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BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

Office Correspondence

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To Mr. Eccles

From Mr. Clayton

Subject: Alvin H. Hansen speech at Academy of Political Science

You have had occasion from time to time to discuss Prof. Alvin H. Hansen, now professor of political science at the Graduate School of Public Administration, Harvard University. At the annual meeting of the Academy of Political Science on November 10, 1937, Dr. Hansen gave a paper entitled "The Consequences of Reducing Expenditures." I read this paper through, and some of the passages several times, as they seem excellent to me. I believe it would be worth your while to read the following excerpts.

"We are currently witnessing a rapid shift in income-creating expenditures both public and private. The props which have been lifting the level of consumption are being withdrawn. The automobile boom has tapered off. We are moving toward a saturation point in installment sales. The government stimulus to consumption is in process of being completely withdrawn in a dramatic reversal from a plus of three billion dollars to a minus of four hundred million dollars within a single year. The full force of this sudden change upon our recovery has perhaps not been adequately appraised. One explanation for this is probably that the public has fixed its eyes on the formal balancing of the budget. And since this is not yet balanced, the impression is abroad that the government is still lavishly spending more than it is taking from the public in tax receipts. But this is looking at the form and not the substance. From the standpoint of consumption stimulation, the "economic budget", so to speak, in contradistinction to the formal fiscal budget, will already in the current year, according to the President's estimates, be more than balanced. In other words, when we take account of the social security taxes, including both old-age and unemployment insurance, it is found that the government in this fiscal year is actually exerting a deflationary pressure on the volume of consumption.

" I do not draw the conclusion that there is inevitably impending a major recession. But I do say that if we are to avoid some considerable recession, either consumption must be pushed forward or else investment must be pried loose from the narrow limits imposed by the immediate requirements of the existing volume of consumption.

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"Many reasons have been assigned for the currently low level of new investment. There are those who are convinced that the basic cause goes very deep; that it is to be sought in a fundamental change which it is believed our social order is undergoing. It is said that "we are passing through a transition period--the implications and significance of which history alone can appraise--a transition from a free economy to a controlled economy. The framework in which private enterprise is permitted to function is becoming more narrowly circumscribed. It is said that business chafes in the new "harness"; that like a "bucking broncho" it refuses to function until its old freedoms are restored. Thus, it is alleged, we are confronted with an irreconcilable conflict between business and government. Private enterprise, operating in a free market, can, it is said, function with a high order of efficiency and even with reasonably full employment. At the opposite extreme it is conceded that a highly centralized collectivism could command and direct the productive resources. But a hybrid economy, an economy which is neither free nor regimented, cannot, it is argued, function at anything like full employment. This limping hybrid system continues to rely on private enterprise, yet the motivating and energizing forces are dampened down and at times almost wholly suppressed. From this point of view, there can be no escape from a deadlock which can be broken only by driving on toward a completely authoritarian state. The present recession is thus regarded as only a preliminary demonstration that a hybrid society, half free and half controlled, can succeed only to a very limited degree. Such a society, it is said, quickly gets all snarled up in its own processes. Every attempt at a solution involves it in a maze of contradictions. Every artificial stimulant saps its inner strength. Every new measure conjures out of the ground a hundred new problems.

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"I turn now to something which is admittedly highly problematical and which raises many difficult problems. It may be that the particular manner in which the deficit has been managed, with reference to the composition of the federal debt, makes it peculiarly difficult for private investment to expand in the amount required for full employment. Business expansion beyond a certain moderate limit finally evokes demands upon the banking system whether in the form of loans or investments. As these alternative employments open up, banks begin to unload their governments. This depresses bond prices. If it is anticipated that long-term government bonds will fall still farther, renewed selling occurs. Thus there is danger that the interest rate as reflected by bond yields will rise far more rapidly than justified by the economic situation. The prospect that such a rise is imminent may prevent flotations and thus check expansion. We are thus caught in a dilemma. The more private investment expands the greater the demands on bank credit; the greater the demand for credit the more banks tend to unload government obligations; with the prospect of higher interest rates there develops a scramble to sell long-term bonds; and finally, the disturbed conditions in the bond market render any further expansion of private investment difficult. Thus deficit financing through long-term bonds, in so far as such bonds are held by "the banks, imposes a limit on the expansion of private investment beyond a fairly moderate amount. If this is true, we shall have to revise our views with respect to the assumed merits of long-term government obligations, at least in so far as fiscal operations are designed to play the role of a compensatory device.

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"The administration, and with it public opinion, has never faced the utter fallacy of trying to boost income, output and employment by raising costs. The question may well be asked whether certain types of federal expenditures have not in large part had the effect of boosting costs when the real purpose was to increase income and employment. We have apparently yet to learn the lesson that high wage rates do not of themselves guarantee a high labor income and full employment. We have too often put the cart before the horse. The all-important desiderata are total income and employment. Had governmental expenditures been combined with a planned program of cost reduction, there might have followed an expansion of income and employment not only via a stimulation of consumption, but also via a stimulation of new investment. This program we have not adequately achieved, and now that the consumption stimulus is being withdrawn, the forbiddingly high level of costs renders it difficult for investment to hold back the receding tide. Thus we are left without the necessary volume of total expenditures, whether for consumption or investment, to carry us on toward full recovery."