into employment by 1942, including those drawn into the armed forces. These and other estimates are summarized in the table below:

Year	Defense Outlays (Billions)	Federal Expenditures (Billions)	National Income (Billions)	Employment (Millions)	Federal Reserve Index
1940	$1.6	$ 9.0	$73	46.0	120
1941	4.5	11.5	80	48.2	130
1942	10.0	16.0	90	51.5	145

6. We have had estimates prepared giving probable tax receipts at various income levels. These estimates, based on (a) the current rate structure, (b) current rates plus proposed excess profits, and (c) suggested increase in various taxes, are given in the table below:

TAX YIELDS

Income Level	Current Rates	Current Rates and Excess Profits Tax	Heavier Tax Structure 1/
70	$ 6.6	7.0	7.5
80	8.5	9.0	10.0
90	10.0	11.0	12.5
100	12.4	13.5	15.5

1/ Existing tax structure amended by (1) an excess profits tax; (2) an increase in the corporation income tax to 25 per cent; (3) lowering of exemption in estate tax to $10,000, and changes in gift tax; (4) abolition of privilege of filing separate returns; (5) substitution of flat tax credit for personal exemption; (6) abolition of optional capital gains tax rate.

The tax receipts of fiscal 1941, for example, are based partly on calendar 1939 and partly on calendar 1940. On account of this lag in revenue collections, not until a full-employment income has been reached and maintained for two full years will the tax revenues reach a level commensurate with the prevailing national income. Thus, during the period of rapid expansion, the tax revenues will lag behind the rising income, and the deficits incurred will correspondingly be relatively large. If the full employment income can be maintained for some years, the deficit would sharply decline, relative to those incurred during the period of rapid expansion.

The following table presents estimates of expenditures, tax receipts, deficits and open market borrowings based on the assumption stated above with respect to the defense program and its secondary repercussions on the economy.

Year	Defense	Federal Expenditures (billions)	Tax Receipts 1/ (billions)	Deficit (billions)	Total Federal Borrowing, Including Guaranteed Issues	Gov't Trust Funds & Recapture of Capital Funds	Life Insurance, Savings Banks, Baby Bonds	Other: Banks, Corporations, Individuals
1940	1.6	$ 9.0	$ 5.4	3.6	3.6	1.0	1.3	1.3
1941	4.5	11.5	6.8	4.7	5.7	2.0	1.8	1.9
1942	10.0	16.0	8.5	7.5	8.5	1.5	2.0	5.0
1942	10.0		9.5 2/	6.5	7.5	1.5	2.0	4.0

1/ Present tax structure plus moderate excess profits tax.

2/ Tax structure revised according to suggestions made above.

It is reasonable to assume that a new revenue bill would be passed in 1941, providing enlarged revenues for fiscal 1942, as indicated in the second set of figures for that year in the table above. Taking these latter figures, we get a deficit of $4.7 billions for 1941, and $6.5 billions for 1942. How this deficit, including the guaranteed debt, might be financed is indicated in the last three columns.

In the event that defense expenditures were shot up sharply in 1943 to around $18 billions, we could expect a deficit of around $14 billions, unless tax rates were sharply increased. The inflationary implications of such a situation are discussed below.

7. This leads us to a consideration of the probable flow of savings, together with the demand for savings funds in terms of (a) requirements of private investment in plant equipment and housing, and (b) financing the Federal deficit. The difference between the gross savings and the demand for savings, private and public, will indicate the necessary increase in the money stream--partly in the form of new money (demand deposits) and partly in the form of activation of funds formerly held idle. Increases in the money stream are expressed in an increase in M and an increase in V.

First, it is necessary to consider the probable course of corporate profits, dividends, net corporate savings and individual savings from dividends. The following table presents rough estimates (in billions) at various income levels.

National Income	Profits of Corporations Reporting Net Income	Net Profits of all Corporations	Net Corporate Profits after Taxes 1/	Dividends	Net Corporate Savings	Individual Savings from Dividends
$74	$ 7.8	$ 5.3	$ 4.3	$3.8	$ 0.5	$ 1.0
80	9.2	6.7	4.8	4.0	0.8	1.2
90	11.5	9.0	6.7	5.1	1.6	1.7
100	14.8	12.3	9.3	5.9	3.4	2.0

1/ These are based on the existing tax structure and are therefore too large if the tax structure is revised upward.

We must next seek to piece together the total probable flow of gross savings from all sources--corporate, individual and institutional.

(15)

Very rough estimates (which are being revised) are given in the table below:

(In billions)

National Income	Depreciation and Depletion Funds	Net Corporate Savings	Individual Savings from Dividends	Individual Investments in Real Estate, New Issues, etc.	Institutional Savings; Life Insurance, Savings, Deposits, Bldg. & Loan Trust Funds, Baby Bonds, &c.	Total Gross Savings
$ 74	$ 4.7	$ 0.5	$ 1.0	$ 2.0	$ 4.5	$ 12.7
80	4.8	0.8	1.2	2.2	5.0	14.0
90	4.9	1.6	1.7	2.4	6.0	16.6
100	5.0	3.4	2.0	2.6	6.5	19.5

We may now set the estimated volume of gross savings over against the total demand for savings, private and public, together with the deficiency which must be made up by an increase in demand deposits or by use of idle funds. This is done in the table below:

(In billions)

Year	National Income	Private Fixed Capital Investment Plant, Equipment, Housing	Federal Deficit Plus Guaranteed Issues	Total Demand for Savings	Total Gross Savings	Gap Filled by Idle Funds and Additional Bank Credit
1940	$ 74	$ 10.0	$ 3.6	$ 13.6	$ 12.7	$ 0.9
1941	80	12.0	5.7	17.7	14.0	3.7
1942	90	14.0	7.7	21.7	16.6	5.1
1943	100	16.0	14.0	30.0	19.5	10.5

The figures for 1943, while set down here for illustration purposes, really present a contradiction. It is probable that a deficit of $14 billions would create a considerable inflation and so drive the national money income up beyond the $100 billion level. If the income is to be held to this level, heavy consumption taxes would have to be applied, thereby reducing the deficit.

If these estimates are at all probable, they would indicate that the defense program and the required plant and equipment incidental to this program and to the expansion of the national income could be financed without any considerable increase in bank credit until a national income of $90 billions is reached. It will be noted that the estimated gap to be filled by increase in demand deposits and by use of idle funds for the two years 1941-42 amounts only to $8.8 billions. Considering the vast volume of idle funds now available (estimated at about $10 billions) it appears that no large amount of bank credit expansion (certainly not of inflationary proportions) is necessary during the years 1941-42.

From the standpoint of the M V type of analysis, no substantial increase in demand deposits is necessary to circulate a national income even of $100 billions. At the current volume of demand deposits, the income velocity would be 3.1 compared with 3.5 in 1923-29. Using both demand deposits and currency combined (to represent M) the income velocity would be 2.6 compared with 3.0 in 1923-29.

8. These considerations raise the question of the appropriate method of financing the deficit incurred by the defense expenditures.

What part, if any, should be financed from borrowing from the commercial banks? What part shall be financed from borrowing from the public and what part from taxes? Should the proportion financed from each of these three sources vary at different levels of business activity?

In general, it may be argued that in the earlier stages of recovery from depression considerable reliance should be placed on borrowing from banks. In the deflationary phase the volume of demand deposits, as well as their turnover rate, typically declines sharply. An increase in the level of income can, in the circumstances, be facilitated by monetary expansion (both M and V) to a level corresponding to the requirements of a larger volume of transactions. Thus some expansion (varying with the magnitude of the prior contraction) can be justified. And particularly if considerable reliance is placed upon governmental expenditures as a means of securing recovery, it is appropriate to borrow from the banks, since this procedure increases or maintains a high degree of liquidity for private enterprise and facilitates recovery by keeping interest rates low.

But, as the national income rises, it is appropriate to turn increasingly (a) to borrowing from the nation's savings stream, and (b) to taxation. As the national income rises, savings will tend to increase, thereby making available funds from which the Government can borrow and tax. As the recovery approaches full employment, increasing reliance on taxes rather than on borrowing is indicated since taxation is, on balance, more restrictive than borrowing. Borrowing from the commercial banks is most expansionist in effect, borrowing from other sources and

taxation of the savings stream (progressive taxes) occupy an intermediate position, while consumption taxes are definitely restrictive. Thus the normal sequence in financing governmental outlays in different phases of recovery are; first, borrowing from banks; second, borrowing from savings stream; third, progressive taxes and, fourth, consumption taxes.

This sequence more or less automatically takes place without conscious planning or design. At higher levels of business activity, commercial banks are able to find, in some measure, other outlets for their funds. Moreover, at higher income levels, the volume of savings increases and it is possible to sell more bonds to savings institutions, Government trust funds and the public. Finally, the progressive sector of the tax structure yields much larger revenues when the national income has risen.

These tendencies partly explain the changing proportion of the Federal expenditures financed from (1) borrowing from commercial banks, (2) borrowing from other sources, and (3) from taxes in the period 1933-36 compared with the period 1937-39. The first period was one of rapid increase in the national income from $40 billions to $65 billions. The second was a period of relative stability at around a $70 billions income level. In the first period, 50 per cent of the Federal expenditures were raised from borrowing, of which one half was from commercial banks and the Federal Reserve Banks, while less than half came from savings institutions, trust funds and the public. In the second period only 30

per cent was raised from borrowing, all of which came from savings and none of it from the commercial banks. The decline of commercial bank holdings of Governments in the recession of 1937 largely accounts for this fact, while the growth of Government trust funds partly accounts for the increasing role of savings in Government financing operations. Moreover, larger receipts from the progressive taxes at higher national incomes enabled the Government to raise nearly 70 per cent of its requirements from taxation in 1937-9. It is not suggested that the relative proportions raised (a) from taxes, (b) from banks, and (c) from borrowing from the savings stream, were the correct ones. It is only suggested that the changes taking place from the first period of rapid recovery to the later period of relative stability at moderately high income levels was in the right direction.

Starting from the income level of $73-74 billions in 1940, how far should the defense expenditures be financed by borrowings from the commercial banks? We have already noted above that there may be sufficient savings (including funds now held idle) to finance both the Federal deficit and the private demand for capital through fiscal 1942. It does not, therefore, appear necessary, so far as the global figures are concerned, to resort to any considerable expansion of bank credit. But this may not necessarily mean very much. The mere fact that corporations and financial institutions have funds available does not insure that they will purchase Government bonds in so far as private investment outlets are not adequate to absorb their idle balances. Thus the mere availability

of funds does not insure that banks will not have to be relied on to finance a part of the deficit.

According to the estimates suggested above, the open market would have to absorb about $3.7 of new direct and guaranteed issues in 1941, and about $6.0 billions in 1943. It may be assumed that the baby bond market, life insurance companies and the mutual savings banks would absorb about $2.0 billions per year. From 1932 to 1939, life insurance companies, mutual savings banks and all "other" investors increased their holdings of Governments by $1.7 per year on the average. In addition, individuals and corporations with rising incomes and a patriotic appeal ought to take a considerable volume of defense bonds. If the open market operations do not exceed the magnitudes indicated, it ought not to be necessary for banks to participate in 1941 and 1942 in excess of from $1 to $2 billions per year. Such participation would hold bank credit expansion to relatively small proportions.

Moreover, it must be noted that the tax receipts suggested in the above calculations of the deficit may be regarded as minimum. In the event that the tax structure were amended so as to increase sharply the excess profits tax rates and the rates on the upper middle income brackets, the tax receipts could probably be increased by $1 to $1.5 billions, thereby reducing the volume of open market issues during the two-year period.

Unfortunately, the 1940 Revenue Act requiring that any deficit incurred by reason of defense expenditures must be financed by the sale

of short-term obligations militates against their absorption by institutional and private savings funds. For the moment this may not be too serious, since maturing short term obligations may be replaced by longer term issues acceptable to financial institutions and the public. But the matter could later become serious. This legislation should be repealed, thereby giving the Treasury full freedom to finance the deficit by the issue of obligations of such character as appear most appropriate in terms of monetary and fiscal policy. Congress and the public should be impressed with the importance of financing the defense deficit either by borrowing the public's savings or out of taxes. Bank credit expansion on a large scale, when the national income has already reached $74 billions, and huge Federal outlays have been appropriated or authorized to be expended as rapidly as feasible, might invite dangerous price inflation as the economy approached full employment.

Taxation and borrowing from the national savings stream does not <u>invite</u> inflation. But there is, nevertheless, no assurance that price inflation may not in fact come, even though the Federal deficit is not financed by borrowing from the commercial banks. In the first place, individuals may be induced to subscribe to defense bonds in excess of their savings, covering the difference by borrowing from the banks. During the last World War about $3 billions were so financed. If large reliance must be placed on bank credit expansion to finance a war deficit, this method has advantages over direct borrowing from banks. In the second place, a substantial rise in business activity might result in a

considerable demand for bank loans and might induce banks to enlarge their holdings of private bonds and mortgages. Indeed it was this development which accounts mainly for the enormous credit and price inflation of the last World War.

Conditions are now in many respects different. There are currently no good reasons for urging the public to buy bonds beyond their capacity to save out of income. Private business concerns have large internal sources of funds available for expansion, and are relatively little in need of bank funds. Moreover, since much of the plant and equipment required for the defense program will be financed by the Government directly or indirectly, it is evident that this minimizes the requirements of private enterprise.

9. Even to manage defense outlays of $10 billions in fiscal 1942 without running into partial inflation will demand the utmost vigilance. Paradoxical as it may seem, until an approach to full employment is reached, expansion will help to prevent inflation. This is true because, until full employment is reached, the main danger of inflation lies in the development of bottlenecks. Unless these bottlenecks are broken we shall be compelled to choke off further expansion in order to prevent the scarcities caused by the bottleneck from resulting in inflationary price and wage increases in the areas affected. From these areas there is danger that the inflationary development may spread to the whole economy. The only sound way to prevent bottleneck inflation is to break the bottlenecks. In so far as the bottlenecks <u>cannot</u> be forestalled by

the provision of adequate plant and equipment capacity and by an adequate supply of skilled mechanics, priorities and rationing will be necessary. Inflation is far more serious and insidious than unemployment. It will not do to let it get started in any area.

A danger point that is likely to flare up within the next few months is a stock market boom. The market is "biting at the bit", ready to leap forward the moment Britain's staying power seems assured. Stock market booms tend to engender commodity and inventory speculation. Before this movement gets under way, the margin requirements ought to be raised.

If we succeed in avoiding, or at any rate holding to a minimum, bottleneck inflation and speculative price developments in the security and commodity markets, we shall finally encounter, as we approach full employment, the problem of general inflation. For the control of general inflation, taxation bearing on consumption is technically a potent weapon, but practically and politically the matter is very difficult. Theoretically, the most desirable method is probably a tax on pay rolls deducted from wages. According to the Keynes plan, such deductions should, however, be credited to the wage-earners in the form of a blocked postal savings account. These accounts would be unblocked by proclamation of a designated monetary authority after the war emergency is over, and specifically when a slump was beginning to develop. Various statistical series might be invoked to guide the monetary authority, for example, the Federal Reserve production index, income paid out,

wholesale prices, employment, etc.

The difficulty with the Keynes plan is that there is probably little hope that it would be acceptable to wage-earners. Wage-earners can be appealed to on a voluntary basis to purchase Government bonds, and even to pay onerous taxes, but they are not likely to accept a compulsory deferment of wage payments. It will not be easy to convince them that such compulsory deferment is really in lieu of taxes. They will want their wages as earned. Possibly, if the taxes were imposed as a necessary defense measure, with little being said about the future refund, the plan might actually prove more acceptable.

There is moreover the difficulty with pay roll taxes (whether actual or in the form of deferred payment) that such taxes in a period of buoyant expansion and labor scarcity may lead to demands for wage increases sufficient to cover the tax. Should this occur, no curtailment of consumption would result from the imposition of the tax.

It is possible, however, to apply the fundamental principles of the Keynes plan on a voluntary basis. A modified Baby Bond, with 3 per cent interest payable annually, and with subscription privilege limited to $500 per year so as to limit the sale to low-income groups, might be made very attractive and, if properly advertised and pushed with a patriotic appeal, could reach wide masses of the population.

The defect in a voluntary plan, of course, is that its magnitude will necessarily be small compared with what might be achieved by a compulsory plan. It will, therefore, be desirable, once an approach

to full employment is reached, to resort to other forms of consumption taxation. A tax levied on "value added" has been suggested. Such a tax is said to be preferable to a sales tax by reason of greater simplicity of administration. It has, however, the disadvantage that, in practice, it will probably tend to encourage price increases at every stage in the productive process. To some extent, sales taxes also give the retailer an opportunity to raise the price by more than the amount of the tax. But it is probable that the impact of a sales tax on price increases is relatively less than in the case of a "value added" tax. The best plan is probably a contingent sales tax. Congress would fix the rates, but would give a monetary authority (such as the Federal Reserve Board) power to determine when the tax shall be imposed and when it shall be withdrawn. The monetary authority might also be empowered to apply varying rates, within limits imposed by Congress, according to the requirements of the economic situation.

With respect to the broader monetary power of the Board, it would be a mistake to leave them out of account, or to regard them as obsolete. While direct methods of control, supplemented by fiscal devices, should be used in the first instance, the time may nevertheless come when it will be necessary to apply monetary checks to expansion. It is, therefore, desirable that the Board be granted now the power necessary to reduce the excess reserves to manageable proportions so as to make open market operations effective as a check upon bank credit expansion.

If defense expenditures are shot up to $18 billions in 1943, as appears by no means improbable, the danger of inflation will be very serious. With Federal expenditures running at $24 billions, and the tax structure revised to include stiff excess profits taxes and other changes making the rates more progressive, there would still be a deficit of $12 or $13 billions. Add to this the guaranteed debt would require a flotation of $14 billions. It is difficult to believe that this would not produce a price inflation of dangerous proportions. To prevent this it would be necessary to raise perhaps $10 billions in sales or some other form of consumption taxes.

10. We consider next the problem of the post-defense slump. Every great war effort in the past has ended in a slump. Must not the defense effort inevitably do so also?

It may be argued that the two cases are not exactly parallel. Wars, whether they ended in a settlement which afforded prospects for a stable peace or only in a truce, in which both sides were girding themselves for a renewal of the encounter, at all events brought about a cessation of active hostilities. The cessation of hostilities means the release of vast fighting forces for civilian pursuits, even though the productive resources engaged in producing war equipment continued to build armaments as rapidly as under war conditions. The disbanding of the armies of itself brings about a sharp curtailment of military expenditures. Moreover, the cessation of the wastage of materials in actual combat permits a very large curtailment of the armament industry even

though the policy were adopted to maintain the full military strength of the nation. Thus the cessation of war inevitably results in the sharp curtailment of military expenditures, regardless of the policy adopted with respect to the maintenance of military plant built up by the war.

But the expansion of a military machine does not, as in the case of war, necessarily entail any subsequent decline in expenditures. And this is true even though it is decided to build the military force up to a definite size beyond which it is not allowed to grow. There are two aspects to a military production program. One has to do with expansion of the military plant and the other has to do with replacement, maintenance and upkeep at the level reached. The larger the plant, the larger becomes the maintenance, upkeep and replacement. It is perfectly possible to articulate the expansion expenditures with the growing replacement, maintenance and upkeep expenditures in such a manner that the total outlays on both together will rise to an asymptote without turning into a decline. As replacement, maintenance and upkeep increases, the expansion expenditures are tapered off until eventually the whole consists of replacement, maintenance and upkeep. The following table (in billions) illustrates such a development in a manner that is at any rate not inherently unreasonable.

(28)

Year	Total Military Expenditures	Expenditures for Expansion of Military Plant	Operating Expenditures: Replacement, Maintenance and Personnel
1941	$ 4.5	2.5	2.0
1942	10.0	6.5	3.5
1943	12.0	7.5	4.5
1944	12.0	6.0	6.0
1945	12.0	5.0	7.0
1946	12.0	4.0	8.0
1947	12.0	3.0	9.0
1948	12.0	2.0	10.0
1949	12.0	1.0	11.0
1950	12.0	0.0	12.0

Contrary to the assumption made at the beginning of this paper, when we were contemplating the construction (as currently envisaged) of a military plant involving the expenditure for expansion of nearly $20 billions, the plan suggested in the table above involves a doubling of that program. The operating expenditures, including replacement and personnel, to maintain a military establishment of this magnitude would require, it is estimated, an annual expenditure of approximately $12 billions.

The precise figures chosen are of no special significance. What is significant is that some such pattern, involving expansion over a prolonged period, will inevitably have the effect of raising to higher

and higher levels the cost of replacement, maintenance and upkeep. A point is therefore necessarily reached sooner or later at which the mere limitations of productive resources will compel a tapering off of the expansion expenditures, so that whatever level of maximum defense effort is reached--whether $10 billions, $20 or $30 billions,--eventually this level of expenditures will turn out to consist exclusively of replacement, maintenance and upkeep.

Now it is certainly not impossible that some such pattern may be followed in our defense effort. It does not appear probable now, at any rate, that anything can happen in the near future which will turn Europe and Asia into stable, peaceful continents during the next two or three decades. Even though we suppose that somehow Hitlerism completely collapses in Germany, the problems of Europe would not thereby suddenly be solved. A new Europe will have to be created. It will have to be policed by somebody until stable political conditions can be restored. Moreover, the increasingly menacing position of Japan in the Pacific, in addition to the European turmoil, points toward the probability that we may well sharply revise our defense program, perhaps doubling the currently planned expansion.

The greatest likelihood of any sudden sharp curtailment in military expenditures is that the whole program may collapse in consequence of a negotiated peace between Germany and England. If this does not occur it is not probable that we shall suddenly sharply curtail our defense expenditures. Some considerable curtailment, say from $10 to $8

billion dollars, or from $15 to $12 billions, is however not improbable.

The defense program is likely to revolutionize the Federal budget even after the major effort has been completed. Even the present program calling for expansion outlays of $20 billions will entail maintenance, upkeep and replacement expenditures of about $6.5 billions per year. Thus the military item in the budget would be $5.5 billions higher than in the pre-defense period 1937-9. If the non-military items in the budget continue to total about $7.0 billions, as in recent years, this would raise the total Federal budget to $13.5 per annum.

Assuming that changes with respect to the development of new industries, foreign investments and the foreign balance will more or less offset each other, we might expect the stimulus of $5.5 billion additional military expenditures per year to yield a national income of about $85 billions. It is probable that the defense program will accelerate the development of a number of new industries, including commercial aviation, electrification, air conditioning and the like. On the other hand, the foreign trade situation is likely to prove less favorable than in the late Thirties. Investment in plant and equipment, and in residential and commercial construction, together with the purchases of automobile and household equipment, may be expected to be on a considerably higher level than in the late Thirties. But these factors (in part as secondary repercussions of the enlarged military expenditures) have already been taken account of in the $85 billion figure suggested above.

Should we succeed, during the major defense effort, in lifting the national income level to $95 or $100 billions, a subsequent decline to about $85 billions (the cumulative impact of the initial decline would for a time drive the income much lower) would, relative to the high levels previously reached, make a serious depression.

It is possible that shortages, accumulated in various lines during the major defense effort, might cushion the decline. Priorities and rationing may have curtailed automobile purchases, residential building, construction of plant and equipment in non-military lines.

A number of changes relating to the social security program could help cushion the post-defense decline. The unemployment insurance pay roll tax could be reduced to 2 per cent. This, together with shortening the waiting period and liberalizing the benefits, could remove altogether the drag of around half a billion dollars of annual net accumulation experienced in recent years. On the other hand, the unemployment pay roll tax might be kept at 3 per cent, and the fund partly converted into a modified Keynesian deferred payment plan. A part of the fund, under this plan, would be earmarked to the credit of each worker for deferred payment in the post-defense slump, without the worker having to wait for unemployment to enable him to receive benefits. A part would be accumulated in the Unemployment Fund to be paid out in regular unemployment benefits.

Social services are certain to be extended in the near future in various directions. These could be implemented and timed so as to

help cushion the post-defense slump. The old-age assistance program should be greatly expanded. This could be done in various ways. Under the 50-50 Federal matching system, the benefits now range from $6.00 per month in the poorer States to $38 per month. In order to remedy this situation, it will be necessary for the Federal Government to make larger grants to the fiscally incompetent States. The Federal Government might make an outright minimum grant of $15 per old person assisted in all States, with the requirement that each State contribute at least $3.00 in addition. This would establish a minimum benefit of $18 per month in the poorer States. In addition, the Federal Government should match each additional dollar contributed by the States until a maximum benefit of $40 per month was reached. In addition, the means test should be liberalized so as to admit any aged person to benefits whose income was judged inadequate.

A good case could be made to support the thesis that old-age assistance ought to be taken over entirely, both with respect to administration and cost, by the Federal Government. This could help to relieve the States' fiscal situation and tend to check further increases in State consumption taxes.

Other methods designed to liberalize benefit payments to aged persons are as follows: (1) All persons over the age of 70 might be given outright a Federal pension of $30 (man and wife together $45), without having to meet a means test. This proposal would reserve the old-age insurance plan and old-age assistance now in operation to those aged 65

to 70 inclusive. About 3,250,000 persons are included in each group. This proposal follows in general the British system. (2) Every person over the age of 65 might be paid a pension of $15 without a means test, this pension to be supplemented by the current provision for old-age insurance benefits, and, for those not covered by insurance, by old-age assistance on the simplified income means test. The latter proposal is complicated by the fact that under it most persons would receive benefits from two sources.

There is much to be said for the dual system--insurance benefits for those aged 65 to 70 inclusive, and non-contributory pensions beyond 70. In the first place, this plan would preserve intact the old-age insurance system already firmly established and well received by the general public, but would limit its application to those aged 65 to 70. It would cover in the pension scheme all aged persons over the age of 70, thereby restricting the means test (at best difficult to administer and undesirable socially) to those aged 65 to 70 not covered by the old-age insurance. Together with a Federally administered old-age assistance plan for uncovered persons under 70, a Federal pension plan for those over 70 would greatly relieve the burden of the States, and facilitate reduction in State consumption taxes, or, at any rate, enable the States to participate on a Federal grant-in-aid basis in other expanded social welfare programs without raising consumption taxes beyond the present high level.

Public health and Federal aid to education are the most pressing.

The recent inter-department committee on medical care recommended a program consisting of three parts: (1) expansion of general public health services, including the strengthening of public health facilities, increased efforts to eradicate tuberculosis, venereal diseases and malaria, and to decrease the mortality rate from pneumonia and cancer, to provide mental hygiene and industrial hygiene services, to provide more adequate maternal and infant care, medical care for children and treatment for crippled children; (2) to provide greatly enlarged public hospital facilities, including general and special hospitals, and sanitariums for tubercular and mental cases; (3) to provide medical care in the home for the medically needy--those on relief or with incomes below $1000 (about one-third of the population). Such a program would involve expenditures ranging from about $250,000,000 in the first year to about $900,000,000 in the tenth year.

A greatly enlarged public health program should be pushed now as an important and necessary part of defense. Hanson Balwin has stated that, in New York City, 60 per cent of prospective army recruits are turned down largely by reason of physical defects.

Related to an enlarged public health program is the Food Stamp Plan. More than 20 million in the lower income groups are limited in their food consumption to 5 cents per meal per person. The Food Stamp Plan has revealed that the consumption of foodstuff can be very greatly increased in the lower income levels, thereby relieving in some measure the agricultural surpluses. In addition to food, cotton has been

experimented with on a small scale. It is estimated that a subsidy of $600,000,000 through a Cotton Stamp Plan would increase the domestic consumption of cotton by 2,000,000 bales.

A large number of bills are currently before Congress, calling for Federal aid to education in order to relieve the pressure on the State budgets, and to provide more adequate services (for example, adult education). The bills call for Federal contributions ranging from $100,000,000 to $300,000,000 per year.

Assuming an expansion of social security and welfare programs along the lines indicated, with the Federal Government carrying a larger part of the cost, we may envisage a post-defense Federal budget roughly of the proportions indicated in the table below. It is assumed that the Federal Works program (including public works, the W.P.A., C.C.C. and N.Y.A.) will continue at about the pre-defense level of $3.5 billions per year. At higher national income levels, with less unemployment, it may of course be expected that outlays for W.P.A., N.Y.A. and C.C.C. would be considerably lower. On the other hand, it is expected that Federal public works and Federal grants to public bodies for public works would increase along lines discussed below. It is assumed that the agricultural program, while continued at about the former level, would be heavily shifted away from direct subsidies to farmers and increasingly toward the Food Stamp and Cotton Stamp Plan type of outlays. In this manner, the agricultural program would consist mainly of a plan to expand the domestic market for agricultural products through Federal subsidy to the low income urban groups.

(36)

Post-defense Federal Budget

	(in billions)
Legislative, judicial and civil establishments	$ 1.2
Interest on the public debt	1.5
Defense (maintenance and operation of enlarged plant)	6.5
Social security and welfare (including veterans)	2.0
Federal Works (including W.P.A., C.C.C. and N.Y.A.)	3.3
Agricultural Program (including stamp plans)	1.0
Total	$15.5

Even at relatively full employment there would still be room for a restricted W.P.A. program, and perhaps also for the C.C.C. and the N.Y.A. The country is going to be very much surprised how large a list of persons eligible for W.P.A. will remain on the rolls even after employment has risen by five, six or seven millions. As industrial employment increases, 2 or 3 million farm boys will be taken on and, to the extent this is done, urban unemployment is not relieved. This movement is already going on. It is said that airplane manufacturers find young men from the farm excellent workers and quick to learn. Moreover, there are still about 1 million persons eligible for W.P.A., but not on the pay roll owing to lack of funds. Finally, probably a considerable part of the unemployment force is quasi-unemployable, yet these could usefully be put to work on work-relief projects, rather than put them on the dole. Even at peak employment levels, therefore, there is likely to remain an important function for the W.P.A.

A public works program, Federal, State and local, should be carefully planned and held in reserve for the eventuality of a post-defense slump. In addition, low-cost housing should be undertaken on

a scale comparable with the British program during the last two decades. In England something over 50,000 units were constructed on the average annually during the Twenties and Thirties. In terms of our population, this would amount to 150,000 units per annum. According to a publication of the United States Housing Authority, a public housing program which would reasonably assure the decent housing of the entire nation would call for the construction of about 300,000 units per annum over the next 15 years. Such a program would call for a Federal annual subsidy of between $100,000,000 and $200,000,000 extending over a period of 60 years. The capital outlays would not be made by the Federal Government since the U.S.H.A. is authorized to issue guaranteed bonds. The Federal subsidy, plus the local Government contribution and the rents collected from tenants, cover operating costs together with amortization of the U.S.H.A. guaranteed bonds.

11. From the standpoint of long-range planning relating to full utilization of resources and anti-depression policy, two defects in our institutional arrangements present serious obstacles to a full realization of the desired objective. One has to do with the current Federal-State fiscal setup, and the other with lack of a fiscal authority with power to administer a flexible fiscal program with respect to expenditures and taxation.

Any proposal to introduce an effective national fiscal program adequate to cope with modern problems encounters at once the anomalies and conflicts inherent in the overlapping functions and taxing powers of

the Federal, State and local Governments. Moreover, the expanding functions of Government, particularly in the field of social welfare, place upon the States financial burdens beyond their capacity without resort to heavy consumption taxes. This form of taxation runs precisely counter to the main objective of fiscal policy--that of securing reasonably full employment. Thus, in recent years many States have been compelled to levy sales taxes in order to provide old age assistance and other expanding social services. Indeed, the leadership of the Federal Government, through the traditional 50-50 matching system, has compelled the States, by reason of their fiscal incapacity to levy adequate progressive taxes, to resort increasingly to consumption taxation. Thus by 1938 the State and local bodies were collecting $3,250,000,000 in sales, liquor and tobacco, gasoline and pay roll taxes.

This situation will sooner or later necessitate a thorough reorganization and re-allocation of functions and taxing powers. Such a reorganization has been recommended in Canada in a recent report by the Royal Commission on Dominion-Provincial Fiscal Relations. It may be that the time is not ripe for a complete overhauling of the Federal-State fiscal relations in the United States. We are not confronted with anything like so acute a crisis as that confronting Canada. The Federal Government has been able to step into the breach through the assumption of a major part of the burden of urban and agriculture relief and grants-in-aid to local public works projects. The public debt of States and municipalities has accordingly, for the country as a whole, ceased to rise.

The credit position of the local governments has thereby been strengthened materially. But while we are not confronted with an immediate crisis, the cumulative effect of growing social services, financed largely by consumption taxes, is to place an increasing drag upon economic expansion and full employment of our resources.

Short of a drastic reorganization, the problem can be eased by a modification of the Federal grant-in-aid program and by the assumption by the Federal Government of certain responsibilities now carried wholly or in part by the States. Thus the old age assistance program (perhaps converted into an outright pension for those over 70) ought probably to be taken over entirely by the Federal Government. Other social welfare programs which, by reason of administrative problems or otherwise (education, for example) should be left under State control with Federal supervision, should be financed by a variable Federal grant adjusted according to the fiscal capacity of the various States. Without far-reaching modifications in this general area, we shall not be able to undertake an effective fiscal program with respect to full employment of our productive resources.

Nor can fiscal policy ever become a really potent device for economic stability and expansion without placing its operation on an administrative basis. We have long been accustomed to the administrative control of monetary and banking policy. Ad hoc legislation by Congress with respect to open market operations and re-discount rates would patently be impossible. Precisely the same is true of fiscal policy if it

is to be used effectively as an instrument to control employment. The only reason why legislative enactment from time to time is regarded as adequate in this field is that Governmental expenditures and tax rates are still expected to fulfil only their traditional functions. Fiscal policy has not yet won a place as an instrument of economic control continuously to be applied as means to secure employment stabilization and expansion. When such a place shall have been won, comparable with that achieved by monetary policy, it will be recognized that the intermittent use, by specific and ad hoc legislative enactment, of public expenditures and taxation after each special emergency has arisen is quite inadequate for the purpose in hand. It will become necessary to subject these powerful instruments to continuous administrative management in order to render the control sufficiently flexible to cope with the ever-changing economic situation and to prevent disastrous cumulative movements from getting under way.

These considerations are peculiarly pertinent to the problems raised by the defense program. Gearing fiscal policy to the rapid changes in economic conditions which the defense program will call forth requires the development of new procedures. For the time being, one type of tax policy is appropriate. But we may very soon encounter a situation in which a quite different tax policy is called for. Such conditions can not be managed by piece-meal legislative enactment.

At the appropriate time, the President should send a special message to Congress relative to a long-run fiscal program adequate to

cope with the impact of the defense program upon the functioning of the economy. Such a message should call for a comprehensive tax program. In connection with such a long-range program, Congress should be asked to authorize a Monetary and Fiscal Authority. Such an Authority should be assigned the responsibility of advising and recommending to the Executive with respect to the implementation of the comprehensive tax program. The Executive, acting under the advice of the Fiscal Authority, should be empowered to increase or curtail, at the appropriate time, a specially designated category of public works expenditures designed to promote employment stability and expansion. He should moreover be empowered, with the advice of the Fiscal Authority, to determine the timing of the imposition of taxes designed to check inflation or deflation, and to change existing rates within limits imposed by the comprehensive tax program. Congress might specify certain criteria which the Fiscal Authority would be required to take cognizance of in the determination of the appropriate timing of such adjustments. The determination ought certainly to be discretionary, but it is possible that the objective criteria could be sufficiently definitive so that limits could be imposed upon the range within which discretion could be exercised. Upon such determination and proclamation by the Executive the respective provisions of the comprehensive tax measure previously passed by Congress would become effective

Admittedly Congress will be reluctant to delegate power to the Executive on so vital a matter as the timing of the application of tax

rates and expenditures. But if we are to make the economy workable under modern conditions, it will be necessary to engage in bold social engineering. And especially is this true with respect to the defense program and its aftermath. If the magnitude of the defense effort is sharply revised upward, the time is coming when high consumption taxes should be imposed, in order to prevent inflation. If we leave it to Congress to determine when this time has arrived there is the gravest danger that action will be taken too late. And similarly with respect to the timing of appropriate fiscal measures when the post-defense slump begins to set in.

PROBLEMS RELATING TO THE DEFENSE PROGRAM ON WHICH THE BOARD OF GOVERNORS SHOULD EARLY COME TO SOME FAIRLY DEFINITIVE CONCLUSIONS

I. Bottlenecks.

Within the next 12 months there is danger of serious maladjustments unless steps are taken early to prevent bottlenecks in certain areas. The areas that appear most dangerous are: 1. Steel; 2. Railway car equipment; 3. Skilled mechanics.

Various divisions of the Government are interested in the problem, but there is danger that no specific plan will be undertaken to cope with the problem unless a definite leadership is offered. As a first step, it would probably be desirable to call a meeting of the specialists in different Government departments best informed with respect to steel and railway car equipment, and to arrive at some agreement as to the minimum requirements. (I shall undertake to arrange such a meeting.)

Following this, a second step might be for Chairman Eccles to call together leading officials in the Defense Commission, and elsewhere, who would be in a position to act upon a plan.

II. Comprehensive Tax Plan.

By January it is likely that Congress will be tackling the problem of a new revenue bill. It is, therefore, urgent that a comprehensive tax program be considered which would look beyond the immediate situation and envisage the whole defense program; a plan which would take account of the different types of tax policies required at different income and employment levels, and the means of implementing such a policy

in a flexible manner. There is danger that a wrong type of taxes will be levied early in the next calendar year and that there will be a serious lag in the appropriate tax policy later when inflation may be threatening.

III. Federal Borrowing.

Immediately urgent is the question of the repeal of the provision relating to the short-term defense issues. Some conclusion should also be reached with respect to what measures (if any, beyond the modification of the provision referred to) should be taken to divert Federal borrowing from banks to main reliance on borrowing from the public.

Consideration should be given to proposals about how borrowing from the public could be encouraged on voluntary lines, and to the question whether or not some form of compulsory loan policy could be introduced at the appropriate time, such as the Keynes plan.

IV. Monetary control of inflation.

It is urgent that we plan now means of preventing price inflation. While general inflation is not now imminent, the defense program may easily unfold with sufficient speed so that the whole price situation could very rapidly change. We have perhaps been lulled to sleep over the last 7 or 8 years, thinking that inflation is quite impossible. As the defense program grows, the inflation problem will become increasingly serious and it may be upon us much earlier than we now think.

An immediate danger is the possibility of a stock market boom. It might now be desirable, while the market is relatively dead,

to raise the margin requirements and thereby prevent the use of bank funds to set off a speculative stock market.

Consideration should also be given now to the broader monetary control. Ought legislation now to be asked of Congress to enable the Board of Governors to get under manageable control the excess reserves?

Consideration should also be given to whether manipulation of the gold prices and foreign exchange rates might be appropriate instruments to prevent commodity price inflation. In some cases, imports might be paid for by gold. This possibility should be explored in detail.

V. Other Price Control.

Consideration should be given to appropriate Government purchase plans, designed to prevent competitive bidding and consequently undue price increases. Ought Government prices to be fixed on a cost-plus, bulk line or on a public utility fair price basis?

When and in respect to what commodities should rationing be instituted and how should such a program be administered?

What new legislation, if any, is necessary to implement tariff rates as an instrument to prevent abnormal price increases? The powers of the President in the trade agreement program do not appear to fit the case.

VI. Post-war policies with respect to gold and foreign assets in the United States.

It is impossible to know whether a negotiated peace might not be an early possibility, or a conquest of England. In either event,

it would be necessary to be prepared with respect to a new gold policy. Germany now can lay her hands upon about $3.0 billions of gold, and moreover can command control over about $6.0 billions of foreign assets, including gold ear-marked in the United States, balances held in the United States and investments in the United States. This situation calls for some definite program and for modifications of the current policy.

VII. Long range program with respect to a post-defense slump.

First is the possibility of building up cushions against the slump, such as the deliberate starving of certain areas such as housing and automobiles during the defense boom, which would tend to release purchasing at the time of the impending slump.

The deferred payment plan of Keynes is another possible means of cushioning the slump.

Consideration should be given to the post-defense Federal budget. In lieu of the curtailment of defense expenditures, what plans should be made with respect to social welfare expenditures, including old-age pensions, public health, education, food and cotton stamp plans and low-cost housing.

As a means of minimizing the post-defense slump, what could be accomplished by a drastic reorganization of the Federal-State fiscal setup? How far could levelling of consumption taxes be achieved by re-allocation of the functions as between the Federal and local governments, and by a modification of the grants-in-aid system, and by re-allocation of tax sources?

September 4, 1940

A. OUR FUTURE GOLD AND TRADE POLICY

1. The policy of buying gold at a fixed rate ($35. per oz.) was adopted and continued for a number of reasons, not always very clearly defined but, nevertheless, consciously or unconsciously playing a role. In 1934 it was first undertaken partly in response to powerful pressure, particularly from conservative financial groups, against a continuation of the uncertain and somewhat erratic course followed in the last quarter of 1933, when gold was being purchased at prices varying day to day and week to week. The country did not wish to entrust any administration authority--in this case the Treasury--with the responsibility of buying gold on a variable price basis. Public opinion had not been schooled and ripened to accept a flexible exchange policy--at least not one of our own making. There were still important gold standard countries vis-a-vis whom a fixed dollar price of gold would automatically establish fixed exchange rates. And, with respect to England, the exchange rates would be fixed by British action and policy and not by the decision of administrative authorities in the United States. The fixed gold price avoided the difficulties of direct and continuous management. Thus the program to buy gold at a fixed price was adopted largely in response to a demand for an automatic system and for fixed exchange rates in so far as this could be achieved under conditions then prevailing.

Once this policy was adopted, various factors contributed to its retention. The new high price of gold pushed the dollar down in relation to other currencies, and served completely to wipe out the

appreciation of the dollar with respect to sterling. This earlier appreciation had contributed to the deflation. Accordingly, deliberate depreciation of the dollar had been demanded by large and influential industrial and agricultural groups, and any tendency, subsequently, toward a reversion to dollar appreciation was strongly resisted. The heavy inflow of capital which quickly set in early in 1934 would doubtless have brought about an appreciation of the dollar had the Treasury not met this inflow with unlimited purchases of gold at the new fixed price.

More recently, especially in 1938 and 1939, a part of the gold inflow balanced an excess of goods and services over imports of goods and services. While the public was unwilling to permit the Treasury to issue currency for the purpose of financing public works, it was in line with established orthodox theory and practice to permit the issue of currency in exchange for gold, thereby subsidizing an excess of exports and stimulating employment. Both employers and employees welcomed this policy.

Thus, the fear of administrative control of exchange rates by the financial conservatives, the concern of agricultural and other interests with the danger of deflation should the dollar be allowed to appreciate, and the traditional desire of American business and labor to stimulate the recovery by means of an excess of exports combined to bring widespread support for the inauguration and maintenance of the gold-buying policy.

Finally, once the war had started, it was at once recognized that the gold-buying program represented a convenient way of overcoming the limitations imposed by the Johnson Act. Aid could be given the Allies without incurring a repetition of the unfortunate experience with respect to the war loans.

2. Events now force us, however, to reconsider our gold buying program. Germany, in command of the Continent, has at her disposal some $3.0 billions of gold, not including the $1.5 earmarked in the United States. This could be used to buy American exports and to strengthen the German dictatorship and hegemony over Europe. Thus we are confronted with a new problem. It would be illogical to spend billions of dollars for defense against Germany and, on the other side, permit our gold-buying program to aid and strengthen the German economic and military system. This statement does not imply, however, that we should refuse to trade under any terms with Germany. An exchange of goods against goods would, at least, be as beneficial to us as to her. But an exchange of goods against gold would amount to placing our productive resources at the free disposal of Germany.

3. What our future gold policy should be will be determined, in fact, by the kind of world we shall face when peace is declared. We shall limit our consideration of alternatives to two: (a) German control of the European continent, resulting in a military alliance between the British Empire and the United States; (b) a conquest by Germany of the British Isles, resulting in a military alliance between Canada and the United States.

(4)

4. In the former case, multilateral trade could be carried on between the countries of the Western Hemisphere, the British Empire countries, the British possessions in the Far East, China and Japan. Trade between the United States and these countries could be fostered by trade agreements of the type promoted by Secretary Hull, based on equality of treatment of all the countries concerned. Trade with Germanized Europe would be conducted, if at all, on a barter basis whenever such barter trades seemed advantageous to us. Already we have the precedent for the differential treatment of Germany in the fact that the concessions made under the Hull trade agreements were never generalized to Germany. Moreover, trade with Germany, even before the outbreak of war, had shrunk to a small fraction of its former magnitude, and had become equalized on a bilateral basis. Such trade as there was had not yet, on our side, become canalized into a Government trading corporation, but the German trading methods indicate that machinery of this character is the logical method of conducting trade with that country. It is assumed that even though a peace is made between England and Germany, in effect such a peace would be an armed truce. Both Great Britain and the United States would continue to regard Germany, quite frankly and openly, as a potential enemy, even though hostilities had ceased. This condition already describes the relations of the United States with Germany at the present moment. While formally at peace, we are not giving Germany equal treatment, in terms of trade, with other countries, and we do not disguise the fact

that we are arming to defend ourselves against her aggression. Such a status, placing Germany in a special category, could easily become fixed, particularly under peace terms which would, in fact, be an armed truce.

Under these circumstances, it would not be difficult to refuse to buy gold from Germany while continuing to buy gold from other countries. In order to prevent the benefits accruing to other countries from filtering over to Germany, we would have to insist that our purchases would be conditioned on their cooperation. The beneficiaries of our gold purchases would not be permitted to buy gold from Germany, for this would only amount to an evasion of our policy. Nor could they be permitted to utilize their improved monetary and credit situation (by reason of our gold purchases) so as to give Germany a favored position with respect to trade credits. Our own gold buying program could be continued only so long as these countries cooperated with the United States in a program designed to prevent any of the benefits from gold purchases flowing to Germany.

A simpler device would be to stop gold purchases altogether. This would compel this and other gold producing countries to face the problem of liquidating the gold industry. One solution would be to buy up the mines at a moderate stipulated price and close them down. Such a policy would also require the payment of a dismissal wage to the wage-earners. But while we could probably, by this method, manage the liquidation of our own gold production, such a program would create serious difficulties for Canada and Latin American countries. Cessation

of gold purchases from them would certainly not contribute to closer economic and political relations between the countries of the Western Hemisphere.

5. In the event of a defeat of England and a break-up of the British Empire, our international relations would be more than ever centered on the Western Hemisphere. Indeed, this Hemisphere would probably be compelled to become largely self-sufficient. These circumstances would indicate a continuation of gold purchases from Canada and Latin America, but complete cessation of purchases from other gold producing countries. The foreign trade of the United States would be restricted mainly to the Western Hemisphere countries. Since there is very little trade between these countries, almost all of it being with the United States, it follows that there is little scope for a multilateral trade policy. Bilateral balancing of trade between the United States and each of the Western Hemisphere countries would be the logical policy. This could be supplemented by barter trade arrangements, where they could profitably be made.

September 27, 1940

B. GOLD POLICY: ALTERNATIVE FORMULATIONS

The general principles upon which our gold policy must be founded are relatively simple and easily stated. The application of the policy depends, however, upon a variety of circumstances, often conflicting.

The continued use of gold in international settlements helps to give support and encouragement to greater freedom of trade and capital movements in the international markets. The complete abandonment of gold purchases will tend to intensify the movement toward the complete governmental control of all international transactions.

Apart from this consideration, gold purchases by the United States constitute an aid to any nation possessed of gold and in need of commodities which we can supply. If such nations are already utilizing their resources to capacity, the sale of gold enables them to increase their military and civilian supplies beyond their own capacity to produce. Under current world conditions, it may be argued that such nations are extremely lucky to find any country which is willing to take and store away unlimited supplies of gold in exchange for useful commodities.

For our own part, the purchase of gold may however be useful, partly as a means of preventing an unfavorable appreciation of the dollar and partly as a means of stimulating our exports, thereby achieving a fuller utilization than might otherwise be possible of our productive resources.

In brief, then, we will want to continue to buy gold to the extent that we wish to give aid and support to certain countries, and to the extent that our gold purchase policy will support agricultural prices and stimulate employment.

During the war we shall want to give all possible aid to Britain. So long as she has any gold resources, therefore, we shall want to continue to purchase gold. We shall want to pursue this policy even though no direct benefits accrued to our own economy. Moreover, during the war and the continuation of the blockade of Germany, it may be safe to buy gold from all sources without encountering the danger that our gold purchase policy will render aid and assistance to Germany. This is, however, a matter which needs watching. Germany might sell the gold of the countries recently coming under her domination to South America, thereby achieving foreign exchange assets which would be immensely valuable after the war.

The possible outcomes of the war are manifold. But it will help our thinking on the subject to envisage three eventualities. These, of course, shade off more or less into each other. Moreover, social and political upheavals in the belligerent countries may profoundly alter the significance of each alternative outcome for the United States.

The war may end in a British victory. In this event, we should not need to fear that a gold purchase program would strengthen a dangerous potential enemy -- Germany. We should accordingly be free to determine our gold policy on the basis of its effect on us and on

England. England would doubtless be in need of American exports of foodstuffs (though preference might not unlikely be granted to the Dominions and to South America), machinery and other equipment to help rebuild her battered industrial plant. We should want to furnish this aid, and would probably prefer to take gold rather than grant credits. Moreover, after the defense emergency, we shall probably be battling with recession and unemployment and would welcome any lift from increased exports.

In the event of a crushing German victory, including the conquest of England, our sphere of influence would probably shrivel to North America and the Caribbean area. We should, under these circumstances, be arming ourselves to the utmost. We should want to prevent Germany from using her gold resources to strengthen her military power. We would therefore, certainly be compelled to implement a policy under which no gold would be purchased by us directly or indirectly from Germany. We could continue to buy gold from Canada and from the Latin American countries within our orbit. Multilateral trade between these countries is almost non-existant. Bilateral trade between each of these countries and the United States would constitute virtually the whole of Western Hemisphere trade. Gold purchases from these countries could easily be incorporated as a part of that bilateral trade. The volume of our gold purchases, under these circumstances, would be relatively small. And controls could easily be implemented (for example -- quotas based on annual production) to insure that no benefits would flow indirectly to Germany.

In between is the possibility of a negotiated peace in which England emerged as the recognized sea power and Germany as the recognized land power dominating the European Continent. This situation presents the most serious dilemma. We should want to pursue a gold policy which would aid and strengthen England and, at the same time, prevent any benefits from this policy flowing to Germany.

Three different types of policies might be invoked. First, we could pursue openly a dual policy — one applicable to Germany and countries in her orbit, and another to the rest of the world. This would admittedly not be a policy of equal treatment. It would discriminate against Germany. But we should doubtless be discriminating against her in other respects also. We have never generalized the tariff concessions made under the Hull trade agreements to Germany. There is nothing in international law which compels us to treat all countries alike with respect to trade, exchange regulations or gold purchases.

Such a dual policy, openly pursued, would involve no subterfuges. Subterfuges fool nobody anyway. It would be a straightforward, forthright policy. It would enable us to continue to give aid to England and other countries which we regarded as actual or potential allies. And it would ease our own unemployment and agricultural problems. It would, moreover, facilitate the development of multilateral trade in the Anglo-American bloc, including the British Empire, the Western Hemisphere and the Far East. It would help to restore free exchange in this area.

Second, an opportunist policy might be adopted. We would announce a cessation of unlimited gold purchases. As a general policy we would not stand ready to buy gold from anybody. We would, however, consider individual cases, not on a country-by-country basis, but in terms of separate deals. We would engage now and then in special barter arrangements in which we agreed to take gold at such prices as might be determined by negotiation.

A third policy could be implemented along the lines of the British Exchange Equalization Account and the Tri-partite Agreement. We might agree to buy gold on a discretionary basis (both with respect to volume and price) from certain countries included in the gold stabilization arrangement. These countries would agree to buy gold exclusively from each other, but entirely on a discretionary basis. In this manner Germany and all the countries in her orbit would be excluded.

Since the discretionary purchase of gold by any one country might, in a free exchange market, affect unfavorably the exchange rates of other countries, such purchases would always have to be made on a consultative basis with the various countries concerned. Exchange rates would not be allowed to vary beyond certain limits except by consultation and agreement.

Arrangements might be made with each country to place certain commodities on a proscribed list. Export licenses would have to be obtained in order to trade in these goods. Outside of the proscribed list (if any) a citizen of any foreign country involved in the scheme could

buy anything from us provided he could find the necessary exchange. The exchange would be created by sales of goods to us or by borrowing. If, however, a certain country desired more exchange and wished to sell us gold, that would become a matter for special negotiation between the Exchange Equalization accounts of the two countries. In making such arrangements, we would take into account the goods wanted, the country concerned, etc.

This scheme might offer a device by which the countries in the gold stabilization bloc could limit the purchase of newly mined gold for their own producers.