

ADDRESS AT LUNCHEON OF
THE COMMONWEALTH CLUB OF CALIFORNIA
IN SAN FRANCISCO, CALIFORNIA, APRIL 8, 1949.

BY

MARRINET S. ECCLES
MEMBER OF THE BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

FOR RELEASE WHEN DELIVERED
AT 12:45 P.M., PACIFIC COAST TIME.

TODAY'S CHALLENGE TO DEMOCRATIC CAPITALISM

Today I should like to discuss three subjects because they are closely related: First, the current economic situation; second, the long-range problem of economic stability; and third, the need for establishing peace in the world before we can successfully deal with either our current or our long-range economic problems.

The Current Economic Situation.

For several months our economy has been in a phase of deflationary readjustment. In nearly all important areas, in both soft and hard lines, the supply of goods has overtaken demand at prevailing prices. Many prices have weakened and production has been cut back. Huge crops press down the prices of practically all agricultural commodities, and this is reflected in lower prices of foods. New private construction, particularly in housing, has declined. In many parts of the country a large number of new houses built last year remain unsold and are being marked down in price. Inventories have been at an all time record and pressure to reduce inventories in most lines is very great. Sales volume, on the other hand, is declining. Savings are increasing and bank loans are declining. Our export surplus has been contracting as production in other countries has increased and as they have used up their gold and dollar resources.

Some readjustment is not only inevitable but desirable after such a prolonged period of inflation. For nearly a decade the economy has been running under forced draft. During the war the tremendous increase in output that we achieved went largely into the wastes of war. Much of the income generated by the increase in output, however, went to swell the cash balances and liquid asset holdings of individuals and businesses because of shortages in the supply of goods.

With the end of the war there was a huge backlog demand for all kinds of goods in this country and throughout the world. There was also the need of filling empty inventory pipelines and meeting current demand that would have existed had there been no war. These demands were supported by a very large current income, by huge accumulations of liquid assets in the form of currency, bank deposits and Government securities, widely distributed, as well as by easy credit. Excess demand inevitably spilled over into price inflation as the harness of controls, including excess profits taxes, were prematurely abandoned and as private credit expansion pumped new money freely into the already swollen spending stream.

As a result we have had a very substantial inflation. The average of consumer prices at the peak was 75 per cent higher than in 1939, and 35 per cent higher than at the end of 1945. Prices of housing, most foods, and many other consumer as well as capital goods increased much more.

Some prices increased very little while others went up as much as 300 to 400 per cent. Wages also increased from a very little to more than 150 per cent. This disparity in price rises was sure to bring with it serious dislocations that made for future trouble.

Meanwhile, we have refilled the pipelines, taken the edge off of most urgent backlog demands of individuals and businesses, supplied their current demands, and provided to foreigners a very large net export of goods financed by existing gold and dollar balances and Government loans and grants. In addition, we have maintained huge military and veteran aid programs.

Readjustments Needed.

Last October at a meeting of Iowa bankers, when some early evidences of the current deflationary movement were beginning to appear, I expressed the hope that needed readjustments would be permitted to occur. It is important not to dissipate our basic elements of strength and our cushions against the current recession in an attempt to shore up the economy at present inflated levels, thus perpetuating economic dislocations that developed in the inflation process. The deflationary drift of recent months has been painful to some, but beneficial to others. It was certainly unavoidable at some stage and is less onerous now than it would be if further delayed by using one costly prop after another.

One danger is that we will not face up to the necessity for adequate readjustments. It is politically difficult to resist the numerous minority pressure groups. Each one wants the benefits of inflation for himself, but he wants the others to pay for them. The farmer wants a floor under his prices at present high levels, but he wants lower labor and living costs. Labor has fought for lower prices, but resists lower wage costs. Business wants competitive free enterprise, but does not want to make competitive price reductions.

Needed price readjustments should not be postponed by pumping more easy credit into the economy. In my opinion too much credit has already gone into housing and purchases of consumer goods at inflated prices.

The Longer-Range Problem.

But the more important aspect of the economic problem is not the transitory one which I have just been discussing. It is the longer-range question called to mind by the astonishing ease with which our economy has met the tremendous production demands placed on it in the war and postwar period. Our remarkable achievements here, however, pose forcefully an old but unsolved problem, given conditions of peace in the world. That problem is: How can we keep our economy producing on a sustained basis at the high levels of which our manpower and productive facilities are capable? How can we provide a steady distribution of the goods and services that we are able to turn out?

Sustainable economic stability is the foremost long-run problem of democratic capitalism. Democracies have not yet succeeded in solving it. On the contrary, recurrent depression has been a chronic tendency of western capitalism. And there is a tendency for depressions to become more severe. From the record it is perhaps not surprising that in other parts of the world there has been a drift away from democratic capitalism. Only a month or so ago, we read in the newspapers that the economic wizards of Russia had met to discuss the timing and severity of our next collapse.

However small our success in maintaining stability, capitalism has succeeded in developing an unrivaled technology of production. For a long time, except in war or general inflation, our capacity to produce has constantly exceeded our use of that capacity. The problem has been to maintain aggregate demand for total output. Let me explain what I mean. When total income at high levels of employment does not flow back directly or indirectly into the expenditure stream, demand becomes insufficient to take off the market what it produced. As a result, production, income, and employment fall off and deflation inevitable sets in.

Whose responsibility is it when this happens? The answer is that it is nobody's individual responsibility, but everybody's collective responsibility. There are millions of people and tens of thousands of businesses in our country who receive income and decide how to use it. There is no assurance that these many income recipients will make a sufficient amount of total expenditures to disburse the entire income. If they do not then trouble begins to develop.

This characteristic pattern of instability has increasingly required collective action through Government to supplement the spending stream in order to provide a sufficient amount of total expenditures. Government intervention is the only answer we have yet devised and it is likely to be the only answer to the problem of depression when it arises, because Government alone is in a position to act on a sufficient scale. I do not like this any more than you do, but it seems to be unavoidable if we are to maintain, without loss of our freedoms, the high living standards for our people which we have the capacity to produce. The experience of history plainly shows that political and other freedoms will not survive in the midst of widespread unemployment and destitution. These freedoms only thrive when there is reasonable freedom from want and insecurity.

Complexity of the Problem Today.

Our problem of maintaining economic stability and providing personal and family security is immensely more complex today than it was before the first world war. Since that time, we have become immeasurably more industrialized, urbanized, and interdependent. Geographical frontiers have largely disappeared. We have seen the rise of huge business, labor and farm organizations with concentrated decision-making and centralized power. Our prices and costs have become increasingly rigid. A great deal

more of our expenditures are for goods of a durable type, the purchase of which is temporarily or indefinitely postponable. The Federal Government as well as State and local governments are asked to provide a vastly wider array of public services as an ordinary day-to-day matter of satisfying community wants.

We now have a Federal debt of \$250 billions. It was only about one billion before World War I. Before that war, the Federal Government's tax revenues amounted to about seven dollars per capita. Today per capita tax receipts average more than \$300. Up until World War II the Federal debt occupied a relatively subordinate place in the economy. The Federal debt was equal to about one-fourth of the entire debt of the country in 1940. By the end of 1945 it represented nearly two-thirds of the entire debt of the country. Fiscal and debt management policies have accordingly assumed a new and strategic importance in relation to the problem of economic stability.

Our more complex economy has fundamentally changed our ideas of personal security and our methods of achieving it. In the interdependent society that we have developed, personal security is attainable by too few people through individual effort and savings alone. Today, the average person's security is no greater than the stability of the economy in which he participates. When unemployment and depression develop, the average person, willing to work, inevitably looks to Government to do something in order to give him an opportunity to make a living.

Responsibility for Leadership.

To recognize frankly the circumstances in which democratic capitalism finds itself today need not be an endorsement of New Dealism, Fair Dealism, or Socialism; nor is it in any sense a commitment to the idea of what is called the Welfare State. I do assert that in the kind of an economy we have today there must be some planning and action by the Government if democratic capitalism is to achieve and maintain a reasonable degree of stability and provide a reasonable degree of individual security. This was recognized for the first time by the Government when the Congress passed the Employment Act of 1946.

Such a need for Government intervention to maintain stability is increasingly acknowledged in all capitalistic democracies, and practically all of them have gone much further than we have. The problem is how to keep such intervention at a minimum. This can be done, I think, only if there is information and understanding as to what the enlightened self-interest of the people is. This implies that individuals having great economic power or occupying other positions of leadership must show a high level of statesmanship, and do all in their power to guide the Government wisely in the development of policies that would maintain maximum employment and production. In the type of economy we have today, the issue of national economic stability will not, and cannot be resolved alone by business, farm, and labor leaders in their own areas of self-interest and independent responsibility.

During the past fifty years our problem of maintaining employment has too often been hidden by chance developments. In the early part of this period, our undeveloped resources and technologies provided great opportunities under our system of government for individual initiative and enterprise. When the momentum of this period slowed down, the necessities of World War I provided a new stimulant. The devastation of the war and the backlog of demand accumulated during this period gave use a postwar inflation boom and also provided a carry-over of support for the uneven prosperity of the 'twenties. But we only succeeded in maintaining high levels of employment during the 'twenties by relying upon excessive expansion of domestic and foreign credits, culminating in the debacle of the 'thirties.

That period was one of major crisis for democratic capitalism. Expenditures failed to absorb output and to provide adequate employment opportunity. Intervention by Government was too long delayed, and when finally undertaken it was entirely inadequate. Recovery was slow and uneven. Democratic capitalism the world over was unable to organize as effectively for the distribution of wealth as it was technically organized to produce wealth. No satisfactory answer to the problem had been found by the time involvement in another world war again postponed the need for solution.

Our immediate short-run problem is to get some healthy readjustments so as to secure a better balance in our economy. But assuming that this is accomplished, the question remains: How do we maintain satisfactory levels of employment over the long-run period, given conditions of peace in the world?

Various measures have been suggested in the past which might well be a part of a positive program looking toward economic stability, such as public works, including housing, adequate social security and minimum wages, farm support prices, etc., coupled with appropriate fiscal, monetary and credit policies. We have much to learn as to the amounts and timing of such actions and their effect on economic stability.

At present democratic capitalism is drifting. Our economy is being stimulated by fortuitous developments and temporary stop-gaps. We are depending on a heavier investment in certain capital goods sectors than can be sustained in steady volume. We are increasing dependence on public subsidy through high price supports and stock piling. Most important of all, we are bracing up our levels of activity by a huge military preparedness program and a large world aid program, both without foreseeable terminal points as to time or amount.

The Overshadowing Problem of Peace.

But the problems of today and of tomorrow, to which I have alluded, are all overshadowed and made infinitely more complex because nearly four years after the war there is, as yet, no peace. You may have noticed a

recent address by Bernard M. Baruch in which he said:

"The overhanging threat of another war penetrates everywhere. Until we make up our minds what to do about this threat of war it is impossible for anybody to know what to do.

"How much of our resources are to go to the 'cold war' and for how long? Are we to be called upon continually to make new commitments?"

And, he added:

"Today the crux of our problem is that there is no peace. We must deal with this first. It is futile to talk of free enterprise with a threat of war overhanging for free enterprise needs peace to function. It is equally futile to talk of planning until we have determined how to achieve a decision in the peacemaking."

I am quoting his words because they so well express what I have deeply believed since the war ended and it became unmistakably clear that the Communists mean to have another war, if need be, to exterminate capitalism.

Not long after the war, Major General John R. Deane, who headed our military mission in Moscow throughout the period of what he calls "the strange alliance" with the Soviet, wrote:

"Never before in our history have we had so much advance warning of the peril which confronts us ... We must adopt a program which is designed not to defend our American way of life passively but offensively to counteract constructively those forces which threaten it."

And he added:

"We have the moral and physical power to stop the Soviet leaders cold and we should not hesitate to use it."

It was his conviction from intimate daily contact with Soviet leaders that the effective way to deal with them was to present them with a decision, not with a negotiation. Every action and move of the Soviet leaders since the war confirms General Deane's conclusion.

Let me cite another informed witness, namely, Winston Churchill. In addressing the Parliament on February 23, 1948, he said:

"The best chance of preventing war is to bring matters to a head and come to a settlement with the Soviet Government before it is too late. This would imply that the western Democracies...would take the initiative in asking the Soviet for a settlement. It is idle to reason or argue with the Communists. It is, however, possible to deal with them on a fair, realistic basis, and, in my experience, they will keep their bargains as long as it is in their interest to do so, which might, in this grave matter, be a long time, once things were settled."

He added:

"I said that the possession of the atomic bomb would give three or four years' breathing space. Perhaps it may be more than that. But more than two of those years have already gone. I can not think that any serious discussion which it may be necessary to have with the Soviet Government would be more likely to reach a favorable conclusion if we wait until they have got it, too. We may be absolutely sure that the present situation cannot last."

Again, last October, he said:

"The western nations will be far more likely to reach a lasting settlement without bloodshed if they formulate their just demands while they have the atomic power and before the Russian Communists have got it too."

In the first volume of his story of World War II, Churchill has eloquently recounted how the victorious Allies, after World War I, permitted the vanquished Germans to regain their military power and to plunge the world into another global war. That is why Churchill termed it the "unnecessary war." He pointed out that until 1934 the victors of World War I possessed unchallenged power not only in Europe but throughout the world.

"There was no moment", he wrote, "in these sixteen years when the three former allies, or even Britain and France with their associates in Europe, could not in the name of the League of Nations and under its moral and international shield have controlled by a mere effort of the will the armed strength of Germany."

It is his contention, and I certainly think he is right, that the tragedy of the second world war could have been prevented if the democracies had not yielded to counsels of appeasement, if, in fact, they had through united action enforced the disarmament clauses of the peace treaty. That would have avoided violence and bloodshed. As I understand him now, it is his informed judgment -- and again I think he is right -- that the best chance of avoiding a third world war is to compel a settlement promptly. That likewise represents General Deane's conclusion. As he put it:

"The chances of attaining our objective by peaceful means will be enhanced immeasurably if we are prepared to defend our position by force at any point where it is threatened. Nothing induces greater restraint on the part of Soviet leaders than a display of strength by their adversaries."

He added:

"Until the Soviet Union has atomic bombs of her own, she will be restrained from crossing swords with those who have."

In any realistic appraisal of the outlook today we are bound to ask ourselves whether we are embarking on the road to peace or to war, and whether we are not relatively better prepared now -- or could soon become better prepared -- to enforce a settlement than we will be five years, or ten years from now. Certainly the Soviets have not been idle since the war ended in strengthening their position -- nor will they be idle in the future. There is every indication that they are consolidating their position and mustering their strength as rapidly as they can. You can find little hope in reading history that a competitive armament race is the way to avoid war.

But beyond all this the question is how long, to what end, and at what consequences to our economy do we follow this path? We do not have inexhaustible supplies of manpower and resources to support indefinitely, with no end point in sight, programs of the magnitude which we are now shouldering or contemplating for armament, both at home and abroad, and for other foreign aid. On the sea and in the air we are unquestionably in the same relatively dominant position today to enforce a peace that the Allies were at the end of world war I. The democracies then could have stopped Nazi rearmament and kept the Japanese from invading the Continent of Asia. There need have been no Munich and no Pearl Harbor.

If we look back over the chaotic interval since the end of world war II such comfort as we may derive from our success during this past year in Western Europe is more than offset by the extent to which we have been losing the cold war in the Orient. Desirable as the Atlantic Pact and the rearmament of Western Europe may be, we must not be lulled into the belief that they are final answers to the problem of lasting world peace.

You may have seen a recent article by that prophetic exponent of air power, Major Seversky, who states that "The indispensable condition for West European rearmament is the existence of a force capable of shielding the undertaking." "Invincible strategic air power," he writes, "operating in part from the British Isles and in the main from the American Continent must therefore have number one priority in planning the economic revival and military defense of Europe." It is his belief that such a strategic air force, whether it delivers atom bombs or any other kind of destruction, is the only deterrent that will be effective against the Soviets. "Under present day conditions", he contends, "huge armies and navies can hardly deter a nation whose great might is on the surface."

It has seemed with increasing clarity to me that the best way to avoid ultimate war, the best hope of peace in our time, is to confront the Soviets with the decisions which will lay the foundations and the conditions of a lasting peace while we have the strength to do so. If the Kremlin is not willing to accept such a settlement, backed up by the moral force of free peoples all over the world and by countless others now enslaved, then is it not better to know it as soon as possible? Will this menacing cloud that hangs over the world grow less threatening if we procrastinate and postpone a settlement?

All this admittedly is outside my field of monetary, banking and credit matters. Yet it is impossible to consider realistically either our short-run or long-run economic outlook without recognizing that the shadow of the Soviets looms behind every major issue. At the moment huge expenditures for military purposes and foreign aid also serve as economic props for which we have not yet developed substitutes. They waste rather than add to our national wealth and there is always the danger that we will cling to them indefinitely, not only in the hope that this is the way to peace, but also because they sustain economic activity at home.

The challenge to democratic capitalism today comes,-- first, from its sworn enemy; and, second, from the failure to face up to the problems of how to achieve and maintain stable economic progress. We must meet these challenges, in my opinion, boldly and soon. We would do well to heed Churchill's warning when he wrote in his current memoirs:

"...We shall see how the counsels of prudence and restraint may become the prime agents of mortal danger; how the middle course adopted from desires for safety and a quiet life may be found to lead direct to the bull's-eye of disaster."