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TO Miss McKinstry

OF 8th Floor

FROM M. Rushton

REMARKS

Kay - this is the list I told Miss Adams we were sending to you. Perhaps it may help in locating the material she is requesting.

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REPORTS OF MR. WILLIAMS
AT MEETINGS OF DIRECTORS ATTENDED BY MR. CALKINS

1944-1949

1/20/44	Post-war domestic economy.
1/27/44	Special report - post-war currency stabilization.
2/17/44	Problems re domestic economy.
4/6/44	Research Department. Post-war international currency stabilization.
6/1/44	Post-war international currency stabilization.
7/6/44	Proposal for formation of international Bank for Reconstruction and Development.
9/7/44	Postwar domestic problems - recent developments.
1/18/45	Problems that might affect interest rates on US Government securities during post-war period.
3/15/45	Hearings before Committee on Banking and Currency (H.R.2211) - Participation of US in International Monetary Fund and International Bank for Reconstruction and Development.
4/19/45	Problems re proposed International Monetary Fund on International Bank for Reconstruction and Development.
7/5/45	Re Bretton Woods Agreements.
7/19/45	Full Employment Bill of 1945 (S-380).
9/6/45	Wage levels, price controls and other Government problems.
11/1/45	Wage-price policy of Government.
12/6/45	Theory and history of monetary policy during last two decades.
1/3/46	Management of public debt and interest rates.
3/21/46	Changes in bus. and credit situation.
4/18/46	" " "
5/16/46	Proposed loan by US to Great Britain; British economic problems.
9/5/46	Trends in stock market.
11/7/46	Adequacy of business inventories in relation to anticipated consumer demands. Budgetary outlook of Government.
2/6/47	International economic situation; Great Britain and other European countries.

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5/15/47	$250 mil.loan by International Bank for Reconstruction and Development to France.
5/22/47	International Monetary Fund, International Bank for Reconstruction and Development, International Trade Organization, etc.
6/19/47	International economic problems.
7/3/47	Discussed statement to Joint Congressional Committee on Presidents Economic Report.
9/18/47	Economic developments in Europe.
10/16/47	Problems of debt management and monetary controls.
11/20/47	Re Presidents recommendation restraining inflationary bank credit.
1/8/48	Message on State of the Union - taxation and monetary policy.
2/5/48	French program for devaluation of franc, etc.
3/4/48	European Recovery Program.
5/6/48	System's authority over commercial bank reserve requirements. (5/11/48 letter to directors from William I. Myers enclosing letter to Mr. McCabe, Chmn., Board of Governors, on this subject.)
6/3/48	European situation.
10/7/48	Economic situation; outlook.
12/16/48	Report on trip to Europe.
3/17/49	Meeting with representatives of Economic Cooperation Administration.
9/15/49	Business and credit situation.
12/15/49	Scheduled trip to Paris re Interim Report of the Organization for European Economic Recovery.

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Author(s): John H. Williams

Article Title: End of the Marshall Plan

Journal Title: *Foreign Affairs, An American Quarterly Review*

Volume Number: Issue Number:

Date: July 1952

Page Numbers:

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Author(s): John H. Williams

Article Title: An Economist's Confessions

Journal Title: *American Economic Review*

Volume Number: XLII Issue Number: 1

Date: March 1952

Page Numbers:

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Author(s): John H. Williams

Article Title: The Marshall Plan Halfway

Journal Title: *Foreign Affairs, An American Quarterly Review*

Volume Number: Issue Number:

Date: April 1950

Page Numbers:

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Author(s): John H. Williams

Article Title: Europe After 1952: The Long-Term Recovery Problem

Journal Title: *Foreign Affairs, An American Quarterly Review*

Volume Number: Issue Number:

Date: April 1949

Page Numbers:

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Author(s): John H. Williams

Article Title: The Task of Economic Recovery

Journal Title: *Foreign Affairs, An American Quarterly Review*

Volume Number: Issue Number:

Date: July 1948

Page Numbers:

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Author(s): John H. Williams

Article Title: An Appraisal of Keynesian Economics

Journal Title: *American Economic Review*

Volume Number: XXXVII Issue Number: 2

Date: May 1948

Page Numbers:

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Author(s): John H. Williams

Article Title: Economic Lessons of Two World Wars

Journal Title: *Foreign Affairs, An American Quarterly Review*

Volume Number: Issue Number:

Date: October 1947

Page Numbers:

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Author(s): John H. Williams

Article Title: International Monetary Plans: After Bretton Woods

Journal Title: *Foreign Affairs, An American Quarterly Review*

Volume Number: Issue Number:

Date: October 1944

Page Numbers:

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Author(s): John H. Williams

Article Title: Currency Stabilization: American and British Attitudes

Journal Title: *Foreign Affairs, An American Quarterly Review*

Volume Number: Issue Number:

Date: January 1944

Page Numbers:

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POLICIES OF THE UNITED STATES AS A CREDITOR NATION

BY

JOHN H. WILLIAMS

DEAN, GRADUATE SCHOOL OF PUBLIC ADMINISTRATION,
HARVARD UNIVERSITY

AN ADDRESS
BEFORE THE
ACADEMY OF POLITICAL SCIENCE
AT ITS
ANNUAL MEETING ON
"THE PROBLEMS OF TOTAL WAR AND ROADS TO VICTORY"
NOVEMBER 10, 1943

THE ACADEMY OF POLITICAL SCIENCE
COLUMBIA UNIVERSITY

1944

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POLICIES OF THE UNITED STATES AS A CREDITOR NATION

JOHN H. WILLIAMS
Dean, Graduate School of Public Administration, Harvard University

FOR the second time we are facing the problem of carrying over into peace the spirit of international coöperation developed in war. Last time our experience was very disappointing. It is a striking fact that the chief development in economic theory during the inter-war period was the closed economy analysis, and in economic policy one of the main developments was the movement in various countries toward self-sufficiency. Some people explain in psychological terms the wave of nationalism that so often follows war; war develops our pugnacity, and after we have rested a while we want to fight again. But the explanation goes much deeper. War profoundly changes international relationships and presents most difficult problems of readjustment.

In the last war the position of the United States was changed from a debtor to a creditor nation. Another great change was in the position of Germany, where economic exhaustion at home, the loss of foreign assets, and the reparation payments were major causes of the great post-war inflation. After this war the United States will be the only large creditor nation. Some younger countries, such as Canada and Argentina, which will also come out of the war in a creditor position, will probably in the longer run again become net capital-importing and interest-paying countries. The most striking change will be in the position of England; she will enter the post-war period as a debtor country after having been for more than a century the world's leading creditor.

England's post-war problem is highly complicated. She has lost the greater part of her foreign assets, and there is now an accumulation of sterling balances owed to foreign countries—quite apart from lend-lease transactions—which is estimated at four to five billion dollars and is growing at the rate of two billion dollars a year. England is worried about her future position in shipping and aviation. Her internal reconstruction

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will require imports, particularly of raw materials and food products, while she is planning to coöperate with us in providing relief for other countries. At the same time, because of her debtor position, she will have the quite new problem of developing a large excess of exports. England will have an interest second to none in maximizing foreign trade by helping to restore a multilateral system of world trade. Even her previous ability as a net importing country to keep the upper hand in bilateral trade agreements will largely have been lost. But it seems likely that England will approach the task of international currency stabilization with a cautious attitude. Two main questions are: (1) whether any plan for currency stabilization will give her sufficient freedom both to find the equilibrium rate of exchange between her currency and others—always a major problem after a war—and to permit an orderly adjustment of rates thereafter as basic conditions change; and (2) how to reconcile the requirements of international currency stability with the maintenance of a high degree of control over her internal economy.

I cannot deal with the general problem of currency stabilization or the plans now under discussion between our Treasury experts and those of the British Treasury,[1] but my remarks today are concerned with one aspect of that problem. It is part of the tradition of the subject that the creditor country has a special responsibility for international monetary and trade relations. One of the reproaches running all through the inter-war period was that we did not play our rôle, and that in consequence the restoration of the gold standard in the nineteen-twenties led to intolerable deflationary pressures upon other countries and a new collapse. Rather than repeat that experience the debtor countries would prefer to take their chances with bilateral trade agreements and exchange controls, poor as they recognize this alternative to be. We owe it to ourselves and to them to survey the inter-war experience and the peculiarities of our present position.

Many of the worst features of the last post-war period had nothing to do with the normal relations between debtor and creditor countries. We ought this time to be able to avoid the wild gyrations of currencies that followed the last war. Prac-

[1] See my paper in *Foreign Affairs*, July 1943, and a forthcoming paper in the January issue.

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tically all nations will come out of the war with effective systems of exchange control, and these should be relaxed only slowly and carefully. It seems not improbable that England will retain more permanently control over the short-time movements of capital resident in Britain, even though to do this she must retain the machinery of a general exchange control, and free trade movements from it by means of general licenses.[2] The main cause of the recurrent flights of capital between the two wars was the economic and political insecurity in Europe. If this can be removed we shall be in a better position to see how much control over capital movements is essential.

Two of the chief mistakes last time, reparation payments and inter-Allied debts, we must hope will not be repeated. I realize I cannot dispose of the reparations question as summarily as this. German confiscations of property in occupied countries will require restitution of national ownership, at least; Russia may demand, and be able economically to accept, payments in goods or in services; and there may be other possibilities; but surely the transfer problems which bedeviled the world in the nineteen-twenties will be avoided. One of our cleverest moves in this war was to think up lend-lease, and my only regret is that we did not at the time provide for its extension for perhaps three years after the peace, on the theory that the first phase of peace is but a projection of the war—war does not end when the shooting stops but when the difficult transition back to more normal international conditions has been achieved. A considerable part of the inter-Allied debt last time was incurred after the Armistice.[3]

The experiences of the twenties and thirties do not suggest that the rôle of a creditor country under post-war conditions is a simple one. We were condemned, probably more than for anything else, for our protectionist policy, and the criticism was deserved; but our policy was quite in line with that of

[2] I am not entirely sure, indeed, that England and some other countries will forswear all direct control over imports; when the choice is between this and changing exchange rates the answer is not clear a priori.

[3] Since the meeting of the Academy, Leon Fraser, at the *New York Herald Tribune* Forum, November 16, 1943, has suggested a "moratorium for a period of five years of any post-war lend-lease repayments involving transfers out of Great Britain, any repayments thereafter to be limited to the return to the creditor, of the same commodity as was shipped."

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other countries demanding but unwilling really to accept the reparation payments. As a creditor nation we were expected to assist in restoring and maintaining international stability by exporting capital. The capital movements occurred, mainly to Germany and Latin America, but have generally been regarded since as disturbing rather than corrective factors. Especially significant was the controversy which developed after England's return to gold in 1925. The reproach that we were sterilizing gold and preventing the internal monetary expansion required by gold standard theory was quite unfounded; as we saw more clearly later, we were in the early stages of the expansion which led to the crash of 1929, though that was obscured by the fact that the rise was in security prices and in incomes rather than in commodity prices. Our attempt to push out gold in 1927 by lowering interest rates ended in failure, and is thought by many to have intensified the stock market boom. The chief mistake was in the overvaluation of the pound. It should make us more aware this time how important it is to find the equilibrium rates if currency stabilization is to be attempted with any prospect of success. Despite all that was written on the subject and the great interest developed in " purchasing power parities ", this seems to be mainly a trial-and-error process involving mutual consent and a flexible approach providing for orderly change in rates as the basic circumstances warrant. How to do this consistently with the general objective of exchange stability seems to be the essence of the problem; adequate discussion of it would go far beyond the limits of this paper.

There are some peculiarities of our creditor position which we ought to puzzle over ourselves and try to make clear to others. For this rôle we lack many of the advantages which England had in the nineteenth century. England was at the center of world trade and finance, sterling was the medium and the London discount market the clearing mechanism for international payment, and the Bank of England by its discount rate could greatly influence capital movements and the flow of gold. England had a unique position such as will probably never be enjoyed by any single country in the future. When reference is made, as occurs so often, to how well England performed her function as the creditor country, with the implication that now it is our turn to do as well, these differ-

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ences must not, if we are to think clearly, be forgotten. The problem has become more difficult all round; and even then it was not simple or the performance very good much of the time. The nineteenth century was one of great economic progress but one marked by great world-wide depressions and by periodic breakdowns of the gold standard.

But all comparisons are relative, and the problem was simpler then than now. For England, once her industrial revolution had come to full development and found full expression in her trade and capital relations with the rest of the world, there could be no doubt of where her interests lay and no room for a divided national feeling about her commercial or financial policies. Rarely has there been a time, too, when what suited the creditor country so well suited many of her debtors. Though there always was a danger that international free trade theory too literally applied might interfere with the national development of countries less advanced, and conflicts on this point were never absent from our colonial period onward, the nineteenth century witnessed on the whole a harmony of trade and capital relationships which may never be seen again. Capital exports and interest payments were matched by manufactured exports from the lending country and food and raw material imports from the borrowing countries with cumulative advantages for both.[4]

One of our peculiarities is that we are still a mixed agricultural-industrial economy. When we talk of maximizing imports there is certain to be a divided national interest about what imports are involved. At an earlier stage when we were a great agricultural exporting nation and a young industrial nation, the emphasis was on protecting manufactures, and the conflict was between the industrial North and the agricultural South and West interested in expanding export markets and getting cheaper manufactures in exchange. Now it is agriculture, too, or perhaps mainly, that wants protection, and the day of an undivided national interest in commercial policy seems still far distant. I grant that this point can be overstressed, and I have often said that trade tends to be greatest among

[4] I have always felt that the full significance of this growth process was missed by the classical theory of international trade and the gold standard, which was essentially a static theory assuming full employment of known resources, and revolved too much around the "terms of trade".

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countries of highest purchasing power, regardless of their special characteristics; but it remains a troublesome feature of our international situation, and may well have intensified effects on other countries after the war, when we shall have synthetic rubber and other new products formerly imported to think about.

Another of our peculiarities is that, though this country is the world's greatest reservoir of capital and will probably always be a net exporter of capital over any long period, it is probably also, under favorable conditions, still the greatest magnet for outside capital, for investment and speculation as well as for safety. In a boom we might easily shift from being a net exporter to being a net importer of capital, exerting deflationary pressure upon debtor countries, from which they could probably not find relief except by direct control of capital outflow. The late nineteen-twenties have been often cited as an illustration of this phenomenon, and the attraction of foreign capital into our stock market has been emphasized as one cause of the great depression.

I have been dwelling mainly upon the difficulties of our position rather than their solution, and I am afraid this fairly represents the present state of my thinking. I do, however, want to make some more positive suggestions. In the immediate post-war period the chief need will be for relief and rehabilitation.[5] This should be handled by free contributions, or under lend-lease. But there will also be a need for reconstruction in a broader sense, involving loans. Our Treasury published in October a tentative plan for an international bank, but it is difficult to see how there can be a truly international bank in a world composed of one large creditor and many debtor countries; however the bank is formally organized, the funds will have to come chiefly from this country. Relief and reconstruction will make heavy demands upon American production during the period of transition from war- to peacetime production. This demand for exports will come on top of a huge deferred demand here at home for producer and durable consumer goods, a demand backed by the great accumulation of unspent wartime incomes. We shall need to ration our

[5] Reports are now beginning to come out of the plans of the United Nations Relief and Rehabilitation Administration; they call for expenditures of two and a half billion dollars. See *New York Times*, November 16, 17, 1943.

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production between home and foreign requirements and to maintain our direct controls, as well as fiscal and monetary controls. With the war ended, the task of persuading the public that these controls are necessary will probably be much more difficult than now. It is in this early post-war period that the danger of inflation will be greatest. If the war ends in Europe before it does in Asia, the difficulties of transition will be lessened; some expansion of peacetime production should now be planned, to take effect as soon as war in Europe ends.

Looking farther ahead, the world will need both our capital and our markets. How to bring both things about is something of a puzzle. Maximizing foreign trade all round will, of course, help all countries. But that may not be enough to right the great unbalance which will exist, and to meet the much greater needs of England and some other countries to expand their exports. This is another aspect of the fact that we are not yet a mature creditor country in the nineteenth-century British sense. England was a creditor on income account, with a net excess of imports. In our balance of payments, interest receivable is offset by tourist expenditures and foreign remittances, which will probably increase after the war; and when we add to these our capital exports we shall probably continue to have an excess of merchandise exports for a long period to come. To bring about a combination of exports of capital from this country accompanied by goods exports from other countries would seem to require something equivalent to a sustained one-way movement of gold from this country, accompanied by rising prices here relative to outside price levels, and even, as some writers suggest, by a continuing direct control over our exports. But it seems unlikely that such policies will be adopted. One service we could do to foreign countries would be to restrict our lending to the really necessary demand in the foreign country for foreign goods—producer goods and really essential consumer goods. Expenditures for domestic labor and resources should be financed at home. Often what is most needed is engineering or financial advice rather than a loan.

The greatest contribution we can make to world stability is by maintaining high production and employment here at home. This would maximize imports and create the most favorable conditions for reducing tariffs, though it probably would not, by itself, lessen exports. The advantages of a high level of

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production are sometimes overstated to imply that international trade adjustment could be made a one-sided process of expansion in the high production country. If the expansion could go on indefinitely without danger of a boom this might be true, but in the post-war period, as I have said, this danger will be real. There is also the difficulty I mentioned earlier of reversal of the capital movement, and the feeding of expansion in the creditor country by deflationary pressure on the outside world. All in all, however, internal stability at a high level would be much our best contribution.

But this only shifts the emphasis to another problem no less difficult than international monetary and economic stabilization. It raises issues about methods on which public opinion is far from united; and government planning in the domestic field for the post-war period is probably less advanced today than in the international. One of the great unknowns, also, is what is to be the character of internal planning in other countries. In England, many recent utterances by political leaders and economists seem to foretell the retention of a much higher degree of internal control, not only for the period of transition to peace but more permanently, than England had before the war. How much of such control is compatible with international monetary stability and a multilateral trade system will be one of the chief problems of the post-war period.

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Author(s): John H. Williams

Article Title: Currency Stabilization: The Keynes and White Plans

Journal Title: *Foreign Affairs, An American Quarterly Review*

Volume Number: Issue Number:

Date: July 1943

Page Numbers:

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THE
IMPLICATIONS OF FISCAL POLICY FOR MONETARY POLICY AND THE BANKING SYSTEM

By
JOHN H. WILLIAMS
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THE IMPLICATIONS OF FISCAL POLICY FOR MONETARY POLICY AND THE BANKING SYSTEM

I

One of the most striking facts about the development of fiscal policy in the past decade is that while it grew out of monetary policy and was designed to supplement and strengthen it, fiscal policy has ended up by threatening to supplant monetary policy altogether.

The emphasis on central bank control was carried to great heights in the late twenties and early thirties. Failures to achieve adequate control were ascribed to the shortcomings of the central bankers rather than to any weaknesses inherent in the method of control. But as the great depression deepened, despite the fact that the easy money policy was carried to lengths unprecedented in this or any other country, the conviction grew that whatever might have been the defects of central bank policy, the main trouble lay in the inadequacy of this method, by itself, to control investment and the level of output and employment.

Fiscal policy was designed to supplement monetary policy in two ways. First, if an easy money policy would not, by itself, sufficiently induce investment, this object could be achieved by creating new community income through budgetary deficits. In this sense, fiscal policy could perhaps be regarded from the beginning as a substitute for central bank policy. The analysis of income-creating expenditures has been the chief preoccupation of fiscal theory. In the pump-priming version of the theory the emphasis was laid on the power of deficit spending to stimulate private investment. In the later versions it was placed on the need for compensating, by means of public expenditures, for chronic tendencies toward over-saving and under-investment.

But throughout the analysis attention was also given to the ways in which fiscal policy could make central bank policy more effective.

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Monetary analysis had been directed increasingly toward the role of the rate of interest as the controller of investment. Until Keynes' *Treatise on Money* appeared in 1930, the main emphasis had been on control of the short term rate. That short term credit was the only proper concern of banking and of monetary control was an idea deeply rooted in the history of banking theory. It appeared to follow, for example, from the commercial loan theory of bank assets, which had its roots in the controversies of the banking and the currency schools in the first half of the nineteenth century, but which had persisted with such vitality as to dominate the philosophy and many of the basic provisions of the Federal Reserve Act. While the theory was never lived up to entirely in banking practice, short term assets played the predominant role in banking changes and it was through them that adjustments were made to changes in the reserve position of the banks. The result was a high degree of sensitivity in short term open market rates. Historical charts of interest rates show that until recent years short term rates fluctuated widely above and below the long term rates; and some of the older economic treatises insisted, though I think with much exaggeration, upon the constancy of the long term rate as indicating a persistent natural tendency of saving and investment to equalize at an unchanging rate of interest.

Since the first World War, revolutionary changes have occurred in American banking. The postwar boom of 1919-20 was a great blow to the commercial loan theorists, for it was an inventory boom and found its banking expression primarily in excessive commercial loan expansion. It was followed by important changes in financial practice, whereby business became increasingly its own banker so far as working capital was concerned. Commercial loans diminished. By 1929 commercial paper eligible for rediscount was only 12 per cent of total earning assets, and by 1932 only 8 per cent. In the stock market boom of the late twenties, we saw the enormous increase in security loans both for the banks' own account and for the account of others. Out of this experience came the grant of authority to the Reserve System to control the stock

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market use of credit. This was a fundamental, indeed a revolutionary, development in monetary policy, away from the traditional over-all quantitative control of the supply of money toward the control of a specific use of money.

But the greatest change which has occurred in banking since the Reserve System was established has been in the growth of bank investments. This growth began in the first World War when the banks, with the aid of the new Reserve System, bought government securities for their own account and made loans to finance purchases by the public. That this change in the composition of bank assets was not merely a temporary wartime change was indicated by the fact that as the federal debt was reduced during the twenties, the banks did not reduce their holdings of government securities. Then followed, beginning in 1931, the continuous series of budget deficits to the present day. The federal debt, direct and guaranteed, has risen from $15,922,000,000 on June 30, 1930 to $54,747,000,000 on June 30, 1941, and the holdings of federal government securities by the commercial banks have risen from $4,981,000,000 to $20,098,000,000. At the present time investments, mainly in government securities, comprise about 57 per cent of total earning assets.

As this great change occurred in bank assets, the theory of assets underwent important changes. The commercial loan theory came in for closer scrutiny and some of its fallacies were revealed, though not I think without leaving in it an important kernel of truth. Attention was directed toward what was called the "monetary theory" of bank assets, by which was meant that changes in *any* type of assets affect the quantity of deposits and currency, which in turn was held to produce economic changes. The implication was that what kinds of changes occur in the *composition* of bank assets is immaterial.

As bank investments have increased, long term interest rates have shown increased sensitivity to changes in bank reserves, and the emphasis in monetary theory has shifted to the need for controlling the long term rates, as more effective for the control of

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investment, income, and employment than control merely of the short term rates. It was in connection with the long term rate of interest that fiscal policy was expected to strengthen central bank policy. The appearance of excess reserves came as a distinct shock to many monetary theorists in the early thirties. Much of previous monetary theory had been built on the assumption that the banks would always be loaned up. But it became unmistakably clear, as bank reserves expanded, that bankers were interested in the quality as well as the quantity of their assets, and rather than assume undue risks would hold their reserves idle. It was at this point that monetary policy and fiscal policy joined hands. The financing of deficits, combined with pressure through reserves, affords an avenue for expansion of bank assets and deposits accompanied by a decline in interest rates. In addition to the new money thus created, government borrowing provides an outlet for old deposits which might otherwise remain idle rather than assume the risks of investment in depression. Theoretically, the decline of interest rates would begin in the market for short term securities, but as the short term rates declined the banks would reach out for longer maturities. The fall in the rate on government securities would spread to other investments and loans, attracting both bank and nonbank investors, until after a transition phase of refunding of old securities, the new issues market would be affected and a stream of new investment set in motion.

As we look back over the period since 1932, when the excess reserves and large scale deficits began, we can see that the only part of this expectation that failed to materialize was the revival to an adequate extent of private investment. Though the excess reserves were not used up, bank assets, mainly in government securities, greatly expanded, and the expansion of bank deposits was greater than in any previous period in our history. By 1939 demand deposits and currency were over fifty per cent greater than at the peak of the boom in 1929. As bank reserves and the money supply expanded, the rates on long term governments and on the better grade corporate securities fell to the lowest levels in

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the history of this or any other country,[1] and the rate on short term governments declined to practically zero.

II

My concern today is with the implications of these developments for the future of banking and of monetary policy. There is no denying that we have had the most tremendous experiment in history with the easy money policy. It should be said that the scale on which the experiment occurred was not intended. The conscious, deliberate policy of creating excess reserves by central bank operations lasted only through 1932 and 1933. The enormous increase of reserves which occurred thereafter was due mainly to gold inflow and to a much less extent to the silver purchase policy. But it should be added that for some time the authorities were not unsympathetic to the continuing expansion of excess reserves and the decline of interest rates which accompanied it. The gold sterilization begun in December, 1936 and the raising of reserve requirements in 1936-37 were not intended to reverse the easy money policy, though they did indicate a judgment that there would be no further advantage, and a growing balance of disadvantage, if the growth of excess reserves were allowed to proceed unchecked.

Of special significance were the events which accompanied these attempts to reduce the excess reserves. For a short period in 1937 there was something resembling a government bond panic. One can readily appreciate the apprehension which was felt. Selling of government securities by the banks at a time when the government debt was still increasing could have highly deflationary effects. It would mean that nonbank investors would be called upon to buy not only the new securities being issued but also the old securities being sold by the banks; and this process would have to take place

[1] The most nearly comparable period is that of the late 1890's and early 1900's when interest rates also fell to very low levels. The conditions, however, were hardly comparable. The securities which sank lowest were those bearing the national banknote circulation privilege. Moreover, the national debt was then very small.

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at a time when the volume of deposits, by reason of bank selling, was contracting. Actually the net amount of selling by the banks, and the effects of the selling, were exaggerated in the current discussions. If we look at the full year, June, 1936 to June, 1937, during which the changes in reserve requirements occurred, what broadly happened was that New York City banks sold securities while the interior banks bought. But in the crucial first half of 1937 both classes of banks made net sales. The net contraction of bank holdings of governments was about a billion dollars, and interest rates advanced by about a half per cent. The episode revealed once more, as the bank holiday had done in 1933, that the peculiar vulnerability of New York, which had been responsible for our money panics prior to the creation of the Reserve System, still remains a problem, and one that takes on an added significance now that bank assets consist to such a large extent of securities subject to fluctuations in market price. The country banks met the increased reserve requirements mainly by drawing upon their balances with their city correspondents. Their excess reserve position remained but little affected, while the New York banks were subjected to the double pressure of meeting their own increased reserve requirements and providing reserves for the country banks.

The fact that the raising of reserve requirements was followed by the new depression of 1937-38 caused some persons to place the responsibility for the depression upon the reserve policy, while others ascribed it mainly to the fact that for a brief interval in 1937 the federal budget came into balance. Though in my judgment neither of these developments was a major cause of the new depression, the conjuncture of circumstances had important effects upon the further development of ideas with regard to both fiscal and monetary policies. The gold sterilization policy was dropped, the reserve requirements were moderately reduced, and the Reserve System's newly developed function of "maintaining orderly market conditions" for government securities took on added significance. As for the banks, some said that the new depression, coupled with the disappearance of any nearby prospect of resumption of monetary

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control, had "saved the banks." While there was, of course, much exaggeration in this view, it did point to a growing awareness of the new elements of instability which the combination of excess reserves and government deficits had introduced into the banking system. The selling crisis was short-lived. Gold continued to pour in, the growth of excess reserves was resumed, the banks resumed their buying of government securities, and the prices of the securities steadily rose to new all-time highs, with some minor setbacks such as that on the outbreak of the war in 1939 and on our own entry into the war less than a month ago.

Much the most important change, for our present subject, that occurred as a result of the new depression in 1937 was the change in fiscal theory. The conviction grew that we were faced with something more than cyclical recovery from a major depression. The emphasis shifted from pump-priming to the need for deficits as compensation for long-run structural changes in the economy, changes which were held to be due to chronic tendencies toward over-saving and under-investment, and which were said to call for deficits that might be permanent or at any rate should be continued so long as underemployment prevailed.[1]

I had been, and still am, sympathetic to the alliance between central bank policy and pump-priming. They do not differ from each other in purpose or in general analysis of the problem. Both are aimed primarily at cyclical variations on the assumption that aside from such movements the economy can be self-sustaining. Properly managed they could be mutually reenforcing. In recovery from depression the deficits might play the larger role, both by creating new income directly and by helping to implement an easy money policy. In a boom, monetary policy could play an important and perhaps even the predominant role. A contraction of bank reserves, especially if coupled with some direct controls such as those over stock market and instalment credit, can exert powerful effects upon investment, output, and employment, provided excess

(1) For my own views see my paper on "Deficit Spending", *American Economic Review, Proceedings,* February, 1941.

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reserves are not too large to prevent central bank contact with the money market. With budget surpluses in boom offsetting deficits in depression the problems of bank holdings of government securities would not exist, or at any rate would not reach serious dimensions.

Whether the pump-priming policy could be successful is another question. As I said in my paper last year, it was really never tried. There is no evidence that the Administration, as distinct from some persons within it and some economists offering advice from the outside, ever had a conscious interest in fiscal policy as an instrument of recovery prior to the new depression in 1938. Government spending was primarily for relief and was regarded mainly as the unavoidable accompaniment of unemployment until recovery could be achieved by other means. I have been inclined to agree with those who hold that relief expenditures do not reach down far enough into the economic process to afford much leverage. Public works expenditures, if they could be adjusted to the business cycle, would probably be more effective, and military expenditures also would probably have a greater stimulating effect, even in peace time. Now that our military expenditures are likely to remain large, for improvements, replacement, and maintenance even after the initial expansion has been completed, we may have in such expenditures, so far as they can be adjusted to business cycle changes, a significant instrument of control of economic fluctuations. A further important consideration is that if pump-priming is to be seriously attempted in the future, it must be done in an atmosphere that is favorable to "business confidence" and must give attention to the other economic conditions, including the behavior of costs and prices and the effects of taxation on investment as well as on consumption, which bear upon the revival of output and employment under private enterprise.

The difficulties for banking and for monetary control grow not out of pump-priming but out of the long-run spending policies. The question which I raise is whether a large and growing public debt which continues to be financed to a large extent by the banking

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system does not make impossible a general monetary policy and deprive us of the power to vary the interest rate and the money supply as instruments of control of economic fluctuations.

That such a control is not feasible in war appears to be amply indicated by the fact that all the countries at war, not only totalitarian Germany but democratic England, Canada, and our own country, are pursuing an easy money policy, notwithstanding the fact that the money supply is redundant and interest rates are at or near their record lows. This is a situation without precedent in the history of wars. Prior to the first World War there would probably have been general agreement that to control inflation we should place reliance upon monetary controls first, fiscal controls second, and direct controls last. Even in the last war Treasury financing was done at rising rates of interest, though there was little or no deliberate effort to impose restraints upon monetary expansion. But in the present war the policy is frankly one of easy money. With this policy I am entirely in accord. A restrictive monetary policy is not feasible or desirable so long as the government is the principal borrower and the banks must be relied upon to do a large portion of the lending. The restraints imposed upon inflation must come mainly through direct controls and through taxation. That the possibilities of financing war by taxation may be limited, however, would appear to be indicated by the fact that in England, whose war effort absorbs some 50 per cent of national income, less than 40 per cent of the war expenditures are met by taxes.(1) Our need for borrowing will undoubtedly remain large. It is, of course, desirable that this financing should be done as much as possible outside the banks, but unless and until other sources of funds can be proved adequate it would be the height of folly to prevent bank-buying of government securities.

(1) In the first nine months of its current fiscal year (April 1—December 31) the British Treasury spent almost $14,000,000,000, had revenues of less than $5,000,000,000 and a deficit of $9,000,000,000. *New York Times*, January 2, 1942.

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III

Under war-time conditions we shall probably have to bow to this necessity. But what are the implications of an indefinitely prolonged continuance of large-scale public borrowing thereafter? This question breaks down into a number of aspects, such as the future of interest rates, of the volume of deposits, the condition of the banking system, and the future course of excess reserves and monetary policy.

One of the main lessons to be drawn from our experiences of the past decade is that it is possible to overdo an easy money policy. It is a curious fact that though fiscal policy grew out of the recognition that pushing down the interest rate does not adequately achieve a revival of investment, output, and employment, the emphasis upon low interest rates was carried over not only into the pump-priming policy, where it rightly belonged, but also into the long-run "compensatory" fiscal theories, which in one version rest upon the assumption of chronic over-saving, and in another upon the assumption that in a mature economy private investment *cannot* be adequate, however stimulated. Doubtless the explanation is that even under these assumptions it is desirable to do everything possible to stimulate private investment.[1] Great emphasis was placed by Keynes in his *General Theory* on the need for reducing the interest rate. His thesis is that since, by reason of risk and other factors affecting "liquidity preference," we cannot push the interest rate below a certain minimum, we must use deficit spending (or taxation) to fill the gap between saving and investment.

The question raised by our experience, however, is whether too much emphasis has not been placed upon the interest rate as a cost of investment and too little upon it as an inducement to invest. Interest is but one of the costs of investment and is unlikely in most cases to be the controlling one, even though it is more import-

[1] Another consideration may be the cost of carrying the public debt, but this is surely a very minor point with those who hold these theories, since they repeatedly take pains to demonstrate that the economic cost of public debt is slight.

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ant in long than in short time investment. But there is also the viewpoint of the lender. When the interest rate falls very low there may be inadequate inducement to invest out of income, or even to keep capital invested. This is, one must admit, not altogether a simple question. We must recognize, for example, that some kinds of institutions have increased their investments, even at falling interest rates, when they have been under pressure to invest and could find safe investments. As already described, it was the pressure of excess reserves, combined with the need for earnings as interest rates declined, which induced the banks to invest in government securities. One could cite too the increase of investments of the insurance companies, also under heavy pressure to invest premiums and maintain earnings. But such facts do not prove that the aggregate of investment would not be greater if interest rates were higher. And when the theoretical problem posed is that of idle saving, is this not the proper question? One of the most striking aspects of our experience during the thirties was that the unprecedentedly large increase in the volume of deposits and currency which resulted from the combination of excess reserves and deficit financing was offset by an equally great decline in the velocity of money. There is no precedent for this experience, on such a scale, in all preceding monetary history. The explanation of it is probably complex. One important cause may well have been the "lack of confidence," quite apart from the interest rate, on which the business and financial world so much insisted during the period of New Deal experimentation. But it may well have been due also to the fact that the interest return from investment was not high enough to overcome "liquidity preference."

That an easy money policy can be overdone is indicated also by the fact that when interest rates fall to very low levels deflationary stresses and strains appear in the economy which are directly attributable to this decline. A wide range of institutions and individuals dependent upon fixed income-yielding investments suffer losses of income whose effects upon their ability and willingness to

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invest further, their sense of security, and even their ability to maintain consumption, work directly counter to the purpose of the easy money policy. If the low interest rates did actually achieve an adequate recovery of investment, output, and employment, these adverse effects could perhaps be dismissed as part of the necessary cost of a successful monetary policy. But when rates reach such a low level that they accomplish little or nothing further to stimulate investment, from the side of demand for capital, while impairing the ability of some important income groups and institutions to invest or even to consume, the easy money policy has overreached itself.

There have been suggestions in recent years, and some of them have come from fiscal theorists who in the past have been most insistent upon low interest rates, that it may be necessary to subsidize some classes of interest receivers, by devising special government security issues at higher coupons than the prevailing open market rates. There could be many candidates for such subsidies long before interest rates reached Joan Robinson's suggested zero.(1) Recently, one or two of the leading insurance companies have announced an advance in premium rates to offset the decline of yield upon investments.(2) Savings banks have had to cut their interest payments to a very low level. Universities and other endowed institutions have had to cut their budgets. We are told that in England it is frankly recognized that the government must sustain the banks by borrowing at rates high enough to cover bank expenses, and that the same subject has aroused some interest in Canada.

One of the chief difficulties of an easy money policy, when it is implemented or accompanied by large government borrowing, is that it becomes increasingly difficult to reverse the policy. This, as I have sought to show, has been the main implication of our

(1) *Essays in the Theory of Employment,* p. 255: ". . . when capitalism is rightly understood, the rate of interest will be set at zero, and the major evils of capitalism will disappear."

(2) See *New York Times* editorial, "Easy Money and Insurance," November 22, 1941, suggesting special Treasury issues for insurance companies.

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own experience of the past decade. And it is the main reason for the suggestions that we may have to make a list of exceptions to the application of the policy. The larger the public debt and the greater the continuing need of the government to borrow and spend, the greater are the hazards for the Treasury and for the banking system that are involved in any reversal of the policy. For the Treasury it would mean financing at rising rates of interest, which means not only a rising cost of borrowing, which by itself might not be decisive though increasingly important as the debt expands, but also an increasing worry that the market may develop an inclination to hold off and wait for better terms and so have increasingly to be coaxed or threatened. To the banks it would mean increased earnings on new issues but losses in market values upon old ones. The result is that even when there may be general agreement that interest rates have gone too low and that it might have been better to stabilize them at some earlier time when they were higher, there is always a strong presumption in favor of stabilizing at the current level, if not indeed of allowing them to go still lower. To put rates up would mean to throw the main burden of adjustment upon the banking system and the Treasury. That such a policy would be unwise in war time seems generally to be recognized, but the problem would be no different in time of peace if the same facts as to size and distribution of the public debt and the continuing need for public borrowing prevailed.

One further important aspect of an extreme, easy money policy, implemented by excess reserves and public borrowing, is that the effects are different upon different rates of interest. In the debates about monetary policy in the late twenties and early thirties, one of the points most emphasized by those who doubted the adequacy of interest rate control[1] as a means of controlling investment, output, and employment was that there was not one rate of interest but many, and that the differences in their behavior greatly complicated the task of central bank control. One complication was a

(1) See my paper, "The Monetary Doctrines of J. M. Keynes," *Quarterly Journal of Economics*, August, 1931.

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perverse cyclical variation, such that when the rates most subject to monetary control were falling in depression and rising in a boom in response to central bank policy, other rates were rising and falling in response to expectations of income affecting risk. Owing to such factors as defects of market organization, inertia, local or regional customs, and the importance of personal relations between lender and borrower, many interest rates were largely insensitive to quantitative monetary controls, which affected mainly the open market rates of the large financial centers. Looking back at our experiences of the past decade, we can see how uneven the effects of the easy money policy have been. Great gaps have been opened up in the interest rate structure. At one extreme, short term open market rates, prior to the recent decline in excess reserves, had been reduced to virtually zero. Such low rates as have prevailed for Treasury bills and other high grade short term paper serve no useful purpose and reflect nothing other than the abnormality of excessive bank reserves. Were such rates more nearly in line with longer term rates, as used to be the case, banks would be under less pressure to reach out for longer maturities to maintain earnings, and one of the main dangers of banking instability would be removed. At the other extreme, some other interest rates, such as mortgage rates and the general level of customer loan rates outside the larger centers, have been largely insensitive to excess reserves and have tended to remain rigid at relatively high levels. For these reasons, the interest rate discussion has entered a new phase in recent years, with a growing recognition that rates may be both too low and too high at the same time, the low rates accomplishing nothing further to stimulate investment while causing injury to many institutions and individuals, while the high rates may still retard investment in some directions. There has been growing recognition also that this kind of problem calls for new methods of attack to supplement the traditional central bank methods. I have not touched upon the government lending agencies, which are the subject of Professor Jacoby's paper on this program. But one major question is the part which such agencies can play in carrying into important areas of credit the effects of monetary policy. A closely related question, and one of great importance, I believe, for the future of monetary

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policy, is whether such agencies, exercising as they do important monetary powers, ought not to be tied more definitely than at present into the organization of monetary control.

IV

There remain the implications of fiscal policy for the future of the banking system. We must distinguish between what has already happened and the long-run effects of large scale, long continued government borrowing from the banks. As regards our experience thus far, it is easily possible to exaggerate the adverse effects. The banking system has shown a high degree of adaptability to the revolutionary changes in bank assets. Each period of unsettlement since 1937 in the government security markets has been met with greater calmness. The banks have made progress in so arranging their portfolios as to be able to hold longer term securities through periods of temporary market stress. They have also developed some sources of new earnings and of service in meeting the credit needs of the community. Looking back to the bank holiday of 1933, we can see that the banking system has made decided progress. Outside the large cities bank earnings have been well maintained, and even in such centers, where the fall in open market rates would naturally be most strongly felt, the decline has not affected the soundness of the banks. But there may be more serious earnings problems during the war period. In the thirties the decline of interest rates was in part offset by reduction of expenses. But with the rise of taxes, wages, and other costs incident to war there is some danger that the banks may be more seriously pinched.

Some other effects of long-run government borrowing from the banks may be more serious than the effect on earnings, as that has thus far developed. Bank buying of government securities increases bank deposits. The growth of deposits has two important aspects. One is the monetary aspect. I have always been dubious about the effect of an increase in the supply of money, taken by itself, upon money spending and thus upon output and employment. It is a permissive rather than an activating factor. There was a time, in the late twenties and early thirties, when

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such a suggestion was vigorously combatted, but now the pendulum may have swung too far in favor of this view. Granted that money supply has only a passive influence unless other factors are present to stimulate its use, it is not prudent to add continuously to a money supply which already is greater, both absolutely and in relation to volume of output and employment, than at any previous time in our history. But this is the logical implication of long continued government spending, combined with excess reserves, unless the financing can be done outside the banking system.

At least equally serious are the implications of a long continued large scale growth of bank deposits for the capital position of the banks. Already there has been a marked reduction in the capital-deposits ratio, particularly in the centers where bank buying of government securities has been heaviest. It is true there have been some important offsetting changes. The margin of safety which capital is supposed to afford depends not merely upon the quantitative excess of total assets over deposit liabilities but also upon the soundness and the liquidity of the assets. From this point of view excess reserves are themselves an important factor in bank safety, since they constitute a buffer which protects the banks from being forced to liquidate assets to meet withdrawals of deposits. It is in this way that the presence of excess reserves has enabled the banks to reach out for government securities of longer maturity as the rates on short term assets have declined. It is true also that the very fact that banks now hold government securities in large amounts means that the quality of their assets has improved. In these respects it can correctly be argued, as some bankers have done, that a smaller capital-deposits ratio is needed than used to be the case. But some of the implications of this line of argument I find disturbing. It implies, for example, that excess reserves will continue to be needed indefinitely, or as long as bank assets continue to consist of government securities other than short term securities. It implies also that as deposits and government security holdings expand and the margin of capital over deposits becomes thinner, it will be less and less possible for banks to increase their other assets, except for those which likewise involve a minimum of risk. Finally, it implies that the function of the Reserve System would be more and more

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that of preserving stability in the government bond market and less and less that of exercising monetary control. Moreover, if the banking system is to become more and more a mechanism for providing funds to finance government expenditure, and a mechanism the preservation of whose stability becomes increasingly a matter of concern to government, could not the ultimate reaction of the public be that such a mechanism should be a public rather than a private institution? It would not need a disturbance on the scale of the bank holiday of 1933 to develop this conviction. Of course, if bank capital could be increased correspondingly with bank deposits, the problem of the capital-deposits ratio would be solved. But falling interest rates and earnings do not encourage investment in bank capital, and maintaining dividends in the face of reduced earnings is not a remedy. If capital were provided by government agencies, the implications of eventual government ownership would be strengthened, and suggestions of government subsidies to sustain earnings would point in the same direction.

V

The obvious solution of many of the problems I have discussed would be to finance government spending outside the banking system. That we have had to rely so heavily upon the banks is indeed the great paradox of deficit spending. Why should this need to be the case, if as the theory maintains, the condition of under-employment which the spending is to correct is due to over-saving or under-investment? Why should not the saving itself finance the deficits? In Kahn's early article on the multiplier this part of the logic of the process was expressly recognized. He pointed out that there should be no problem of money supply. The deficit spending needed to maintain full employment would be precisely equal to the leakages out of income.[1]

It could be argued that the saving might remain idle and thus need to be offset by new money from the banking system. But this is business cycle analysis. It is appropriate to the pump-priming theory, which is cyclical and assumes no increase of either money supply or public debt for the cycle as a whole. But in the

[1] R. H. Kahn, "The Relation of Home Investment to Unemployment," *Economic Journal*, June, 1931, pp. 174, 189.

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long-run "compensatory" fiscal theory business cycle influences play no part. There is no ground for assuming variations in either the quantity or the rate of use of money, except for the long-run tendency with which the theory is concerned, which is the tendency for a part of income to be saved and not invested. As I have said and as Kahn clearly expected, it is the function of public spending, by the theory's own logic, to absorb this saving and restore it to the income stream.

In what may be regarded as an effort to adapt the theory to business cycle changes and the problem of war-time expansion, it has been suggested that government expenditures should be financed by a combination of borrowing from banks, borrowing from non-bank sources, and taxation, in this order, the emphasis shifting forward as output and employment increase and the danger of inflation becomes greater. As a fiscal program for war-time expansion, starting from a state of under-employment, this is the right pattern. But as I said earlier, it does not seem probable that we shall be able, at any stage of our war financing, to avoid a substantial amount of borrowing, or to avoid doing a considerable part of it from the banks.

It has been suggested that the financing of deficit spending in the thirties gave evidence of conforming to this pattern. From 1933 to 1936 bank holdings of government securities substantially increased, but from 1936 to 1939 they were about stationary. This fact, however, affords no proof that bank investment diminishes as output and employment expand, unless the expansion is accompanied by monetary control. The period 1936-39 is the one I described earlier. That bank holdings for the period as a whole did not increase was due to the selling of securities by the banks in 1936-37, when excess reserves were reduced by the raising of reserve requirements. When the pressure was removed by further gold inflow, abandonment of gold sterilization, and a moderate reduction of reserve requirements, bank buying of government securities was resumed. The question I raised was whether in the light of that experience it will be feasible to exert monetary pressure on the banks so long as their holdings of governments remain large and the need of large scale borrowing continues.

Since 1939 the banks have greatly increased their holdings, both

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absolutely and in relation to the increase of the public debt. In 1930-39 they took 36 per cent of the increase in the federal debt. In the two years June 30, 1939 to June 30, 1941, they took 47 per cent.[1] This increase has occurred, moreover, at a time when the need for borrowing outside the banks has received much emphasis and an organized effort has been launched to attract the nation's savings. Such an effort takes time to plan and to gain its full momentum. Probably now that we are actually at war the nonbank part of our borrowing will substantially increase. But nothing in our experience thus far indicates that it is possible to finance large scale, long continued public borrowing without considerable dependence on the banking system.

I do not regard the monetary and banking difficulties which I have discussed in this paper as necessarily decisive arguments against large scale deficit spending, indefinitely prolonged. My principal doubts about such a policy rest on other grounds, some of which I discussed at our annual meeting a year ago. I am not sure that with careful handling some of the banking difficulties might not be removed or considerably lessened. One way might

(1) Net Changes in Holdings of Federal Government Obligations Direct and Guaranteed

(Millions of dollars)

June 30 dates	Total outstanding interest bearing securities	Federal agencies and trust funds, and Federal Reserve Banks	Commercial banks		Mutual savings banks	Insurance companies*	Other
			Central Reserve N.Y.C. member banks	All commercial banks			
1916–1919	+24,262	+ 382	+ 645	+ 4,390	+ 660		+18,800
1919–1930	— 9,312	+1,122	+ 464	— 162	— 150		—10,100
1930–1940	+31,952	+7,970	+4,339	+11,571	+2,590		+ 3,700
1940–1941	+ 6,873	+1,131	+1,782	+ 3,546	+ 320	+ 500	+ 1,400
1933–1934	+ 5,003	+1,196	+ 659	+ 2,826	+ 250	+ 500	+ 200
1934–1935	+ 4,607	+ 548	+ 558	+ 2,416	+ 570	+1,100	0
1935–1936	+ 5,939	+ 328	+ 954	+ 2,552	+ 510	+1,300	+ 1,200
1936–1937	+ 2,758	+1,361	—1,133	— 712	+ 340	+1,100	+ 700
1937–1938	+ 963	+1,243	+ 110	— 516	+ 300	+ 200	— 300
1938–1939	+ 3,908	+1,096	+ 744	+ 1,654	+ 350	+ 600	+ 200
1939–1940	+ 2,538	+1,074	+1,002	+ 855	+ 70	+ 300	+ 300
1940–1941	+ 6,873	+1,131	+1,782	+ 3,546	+ 320	+ 500	+ 1,400

* Prior to 1932 holdings of insurance companies were included in other holdings.

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be through lessening the dependence upon excess reserves. This is in part a matter of altering bankers' psychology by recreating the willingness and the habit of resorting to the central bank to meet temporary changes of reserve position. In the past year, mainly through cessation of gold inflow and the expansion of deposits and currency, the excess reserves have been greatly reduced. It is not improbable that within the next year bank reserves will need to be increased. If, however, advantage could be taken of the present circumstances to create in our banking system the conditions which now exist in England and Canada, where there is assurance of an easy money policy supported by ample bank reserves but without large excess reserves, that would be a long step toward removing some of the abnormalities that have developed in the past ten years. Reduction of excess reserves would mean, as we have seen in recent months, that short term interest rates would rise, removing or lessening one of the important gaps in the interest rate structure. With short term rates higher, banks would be under less pressure to invest in long term government securities, and we might approach more nearly a logical division of the government security market, with the banks holding the short term securities and nonbank investors the long term public debt. Such a distribution of the debt would lessen the dangers now involved in temporary fluctuations in government security prices, and might permit again some use, under peace-time conditions, of a general monetary control.

I do not think, however, that this change will be easy to bring about. And it would still remain true that the larger the public debt becomes the harder it will be to avoid the kinds of difficulties I have described. The real solution, and the only logical one, would be to finance deficit spending outside the banking system. For the advocates of large scale, long continued public spending this seems likely to become a major challenge. My own belief is that the monetary and banking difficulties raised by public spending constitute an added reason for seeking correctives for secular defects in our economy in other directions, including taxation—though I am convinced that as yet our knowledge of the economic effects of taxation is not very great—and for using deficit spending primarily for business cycle changes.

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Author(s): John H. Williams

Article Title: The Postwar Monetary Plans

Journal Title: *American Economic Review*

Volume Number: XXXIV Issue Number: 1

Date: March 1944

Page Numbers:

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INTERNATIONAL TRADE WITH PLANNED ECONOMIES: THE ITO CHARTER

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AN ADDRESS
BEFORE THE
ACADEMY OF POLITICAL SCIENCE
AT THE
SEMI-ANNUAL MEETING ON
"FREE ENTERPRISE — NATIONAL AND INTERNATIONAL"
APRIL 17, 1947

THE ACADEMY OF POLITICAL SCIENCE
COLUMBIA UNIVERSITY
1947

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I

WHEN I last spoke on this program, in April 1945, our subject was the Bretton Woods agreements. As we meet today, the representatives of our country, England, and sixteen other countries are meeting in Geneva for the dual purpose of agreeing upon a final draft of an ITO Charter for presentation to a world conference on trade and employment at some later date, and of making tariff concessions among themselves. The Monetary Fund, the World Bank, the International Trade Organization and its Charter, and the current tariff negotiations are all parts of a general plan, dating back at least to 1943, for restoring multilateral trade in the post-war world and reducing, so far as possible, the restrictive trade and monetary practices which in the inter-war period increasingly threatened to destroy the multilateral system.

I think I should say at the outset that in my discussion two years ago, as well as in earlier papers, I favored the International Bank but had some reservations about the Monetary Fund. Apart from technical questions about the mechanics of the Fund and the principles of international monetary adjustment, my doubts had to do mainly with the question whether in our preoccupation with a long-run monetary plan we might not fail to deal adequately with the concrete problems of the transition period; and, in particular, whether in this over-all approach we might not fail to recognize that the interconvertibility of the dollar and the pound is the inner core of the monetary problem and that its achievement would have to depend upon the measures taken, outside the Fund and the Bank, to correct the British balance of payments difficulties.

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Perhaps the largest question about the success of our efforts to restore a multilateral trade and currency system is whether we have not made a major, and possibly an irreparable, mistake in not dealing sooner with the British problem. By the time we got to the Anglo-American loan negotiations in the last half of 1945, much of the spirit of wartime coöperation had been lost, and the solution arrived at was, in my opinion, inadequate for the problem. We should have made a gift rather than a loan—perhaps at an earlier date we could have agreed upon a post-war extension of Lend-Lease. But if it had to be a loan it should have been interest-free. Britain's problem today is how to increase her exports by seventy-five per cent beyond their pre-war volume while restricting imports to their pre-war level. It seems increasingly clear that the loan will be used up before the end of the five-year breathing period that it was intended to finance; and if by 1952 the British balance of payments deficit is not corrected, and with enough margin to begin payments on the loan, it seems idle to expect that our efforts to restore a multilateral system of trade and currency can be successful.[1]

One other comment on the Monetary Fund seems relevant to our current discussions of the International Trade Organization and its Charter. One point I strongly emphasized was that the Monetary Fund should not be used in the transition period, before the more normal trade conditions which its logic assumes had been realized. Thus far, no use has been made of the Fund, but in accordance with its provisions the member countries have declared their official parities; and with the general condition of inflation existing in the world, there has been an understandable tendency to overvalue relative to the dollar. Whether any such development was contemplated by the authors of the Fund agreement, whether, in dealing with such a large-scale problem of fundamental readjustments of rates as we may face after the inflationary conditions have passed, the Fund will be able to avoid another vicious circle of currency depreciations such as occurred in the inter-war period, and whether it might not have

[1] The most serious aspect of the British problem is not whether in the transition period she will be able to correct her balance of payments deficit with the aid of the loan, difficult though that problem is, but whether in the long run she will be able to maintain the new equilibrium required by her changed international position, including repayment of the loan. This is primarily a question of productivity and real income. See below, pp. 43-44.

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been better to postpone the whole matter of official parities until more normal trade conditions have been achieved are among the larger questions for the future.

But one question which seems to be emerging with increasing definiteness, and which the premature declarations of parities may have helped to emphasize, is whether countries may not in future rely mainly upon direct trade controls and use them as a means of avoiding changes in exchange rates. There was already a tendency in this direction before the war, and war and post-war experience may have pushed it further. It may well be that the general pattern of adjustment technique will be one of trade restrictions first, exchange controls second, and exchange-rate variation third. Exchange control over capital movements is already provided for in the Fund agreement, but the intention is to do away with exchange control over current transactions, and the Anglo-American loan agreement provides for the freeing of British current transactions from exchange control by July 15 of this year. But in the discussions of the Bretton Woods agreements in England and elsewhere much was made of the fact that the monetary agreement did not cover trade restrictions and that there was still the possibility of accomplishing through direct import controls whatever the member countries might seem to be giving up in the way of monetary controls. It is not surprising therefore that the ITO discussions have provided the real field for debate as to the reservations on which countries will insist before committing themselves to any plan for the restoration of multilateral trade.

II

Throughout the post-war trade and monetary discussions there has been a common pattern of differences of national attitudes, the United States attempting to lead the way toward multilateral trade and reasonably stable and convertible currencies and the other nations endeavoring to safeguard themselves against the possible hazards involved. The ITO Charter has gone through several drafts since it was first drawn up by our State Department.[2] It was considerably revised at the first meeting of the Preparatory Committee last fall in London and

[2] *Proposals for Expansion of World Trade and Employment*, November 1945. These proposals developed out of the discussions leading to the British loan agreement, and were accepted in principle by the British government.

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doubtless will be further modified at Geneva. This has been a continuous process of relaxing the logic of the multilateral system in order to gain wider adherence. The number and variety of "escape clauses" have increased. One of the most fundamental is the right to protect foreign exchange reserves by direct import trade restrictions. To this are related the reservation, much insisted upon, of protecting the home economy against external deflations—I see no reason why protection from external inflations should not equally be emphasized—and the reservation of a large degree of freedom to deal with economic fluctuations at home and to protect a country's internal economic planning.

One interesting difference between the Fund agreement and the ITO Charter is in the nature and degree of the authority assigned to the two institutions. Whereas, in the Fund agreement, the Fund must be consulted and must give its consent before there can be any resort, after the transition period, to exchange control over current transactions (for example, in the scarce currency provision) or before a member country can change its exchange rate beyond an initial ten per cent, in the ITO Charter the individual member country may suspend a number of major Charter obligations if, on its own appraisal, it considers certain criteria of economic strain specified in the Charter to have been fulfilled; in invoking such escape clauses the member need not even consult in advance with the ITO, which can, it seems, only review the case and approve requests for retaliatory action by other nations if deemed justifiable.

The Charter has been criticized as being merely a collection of escape clauses. Besides those I have mentioned, there are clauses which permit considerable latitude with regard to international commodity agreements, bulk buying by the state, domestic subsidies, protection of young industries, particularly in undeveloped countries, protection of a country's right to decide what imports are desirable and what are not, and so on. On such grounds, the Charter has been described as representing merely an official sanctioning of the restrictive practices of the thirties, and perhaps some new ones, whereas its main purpose before being subjected to international negotiation had been substantially to reduce such practices.

Such criticism, it seems to me, does not penetrate very deeply into the nature of the problem. Without denying that we may

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too readily concede too much, we have to recognize that under the conditions now existing in the world it is a choice between this kind of approach and none at all. In criticizing escape clauses, we must not overlook the fact that we have our own. The President has found it desirable to assure Congress that any trade concessions to which we might now agree in Geneva will be withdrawn if they injure any American industry.

III

Much of this is by now familiar ground. We are brought back always, whether we are discussing the trade aspects or the monetary aspects, to the fundamental nature of the problem of international adjustments in the modern world, and to a recognition of how much more complex a world it has become since the English classical economists handed on to us the theory and the system of free multilateral trade and its monetary complement, the gold standard. That system assumed not only external freedom of trade at stable exchange rates but also, internally, a laissez-faire private-enterprise system. Through the free interplay of economic changes, working through the cost-price structures of the trading countries tied together through fixed exchange rates, the countries held each other automatically in balance in a balanced world. It was a beautiful conception, though oversimplified even for its own day.

I cannot in this short paper review adequately the changes in ideas or conditions, but four broad sets of facts must be emphasized.

1. The multilateral trade system developed out of the conditions of an expanding world in which different kinds of countries played complementary rôles, the manufactured products of the industrial countries being exchanged for the foods and raw materials of the less developed countries, the process being fostered by the flow of capital from the more to the less advanced countries, and the whole system revolving about England as the trade and financial center. In such a system, international trade adjustment was to a large extent a self-regulating process, and, to the extent that it was not, the mechanism of the London money market in normal circumstances provided such control as was needed. Even in the nineteenth century, however, the multilateral system was a fair-weather system, which broke down under conditions of war and of major booms and depres-

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sions. But there was no room for doubt about its maximizing effect upon international trade and hence of the desirability of restoring it whenever it collapsed. Even before the First World War, there were indications that the system was undergoing change and that England was losing her central place. Now, as a consequence of two wars and the intervening maladjustments, we have a very different kind of world, and one of the basic questions is whether a substitute can be found to perform England's rôle of market of last resort and her rôle as creditor and controller of the international system.

2. The system never had the unqualified support of all the trading countries that its logic assumed. In the nineteenth century the main reservation was found in the unequal development of the trading countries and the case, strongly argued virtually everywhere except in free-trade England, for protection of young industries and young countries. But tariffs, though they modified the terms of trade and may at times have restricted its volume, did not interfere seriously with the multilateral system so long as England's large free market remained open.

3. The second great reservation upon the free working of the multilateral system has been the increasing emphasis upon internal stability at high employment. The maladjustments growing out of the First World War and the great depression of the early thirties have greatly increased this emphasis. Indeed, it seems not too much to say that, taken together with England's changed position in the world and the growing predominance of our own country in the grand aggregate of world production, these changes have completely altered our conception of the problem, to the point where we find ourselves compelled to recognize the dependence of order and stability in world trade upon the maintenance of stability at high employment in the leading countries, and particularly in this country. Some of the countries participating in the ITO discussions, notably Australia, have carried this changed viewpoint so far as to insist that adherence to a multilateral system must be conditioned on some kind of guarantee of stable high employment in the United States, the alternative being complete freedom to the other countries to set up regional or bilateral systems based on common policies to maintain high production and employment within the trade area, and to protect themselves against external disturbance.

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4. To an increasing extent this reservation in favor of internal stability has been developing into what I think must be recognized as a third kind of reservation, namely, the right of a country to plan its economic and political system, even though this may mean nationalizing its industries and controlling its economy for purposes of social security and welfare, as well as business-cycle stability. Thus we have a very mixed world with countries ranging all the way from our own still predominantly private-enterprise system through various degrees of planned economy embracing elements of state socialism to a completely controlled economy like that of Communist Russia.

IV

Our problem is how to restore a multilateral trade system which was the product of the comparatively free economic world of the nineteenth century in such a world as this and make it work to the general advantage. It can be done, if at all, only by a process of evolution, and success will have to depend primarily upon what can be done, outside ITO and its Charter, to promote conditions favorable to such a process. We shall have to recognize that the task is essentially one of pioneering, of fitting an old technique to a new set of conditions, and that doctrinaire insistence on old principles and formulas is not the right approach. On the other hand, it seems no less true that much of what I have referred to above as reservations upon the free play of the multilateral system will have to be thought through anew to see what are the limits which external forces necessarily impose upon freedom of internal planning.

I have not now much confidence in the suggested formula that we can have the best of both worlds if only the nations will combine upon common domestic policies for maintaining high employment. Though I made such a suggestion regarding this country and England in my first paper on the Monetary Fund in 1943 [3] I was relying heavily on the intimate wartime coöperation we then had; I question now its feasibility even for these countries; and any general extension of the idea of common do-

[3] "Currency Stabilization: The Keynes and White Plans", *Foreign Affairs*, July 1943. Reprinted in my book *Postwar Monetary Plans and Other Essays* (2nd ed., New York, 1945), ch. 1. See also R. G. Hawtrey, *Bretton Woods for Better or Worse* (London and New York, 1946), pp. 112-14.

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mestic policies to a large number of countries in such a mixed world seems visionary. Hardly more practicable is the idea of a "guarantee" for continuing high employment by this country as the necessary condition for adoption of a multilateral system. We must indeed recognize the importance, for the problem, of stability here at home, and the reasonableness of escape clauses if this condition is not realized; but it will be unfortunate if our efforts at international trade and monetary coöperation degenerate into mutual reproaches such as this formula so readily suggests.

For the world at large the problem is one of finding the limits of tolerance which external conditions impose upon the freedom of internal action. In the inter-war period the international maladjustments and the great depression, combined with the development of "closed economy" economics, pushed to extravagant lengths, in my opinion, the analysis of currency depreciation, exchange control, and restrictive trade devices as buffers to protect the home economy and the freedom of internal policy. Now I think the pendulum is swinging back. The Second World War has uncovered the absurdity—which was always there—of supposing that nations ever really had a choice as between living in this world or in closed economies. But the swing back is only partial. It does not mean that other countries have given up, or should give up, their freedom to plan for internal stability and security. What is, I think, being forced upon us is a clearer recognition that such freedom can be exercised only within the limits imposed by a country's international position, by the extent to which its own well-being is dependent upon its relations with the outside world. Where the pendulum will come to rest, just what the nature of the ultimate compromise will be, no one can say. The swing in the British attitude has been striking, as between, for example, Lord Keynes's paper on "National Self-Sufficiency" [4] in 1933 and his posthumous paper on "The Balance of Payments of the United States" [5] in 1946, or the Chancellor of the Exchequer's recent statement that British policy is being dominated by the exigencies of her balance of payments position; [6] and almost

[4] *Yale Review*, vol. XXII, Summer 1933.

[5] *The Economic Journal*, vol. LVI, June 1946.

[6] *The New York Times*, April 17, 1947.

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nothing now is being heard of currency depreciation as the way out. To a striking degree, the problem is being posed as the classical economists might have posed it, in terms of productivity and real income.

V

I have always insisted that international trade adjustment is a two-sided process. If for other countries the meaning of this is that external forces impose upon them limitations of productivity and real income which circumscribe their freedom of internal planning, what are the implications for ourselves?

I referred earlier to England's rôle in the nineteenth century. Our position in the world today is in some respects similar to England's former position, but in some respects it is different. We are not nearly so dependent on external trade. As our history has so often proved, in our mixed industrial-agricultural economy there is much more room for internal conflicts about external policy; and at the same time we are much freer from external restraints upon internal policy. Though multilateral trade is the natural and logical complement of our kind of economic system, we could dispense with its benefits more readily, in case of need, than almost any other country. It follows that whatever hazards there may be in restoring multilateral trade, should it not work well, would affect us less than almost any other country. At the same time, it is probably true that with our favorable trade-balance position, our lesser dependence on foreign trade, and our much greater freedom from controls in domestic trade, we are less well equipped than some other countries, and perhaps notably England, to play the game of bilateral bargains and restrictive trade practices if it should come to that.

It is not easy to say what these differences add up to, but it does seem true that if we are to play England's former rôle in the multilateral trade system, we must do it in a more conscious and deliberate way than ever she did. In the forefront of the problem is the need for maintaining stability at home. This, as I have said, has been much emphasized by other countries, and while it can be pushed too far and developed into a general alibi for bad behavior, it does seem true that the maintenance of high employment here at home is the greatest single contribution we can make toward the success of our own efforts to restore multilateral trade. But we are far from agreed among ourselves as

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to how this can or should be done, and the most relevant and hopeful aspect of the matter is that, looking beyond the present inflation and its correction, we seem to have a good prospect of sustained high production and employment for some time ahead.

For our external policy there are both trade and financial implications, but a less clear prospect as to how matters will turn out. There is need—and this is where the contrast with England's earlier position seems to me sharpest—for a rather drastic reorientation of our outlook on foreign trade. We shall have to learn not to count upon exports for leverage to sustain high employment at home if such a policy means putting further pressure upon the already strained position of other countries. This is less a question of the volume of exports than of the export surplus. There will probably be a larger than normal demand for our goods and services for some time to come, but long continued one-sided trade can end only in the breakdown of the system we are striving to restore. For a proper balance in the world we must increasingly emphasize our imports. We saw during the inter-war period the evil consequences of a mechanical propping-up of our economy by one-sided trade involving either a draining from the rest of the world of its monetary resources or a foreign " investment " which did not give rise to a flow of goods from the borrowing countries.

But this is one of the thorniest aspects of the whole problem, and adequate discussion would run much beyond the limits of this paper. It seems certain that large-scale American financial aid will be essential over the next decade if we are to achieve the objectives of the International Trade Organization and its Charter. Already the total, mainly governmental, has been large. But the need ahead is probably greater in the aggregate than that to which we already are committed. How much it should be, how much of it should be raised from public and private sources, toward what purposes and what countries it should be directed, and how it should be administered are among the largest questions we shall have to face. We need much more knowledge as to how capital can effectively be spent abroad. We saw after the last war that foreign investments misdirected or badly administered are worse than none at all. We greatly need to develop improved standards and procedures and to differentiate more carefully between the kinds of expenditures that should be financed at home by the borrowing countries and those that should be financed from foreign funds.

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So far as government aid is concerned, it seems already clear from our grant to Greece and Turkey that we shall not be able to stand merely upon the present commitments of the Export-Import Bank plus our participation in the Bank for Reconstruction and Development. In my earlier papers, I emphasized the need for stabilization loans, on the model of the League loans after the last war, loans which have a function lying somewhere between credits from the Monetary Fund and the Bank's specific projects for reconstruction and development, loans the purpose of which should be the general rehabilitation of distressed countries. Some such broad and even liberal definition of the task of reconstruction seems essential, even though it involves financial risks, if we are to live up to the logic of the International Trade Organization and restore the capacity of foreign countries to produce and export as rapidly as possible, and at minimum expense to standards of living already so depressed in many countries.

As I have said, our ultimate objective, if we are really to make the multilateral system work, must be the expansion of our imports relative to exports. Unfortunately, this is more than a question of reorienting our commercial policy, difficult though that is. In the background lies the much debated question of a chronic shortage of dollars, such as we had in the inter-war period, and of how much this was due not only to errors of policy on our part but to a cumulative productivity advantage by this country, combined with an abnormally strong foreign demand for our consumer durable goods and capital goods. Such a case of deep-seated and continuing disequilibrium was not regarded as possible in the classical theory of international trade, and foreign investment was always counted upon to bridge any temporary gap. In the inter-war period, however, capital movements were often perverse and intensified trade maladjustments.

Possibly this time, with capital movements from other countries subject to exchange control and our own to a large extent governmentally directed, foreign investment may come nearer to serving its true purpose, which should be to increase the capacity of the borrowing countries to export. But to alter our trade balance enough to overcome the dollar shortage problem may be a long drawn-out process. I find no comfort in Lord Keynes's suggestion in his last article that the United States is

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becoming a " high-cost, high-living " country,[7] by which I take it he meant that our need to import is increasing and our competitive ability to export decreasing. When I try to draw up on paper a list of the changes in imports and exports that might overcome our export surplus I have difficulty, and find myself wondering whether any theory of international trade adjustment is capable of providing a convincing answer. In any case, Keynes's reasoning seems not to fit the facts. Historically, " high living " in this country has been a reflection of high productivity; and the fact that during and since the war a great deal of capital has gone into American industry, while nationalization of British industries has been retarded, does not suggest any lessening of our export advantage in the post-war period.

VI

It seems clear from this brief survey that the development of a workable system of trade for the post-war world—a system acceptable to both free and planned economies—will have to be an evolutionary process. The International Trade Organization and its Charter can do no more than set the process going, by providing the machinery and the framework of reference for continuous international supervision and revision of trade practices and policies. What the result will be we cannot foresee, but it will certainly be very different from the nineteenth-century system. It will be a compromise between the desire to benefit from freer international trade and the desire in so many countries to protect internal planning. The fundamental criterion is the necessity of two-sided adjustment. If the experiment is to succeed, we cannot expect to impose our kind of economic system, and the kind of international trade system that goes with it, upon the rest of the world. But it would be no less a mistake for other countries to assume that they can have the advantages of multilateral trade without yielding to any of its compulsions.

As a working guide toward this kind of compromise, the key principle of the Charter is that of nondiscrimination. Through the escape clauses the Charter permits trade restrictions and controls in a wide variety of circumstances, but it tries to hold fast to the essential principle of the multilateral system, which is to buy in the cheapest market and sell in the dearest. Whether this

[7] *Economic Journal*, vol. LVI, June 1946, p. 185.

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principle can be given force and substance in such a mixed world is the core of the problem.

The task becomes more difficult the greater is the difference in the nature of the economies embraced within the system. One question on which we have no light as yet is whether a completely controlled economy like that of Russia can fit acceptably into the kind of system we are trying to devise, or would act in good faith as a member of such a system. Thus far, Russia has stayed out of the ITO discussions, as she has stayed out of the Monetary Fund. This may be the better course, from our point of view as well as hers, until we know more about the possibilities of trade and monetary coöperation among nations less widely separated in kind. Russian foreign trade thus far has been astonishingly small, and perhaps the chief question at this stage is, not whether Russia herself should be included in ITO, but how far she may extend her influence and her system over other countries.

There are questions about the workability of the principle of nondiscrimination involving other countries than Russia. One of the chief is its applicability to state monopolies and state trading. Any kind of trade or monetary restriction, even a tariff, has some discriminatory effect. But so long as trade is between individuals (and not dominated by cartels, against which the Charter takes a strong stand) there is a much better possibility of its according with competitive commercial principles than when the trade is between individuals in some countries and state monopolies in others. Probably only experience can decide how feasible nondiscrimination is in such a case, but the farther the movement toward planned economies goes in other countries, the more this will become the test question for the success of ITO and its Charter.

In the Charter there are many qualifications and exceptions to the rule of nondiscrimination, involving such difficult matters as international distribution of commodities in short supply, quotas imposed under intergovernmental commodity agreements, and the difficulties of establishing global import quotas without discriminating against countries of origin. We are brought back to the fact that at best nondiscrimination will work imperfectly in the present kind of world. At the same time, attempts to force the principle unduly might well have bad effects. To the extent that we put pressure on other nations to

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give up their present arrangements before we are prepared to offer better ones, we are likely to increase the financial cost to ourselves of reconstruction. Moreover, nondiscrimination should apply to services we supply to others (such as shipping) as well as to goods they buy from us; and when we apply it to goods we ought not to do so in a spirit of seeking advantage for ourselves. The British have been saying that if they have not the dollars to buy tobacco (or it might be food) we ought not to prevent their getting it elsewhere if they have the money or the goods to trade for it. Nondiscrimination ought not to mean that if countries cannot buy from us we will not let them buy from others.

VII

In a multilateral trade world, many of the current difficulties would disappear. We would not, for instance, have the distortions of soft *versus* hard currencies; a country's trade could be cleared with all others as a whole. We are seeing today, as in the pre-war period, the vicious-circle consequences that ensue when multilateral trade breaks down. And we are finding it no easy matter to live in a world part planned and part free. Thus Belgium, after correcting her internal inflation by drastic monetary measures, removed controls and has enjoyed perhaps the best recovery in Europe. But she is finding it hard to submit to British restrictions on imports while her own markets remain open to British goods. Sweden, which has been moving increasingly toward a planned economy since the middle thirties but has prided herself on her multilateral trade policy, has since the war made a trade agreement with Russia and has appreciated her currency to shut out the effects of our price inflation following the breakdown of OPA. But the combination of export trade to Russia and other countries financed by Swedish credits and of cash-financed imports whose volume has been stimulated by the currency appreciation has been draining her exchange reserves. Last March she was forced to impose a direct control of imports, which drew a rather sharp note of inquiry from this country. There are indications that the trade position of Canada, which also appreciated her currency to stave off our high prices, is developing along similar lines.

Developments of this sort in the transition period, along with the British difficulties, the uncertain future of the German econ-

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omy, and the many other uncertainties in Europe, do not suggest the early reëstablishment of a multilateral trade system. But they do indicate the necessity of starting from where we are and not trying to impose some system ready made. One point we should emphasize for ourselves is the need for tolerance and understanding of the difficulties of others. The main hazards and hardships rest upon them. As the London *Economist* has been emphasizing, a policy of austerity in Britain or elsewhere implies for its success an attitude of leniency in other countries, and particularly here. For the transition period, and perhaps for some time thereafter, our attitude toward bilateral agreements and discriminatory practices will have to take account of circumstances, and the question to be asked should be whether they are likely to encourage a growth of trade or have the opposite effect, rather than whether they violate the pure principles we are seeking to promote.

The International Trade Organization can hardly be inaugurated before the latter part of 1948, and, as in the case of the Monetary Fund and exchange restrictions, its provisions regarding trade restrictions will not go into effect until the end of the transition period. For the success of the experiment much will depend upon what happens between now and 1951. In creating conditions favorable to the restoration of a multilateral trade system, the heaviest responsibility will be our own. Granted that the outcome must be some kind of compromise, will it be possible in such a heterogeneous world, part controlled and part free, to move in the direction of the multilateral system, which is the logical counterpart of our free-enterprise economy, or will the balance swing the other way? Perhaps it is rash to try to answer the question, but it does seem clear that the greatest contribution we can make toward preserving our kind of economic system, here and elsewhere in the world, will be through the maintenance of a stable and prosperous economy at home coupled with a liberal and constructive trade and investment policy abroad.

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Author(s): John H. Williams

Article Title: International Trade Theory and Policy - Some Current Issues

Journal Title: *American Economic Review*

Volume Number: XLI Issue Number: 2

Date: May 1951

Page Numbers:

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Author(s): John H. Williams

Article Title: The Implications of Fiscal Policy for Monetary Policy and the Banking System

Journal Title: *American Economic Review*

Volume Number: XXXII Issue Number: 1

Date: March 1942

Page Numbers:

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Author(s): John H. Williams

Article Title: Federal Budget: Economic Consequences of Deficit Financing: Deficit Spending

Journal Title: *American Economic Review*

Volume Number: XXX Issue Number: 5

Date: February 1941

Page Numbers:

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ECONOMIC AND FINANCIAL ASPECTS OF THE DEFENSE PROGRAM

BY

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HARVARD UNIVERSITY

AN ADDRESS
BEFORE THE
ACADEMY OF POLITICAL SCIENCE
AT ITS
SEMI-ANNUAL MEETING ON
"AMERICA FACES THE FUTURE"
APRIL 16, 1941

NEW YORK
PUBLISHED BY THE
ACADEMY OF POLITICAL SCIENCE
1941

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ECONOMIC AND FINANCIAL ASPECTS OF THE DEFENSE PROGRAM

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Dean of the Graduate School of Public Administration
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THE problems of defense are like those of war itself. When I took part in the Academy's program on "America's Preparedness" in the spring of 1939, I pointed out that one important difference between war and preparation for war is that a war, even a long war, is relatively short whereas preparation for war may be indefinitely continued; its yearly cost would be much less than that of war but would have to be borne for a longer period. I did not then foresee that the defense program upon which we embarked last year would be dictated by circumstances requiring us to make our maximum possible effort in the shortest possible time. By their scope and by the urgent necessity for speed our present defense expenditures and our aid to Britain raise problems which are practically identical with those of actual war.

These problems are fundamentally economic rather than financial or monetary. Finance is but a means to an end. The end is to make available to government the goods and the man power that it needs for war or defense. The economic changes involved are twofold. We need to divert resources from peace to war-time purposes. But we also need to develop our resources to maximum capacity.

The necessity for sacrificing peace-time for war activities is the most familiar aspect of war economics, and the most fundamental. It is a two-sided process, on the one side a diversion of productive facilities to war needs and on the other a diversion of the nation's money income. The problem is to keep the two kinds of change reasonably in balance. If we do not divert the nation's income from ordinary consumption and investment to defense expenditures the government will have to

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create additional money to pay for defense, and if meanwhile a part of the nation's productive resources has been transferred from peace to war production, output as a whole will be rising less rapidly than money incomes, and expenditures will be raising prices rather than output. This, very simply, is the problem of inflation. The sacrifice, of course, is not escaped by failing to take the steps necessary to curtail peace-time consumption and investment. It merely takes a different form; with prices rising our money incomes buy less. Experience has taught repeatedly that when this inflationary process has taken hold of an economy to a marked degree it is much the most undesirable form which the sacrifice could take, and may end by stalling the entire economic machine. But war problems are never simple, and it is not nearly so clear that *some* rise of prices is not desirable if it serves to stimulate production where needed, and if we have at hand the power to control it.

The most difficult aspect of the problem is the time aspect. As already stated, the question is not merely one of diverting the community's money income and productive resources from peace to war; it is also one of developing resources and expanding output to the fullest extent. Unless the country is already running at maximum capacity when the defense program starts, this objective logically precedes the other; and we have to be careful in attending to the diversion problem not to prevent or retard our reaching our potential maximum performance. As Price Commissioner Henderson has said, the first defense against a rise of prices is increased production. We must be as careful of avoiding undue or premature restrictive measures as we are alert to the necessity of warding off inflation. Economists differ not so much about the financial and monetary principles that apply to this kind of situation as they do about where we are in the expansion process and how much further non-defense expansion is permissible. The problem is made still more difficult if, as in the case of income tax changes, we have to try to foresee where we will be six to nine months later when the changes called for will go into effect.

The lesson of 1917 was that we should have diverted income and productive resources much more promptly than we did from peace- to war-time needs. But to have applied this lesson by superficial analogy to our situation in the middle of 1940,

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when the present defense program began, would have been the greatest mistake that we could have made. In 1917 we were already in the midst of a war boom. Our economy was much smaller in relation to the world economy than it is today, and purchases by belligerents were larger in relation to our capacity than they have been thus far in the present war. When our present program began we still had large surpluses of many basic products, of man power and equipment. Since that time production has markedly increased. The Federal Reserve index has in recent months been about 140 as compared with an average of 122 in 1940 and 110 in 1929. Not only have we now a volume of production and of national income never previously reached, but it seems certain that as the defense expenditures and the aid to Britain expand further, production and income will substantially increase.

But even today our problem is not primarily one of general pressure upon resources. We still have large unemployment, though the estimates differ rather widely both as to its present amount and as to how fast it will be absorbed by the defense program. We continue to have large surpluses of many basic products, and in the field of agricultural policy efforts continue to be directed toward restricting output and raising prices. In the noncontinuous process industries there is still much room for increasing output by increasing the number of shifts, and there is still much room generally for lengthening hours of work. On the farm, as the last war showed, there is a potential industrial labor force of two to three millions. In industry today, apart from some threatened bottlenecks, there is much more danger of curtailed production and rising prices and costs from labor conflicts than from any general pressure on resources. In recent months there has occurred a fairly substantial rise in the prices of basic commodities, not only in imports where it is most marked, but in some domestic prices. But there is still no sign of a general spiral price rise that might be called inflationary. For a price rise of the kind and extent which has thus far occurred, it seems probable that increased production coupled with specific price controls is still the best method of control.

One factor which has an important bearing on this question of the limits of permissible expansion is the great advance of

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technology since the last war. That such an advance has occurred is recognized by economists of every shade of opinion. During the thirties it was frequently coupled with tendencies toward oversaving and underinvestment as an explanation of underemployment and depression. Whatever may have been true of the past ten years we cannot plead today a lack of outlets for our technical skill. It is for this reason that I have been from the outset of the defense program, and still am, interested in the question how far we can safely and wisely permit the defense program to supplement rather than supplant our peace-time requirements. I recognize that that is a more difficult objective, but also I think a more intelligent one, than a premature " all-out " emphasis on sacrifice. The longer the period over which our effort is to be made, the more vital it is that we should develop fully, and be prepared to sustain, as much as possible, our economic strength and staying power.

This, to repeat, is the difficult problem of the time schedule. It by no means suggests any subordination of the need for sacrifice, but emphasizes the need for so timing it that it will be at its maximum when pressure on resources is greatest. It requires that we guard against diverting income and resources from peace-time use before we are actually ready to use them foı defense. It requires us to bear in mind, for example, that in the fiscal year 1942, despite all possible efforts for speed, our military expenditures will probably not exceed one fifth of our national income, whereas those of England in the same period will absorb one half to three fifths of her income. But to determine just where we are on the time schedule there are no easily recognizable criteria, except the inflationary price rise which as yet, I believe, is not in evidence. It is on this point, as I have said, that economists differ at present much more than on the principles of control which are applicable.

One especially important aspect of the advance of technology in the past two decades is its bearing on employment. The constantly reiterated goal of monetary and fiscal theorists during the past ten years has been to achieve " full employment ". But we have to recognize that this objective is more difficult than had been thought. It took England a year and a half of actual war to get full employment. I am not suggesting that in this great effort which we are making we may not

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achieve full employment, but it will be a late rather than an early development and not a useful guide to policy. Most of the dangers which we fear will have occurred, if we do nothing about them, before full employment is reached. The older economists thought of inflation as occurring when we had reached the limits of economic capacity, including full employment, but under modern conditions there is no clean-cut line between what we call bottlenecks and a general inflation. "Economic capacity" is itself a relative term. If inflation should arise in the present phase of the defense program, it would be of the "bottleneck" variety, arising out of special shortages of materials or of particular kinds of labor, equipment or plant, or out of particular labor or price policies. The higher the level of production reached, the greater will be the possibility that such disturbances arising out of special situations will spread throughout the economy and produce results essentially similar to those of a general inflation. In proportion as these special problems are solved, the inflation danger will be pushed farther off in time and become more and more a problem of pressure upon our general economic capacity and resources. Some economists have endeavored to estimate when and at what level of output this condition will be reached. Such estimates are largely in the nature of abstract speculation, but it does seem probable that by the time we reach a national income of ninety to a hundred billion dollars (which probably will be next year), and sooner if the bottlenecks are not well handled, we shall need to be pursuing a positive policy aimed at preventing a general inflation.

As we survey the whole defense problem, the economic policies called for fall into two main categories which may be labeled general and special. The special problems are those of the Office of Production Management and of the recently created Office of Price Administration. These are the questions of most immediate importance. They will be discussed here by others this afternoon — questions of price control, priorities, labor policies. I will only say that with respect to some of these problems there may be some need for a new orientation on the part of government. We have for ten years been fighting depression, and many of our policies have been directed toward lifting prices or wages. Our agricultural policies, in

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particular, may need reëxamination from this point of view, and also our policies toward housing, of which I will speak later.

But as production expands, special control measures will need to be supported increasingly by more general measures designed to control and direct the community income. These general measures are financial and monetary. The methods of financing war and defense are taxes, loans and monetary expansion, and the problem in general is how best to employ the first two methods to avoid the third. The appropriate fiscal policy is one combining borrowing and taxation in such proportions that borrowing will decline and tax revenue increase as the national income rises.

Both borrowing and taxation are designed to reach savings and to restrain consumption, but the borrowing, if wisely planned, can reach savings more promptly and surely than taxation, and since it is voluntary is less likely to be restrictive. The Treasury has recently announced its savings bond program, which it is to be hoped will yield substantial revenue. Such a program should not, however, be pushed to the point of forcing the community to borrow from the banks to buy government securities, as happened in the last war. At the same time, so long as there is a prospect that government borrowing may have to be on a large scale, it would be unwise to place obstacles in the way of bank buying of government securities, even though such buying means a further increase in our already redundant volume of deposits.

In planning our tax program it is important to recognize how productive our present tax system, including the revenue measures passed in 1940, will be at higher levels of national income. Further increases in taxes should be planned not primarily with a view to raising revenue, and certainly not on the basis of any preconceived formula about the proper proportions between taxing and borrowing, but primarily with a view to their effect upon the expansionary process and the dangers of inflation. As already stated, the problem is complicated by the fact that the restriction of community expenditures can be overdone as well as underdone, and in the case of income taxation is complicated further by the time lag before the new rates go into effect. One of the difficulties in planning a com-

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bined program of taxing and borrowing is that the tax program if overdone may compete seriously with the savings bonds. Apart from the time lag, income taxation is preferable to general commodity taxation even when the purpose is to restrict consumption. General commodity taxation is not only highly regressive, bearing most heavily on the smallest incomes, but it is more likely also to act as a deterrent to production. We must be careful, however, not to fall between two stools. The great mass of consumption is out of the small incomes, and if our purpose really is, at the appropriate stage, seriously to curtail consumption we must either tax commodities generally or substantially lower the income tax base. Logically precedent to taxation of *general* consumption is the taxation, by means of excise taxes, of special consumption, such as durable consumer goods which compete directly with the needs of defense industries.

There remain the monetary aspects of the program and the rôle of monetary control. Prior to the last war the order of emphasis on control measures would probably have been on monetary measures first, fiscal measures second, and direct measures last. But as a result of this war and the last, which have provided unfortunately an unprecedentedly good laboratory for the study of war control measures, the order appears to have been reversed. In a defense program, as in war, there are special reasons for not relying upon a general monetary control such as might seem appropriate in dealing with peacetime expansion of economic activity. A general monetary control, through bank reserves and the quantity of money, is aimed at interest rates and is designed to affect the cost and availability of funds for investment, which in turn affects the volume of national income, output and employment. But in war or in defense there is the special circumstance that the government is and must be the principal borrower, and that the success of the defense effort rests essentially upon the success of the financing program. The possible dangers which might arise from an excessive money supply or from low interest rates must be weighed against the necessity of ensuring the success of the government's financial program upon which the military expenditures depend. Faced with this dilemma, nations are compelled to consider alternative methods of preventing ordi-

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nary consumption and investment from weakening the military effort and bringing on the general inflation which would logically follow if neither monetary nor other restrictive measures were adopted. It is no accident that other countries, democracies like England and Canada as well as Germany, have in this war subordinated general monetary controls to other types of control and are pursuing a program of combining low interest rates and ample bank reserves with fiscal measures and more specific controls designed to prevent inflation. This in general is the type of program upon which this country has embarked, though it is as yet in an earlier stage of development. The reason in such circumstances why nations have learned to prefer other anti-inflationary measures than the monetary is not merely that such a program facilitates Treasury financing, important as that is, but also that it is much the more effective method of safeguarding against inflation. Historically, there is no proof that if war-time inflation is not prevented by more direct control measures combined with wise fiscal policy, it will or can be prevented by a general monetary control.

In our own case, too, there is the circumstance that a decade of deficit spending has introduced new elements of instability into our monetary and banking system. Rising interest rates mean a fall in price of old securities, and, with government securities the chief asset of the banks, such price declines might have serious effects. Any attempt by the banks to avoid losses by selling securities would mean that non-bank investors would have to absorb both the old issues and the new, or else would require large-scale buying, directly or indirectly, of Treasury securities by the central bank. Disturbances of this sort in the government security markets have historically been one of the most familiar causes of inflation. One large question which may fairly be raised as a result of the past decade of deficit spending combined with large excess reserves is whether we have not introduced a new element of rigidity into our economic system in the form of low interest rates, and whether fiscal policy which at the outset was intended to supplement monetary policy has not ended by supplanting it.

But there are special forms of control which go more directly to the heart of the problem of war or defense, and far from

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interfering with Treasury financing may positively assist it. One such measure would be the rationing of the private capital market. Such a policy, as practiced in Germany or England, is intended to prevent private investment from competing with military requirements, but as yet no such problem appears to have developed in this country. Another and more pressing problem is the competition of durable consumer goods with the needs of the defense industries. In this area there appear to be important opportunities for coöperation between the monetary authority and other agencies of government. The machinery of price controls, priorities and rationing may well prove ineffective unless accompanied by monetary measures designed to control expenditures on durable goods. The two areas in which this problem seems now most pressing are the field of instalment credit for automobiles and other durable consumer goods and the field of residential housing.

With respect to automobiles, the decision has already been made to curtail production in the next model year. How far this action needs to be supplemented by instalment credit control applied to automobiles and other durable goods is a question deserving careful study. Even more important, I believe, is the housing question. If it were not that we have still in our minds as the yardstick for comparisons the top years of the twenties, when we were having a housing boom perhaps without parallel in our history, everyone would probably recognize that residential building has attained major dimensions; and the fact that the defense program itself requires great building activity is all the more reason why we should examine anew the policies of stimulating private construction which were designed to overcome depression and have been continued into a quite different kind of situation.

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Author(s): John H. Williams

Article Title: The British Crisis: A Problem in Economic Statesmanship

Journal Title: *Foreign Affairs, An American Quarterly Review*

Volume Number: Issue Number:

Date: October 1949

Page Numbers:

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