PREPAREDNESS AGAINST BOTH WAR AND INFLATION*

by

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Mr. Chairman and members of the Committee, I appreciate this opportunity to appear before your Committee in its hearings on the problems of controlling inflation.

Defense Preparedness Program

Our defense preparedness program must be designed to prevent war and to prevent inflation, while at the same time preserving the essential freedoms of our democratic institutions. It must also be sustainable for an indefinite period of time. If we fail to make these aims our major goals, the very system which we are trying to maintain will be destroyed. This means we must adopt a realistic foreign policy—one which recognizes the limitations of our resources and manpower, and one which we can pay for currently.

How can we best, within this framework, protect ourselves, maintain our essential economic and democratic strength, and at the same time fulfill our commitments to help defend and protect the other free countries of the world? I believe to do this we must limit our aggregate expenditures on our defense and foreign aid program to a maximum of 50 billion dollars annually. This we can pay for currently, given a total national product of some 300 billion dollars, the estimated amount for the next fiscal year. This money must be used in such manner as to assure the maximum military effectiveness of ourselves and our allies, which means a program most likely to prevent war.

We must recognize the fact that Russia occupies or controls the greater part of the tremendous land mass of Europe and Asia. This land mass has a population of nearly a billion people, and great material resources, and is far removed from our own shores. We can never expect to defeat Russia on land. We would be bled white and destroyed, economically as well as militarily, by any attempt to do so. We cannot hope to be prepared to supply or maintain ground forces at every strategic point around the 20,000 mile periphery of the Communist empire. We cannot be prepared on the ground to meet attacks at the time and place selected by Russia.

There are, however, decisive things we can do with our superior technology and scientific know-how, and within the limitations of a budget we can pay for. We can, with the assistance of the British Empire and such cooperation as other free nations are willing and able to give us, rapidly establish overwhelming control of the air and the sea. From strategic air and naval bases throughout the world, protected by adequate ground forces, we can threaten swift retaliation with atomic and our other destructive weapons if Russia undertakes aggressive action.

We should recognize the facts that our unrivalled productive capacity is our strongest line of defense, that our ability to produce is largely determined by our available manpower, and that our country is the arsenal of the free nations of the world and must not be weakened by a military program which we cannot maintain indefinitely without regimentation or inflation or which leads to war. We should keep our ground forces as small as possible so as to maintain our production at full strength to meet our civilian and military needs and help the other free nations to arm their available manpower and build up their defenses. Our manpower can contribute far more to the defense of the free world in our production lines, in our navy and air force than in the front lines of land armies in Asia or Europe.

We should quickly arrange a peace treaty with Japan and Western Germany, bringing them into the United Nations and helping them and other friendly countries, including Spain, to rearm as quickly as possible so as to be able to deter, or resist if necessary, aggression by China, Eastern Germany, or other Russian satellites. Our present military forces should be maintained in Germany and Japan until they have fully rearmed for de-

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fense. Neither they nor the other free countries can be expected to resist successfully direct attacks by Russia. The addition of such land forces as we could send, and at the same time maintain our supremacy on the production line, and in the air, and on the sea cannot be expected to provide the balance of power necessary to deter, contain, or defeat the Russians.

Russia should know that direct attack by her would mean war with the rest of the free world—war in the air, on the sea and on the land, involving atomic and all other weapons of destruction. This threat of world-wide total war will, I believe, deter the Soviet Union, because it would mean her destruction as well as that of her enemies. A world war would be an atomic war or worse, a war that could not be won by any nation or group of nations, a war that might mean the destruction of civilization. For that reason, we should not think or talk of war as being inevitable. We can, I believe, by the plan I have outlined, make it so costly for Russia to start war that she will not dare attempt it.

Under the protection of American and British air and sea power the free nations on the periphery of the Soviet empire can rapidly rearm with the great help we can give them from our production lines.

We should not attempt to rebuild great military strength in either Germany or Japan for possible war with Russia. Russia may not be willing to tolerate the reconstruction of great military forces of Western powers on her borders, any more than we would if our positions were reversed. I do not believe Germany or Japan will be parties to such a program. It would seem that they do not propose to be the battleground for the defense of the Western world. I believe we must plan on Germany and Japan developing as defensively armed neutral areas, between the Communistic and the Western world.

War can be avoided, I believe, if we do not attempt to build up international competitive and threatening military forces in Japan or on the continents of Europe or Asia. Any attempt to do so is likely to provoke aggression—great standing armies cannot be mobilized, facing each other for long periods of time, without war. In any case, what is the stopping point of expansion and how do you ever demobilize them?

We should not make any commitment to use the atomic bomb only if it is used against us first. Such a commitment offers us no protection. We must retain the initiative for use of all our weapons, including the atomic bomb. Any defense preparedness program may mean an uneasy peace, but it will be as uneasy for the Russians as for us.

I should like now to discuss rather fully the inflationary problems as related to fiscal, monetary, and direct controls.

Why Balance the Budget?

We shall lose the fight against totalitarianism even though our military and foreign policies are successful in maintaining peace if we permit inflation to sap the strength of our democratic institutions. Inflation is an insidious thing. In its early stages it can have a certain exhilarating effect. But as it proceeds it will operate to destroy our free economy. Inflation works a grave injustice on great masses of people. It injures most the aged, the pensioners, the widows, and the disabled, the most helpless members of our society. It diminishes the desire to work, to save, and to plan for the future. It causes unrest and dissension among people and thereby weakens our productivity and hence our defense effort. It imperils the existence of the very system that all of our efforts are designed to protect.

We must recognize that our problem of controling inflation is more complicated now than in World War II. There is no end in sight for the necessity of maintaining very large government expenditures even though nondefense expeditures are reduced to the very minimum, as they certainly should be. People hold an unparalleled amount of liquid assets in the form of bank deposits, Government bonds, equity in insurance policies, building and loan shares, and other forms. Potentialities for inflation are now tremendous. It would be impossible to prevent inflation under these conditions without at least balancing the Federal Budget.

Everyone will agree that our military and foreign aid program will divert large supplies of goods and services from private consumption and investment. This is a physical fact that will not be changed whether or not we tax ourselves to pay for it. The production of the goods and services for this program will provide money income to those who are engaged in it, but it will not provide a corresponding volume of goods or services for which this income may be spent.

Without a pay-as-you-go tax program the Government will have to borrow to make up its deficit, either from the banks or from the nonbank public. Although borrowing from the public is less inflationary than from banks, there is no assurance that such borrowing could succeed in soaking up the excess funds available for spending. In my judgment, it would be impossible to avoid distructive inflation and further debasement of the dollar if the policy of an unbalanced budget, however financed, were long continued. An over-all complete harness of controls would only postpone the disastrous consequences.

Borrowing from banks creates new money. Borrowing from nonbank sources does not increase the money supply, but it adds to the total volume of the public debt and to the liquid assets held by the public, thus storing up inflationary pressures for the future under present debt management policies. The money supply is already excessive, considering the fact that it is being used less actively than it could be, compared with past experience. In addition, the tremendous amount of other liquid assets held by the public is like money in many respects because it can be turned into money under the present Federal Reserve policy of supporting the Government security market at fixed prices and interest rates.

As inflation proceeds, the desire increases to convert liquid assets into money and then into goods and services. This is what is known as the flight from the dollar. The need to hold money and other liquid assets is not as great today as it has been in the past. This is because of improved insurance and pension provisions for old age. Also the urge to provide for the contingency of depression and unemployment is less compelling. Under these circumstances the more liquid assets the public holds the more likely they are to cash them and spend the proceeds. Thus you can have an inflation even if all Federal deficit financing is done outside the banks.

How to Raise Tax Revenues

There can be no escaping the fact that a pay-as-you-go tax program will increase the tax burden of all who receive more than a subsistence. We will have to get the money from those individuals and businesses who receive it in relationship to the Government's need and their ability to pay. In this country income and financial resources are broadly distributed. Tax increases to raise 16 billion dollars will likewise have to be broadly distributed.

An increase in individual income taxes should produce about half of the additional revenue required. Since the bulk of the taxable income is in the first taxable bracket, the increase will have to begin there, starting say with a rate of 25 per cent instead of 20, and go all the way up the income scale. There should be an increase in the regular corporation income tax with some credit allowance on that part of income which is disbursed as dividends, these being subject to individual income taxes. We should also greatly strengthen the new excess profits tax law. Excise taxes should be placed on all nonessential goods now exempt and increased on nonessentials now subject to tax.

With the proposed increased tax rates on individual and corporate incomes, it is especially essential that all loopholes in the tax laws be closed. This source alone might provide as much as 3 billion dollars in additional revenue. Exempt income of insurance companies, savings and loan associations, and farm, labor, educational and religious cooperatives, as well as interest from new securities of State and local governments, should be taxed. Depletion allowances should be greatly reduced in accordance with Treasury recommendations, and unusual expenses and promotional and advertising outlays made nondeductible for tax purposes. And there are other loopholes that should be closed. The present capital gains tax is one of these loopholes for tax avoidance. It also promotes inflation, particularly in commodities, real estate and stocks.

To maintain the morale of the taxpayer who pays his honest share of taxes, loopholes must be closed and tax enforcement intensified. The Treasury should have sufficient competent personnel to give the same strict enforcement of tax collection to farmers, professional people, and the small unincorporated businesses as is now applied to other types of taxpayers, notably those whose entire income is subject to withholding taxes.

Credit Restraints Needed

No tax program by itself is sufficient to prevent inflation under the conditions we face. It must be backed up by restrictive credit and monetary measures. Many individuals and corporations, when their expenditures are squeezed by higher taxes, will try to supplement their incomes by borrowing. Other credit demands will continue as there is an increasing effort to borrow to build up inventories, particularly of scarce goods, to take advantage of investment opportunities, and to speculate on the inflationary rise. The harm to our economic stability from such private deficit financing is at least as great as that from deficit financing by the Government. In fact, the whole postwar inflation, and particularly since the Korean outbreak, has been due to private rather than Government deficit spending. If we impose painful taxes to avoid one form of deficit financing we must surely seek out a way to put a check on the other.

To prevent inflation we must stop the over-all growth in credit and the money supply whether for financing Government or private deficit spending. The supply of money must be controlled at the source of its creation, which is the banking system. Under our present powers, the only way to do this is by denying banks access to Federal Reserve funds which provide the basis for a six-fold expansion in our money supply. The only way to stop access to Federal Reserve funds is by withdrawing Federal Reserve support from the Government securities market and penalizing borrowing by the member banks from the Federal Reserve Banks. As long as the Federal Reserve is required to buy Government securities at the will of the market for the purpose of defending a fixed pattern of interest rates established by the Treasury, it must stand ready to create new bank reserves in unlimited amount. This policy makes the entire banking system, through the action of the Federal Reserve System, an engine of inflation.

If access to Federal Reserve credit were strictly limited or denied, and if there were more sellers than buyers of Government securities, then prices of outstanding Government securities would decline and interest rates would rise until the market became self-sustaining. More sellers of Government securities than buyers indicates that the public is not willing to hold at existing rates. The only way to restore the balance is to let interest rates go higher to meet public demands. The Government with the support of the Federal Reserve has the machinery and the power to decree what prevailing interest rates are to be. But lacking the power to require the holding of its securities by the public, the Government cannot prevent their being offered for sale if the public is not willing to hold at those rates. If interest rates are not to be allowed to rise in response to market forces, then the Government must create all the money it takes to keep rates down. This in effect makes interest bearing money out of all Government securities and adds to the liquidity of all private debt as well. It is hard to conceive of a more inflationary monetary policy.

There is another aspect of an interest rate freeze that under present conditions works to promote expansion of our money supply. Interest rates on short-term Government securities are about half of what rates are on long-term issues. Corporations and other nonbank investors hold short-term securities, however, because they do not wish to take the chance of a market loss on long-term issues should they need their funds. But if the policy as announced by the Secretary of the Treasury is to prevail, that the existing pattern of interest rates will not be allowed to rise, then long-term Government bonds in effect become demand obligations. The lower yielding short-term securities held by nonbank investors will be shifted to the Federal Reserve. This process generates demand for long-term Government securities, helps to maintain a lower long-term rate than would otherwise prevail, and gives the appearance of tremendous success to each Government financing effort. It is, however, a success bought by the creation of tremendous sums of money, at the cost of progressive decline in the value of the dollar.

To allow interest rates on Government securities to respond to the forces of the money and credit market, I realize, raises problems of debt management because of the large volume of debt maturing each year and the demand liabilities in savings bonds. With large and frequent refundings, the process of permitting interest fluctuations involves careful management. If a refunding offering is not in line with market rates, Federal Reserve support is necessary to insure its success.

These are important problems which a frozen pattern of interest rates can avoid. But they are not nearly as formidable as the problems that we take on if we accept a frozen interest rate structure. We cannot prevent increases in the volume of our money if we are unwilling to deny Federal Reserve credit when inflation is taking place, and to allow interest rates to rise if market forces operate in this direction. Inflation and debasement of the value of the dollar is the price we pay for the luxury of a booming Government securities market. Any tax program we are likely to adopt can hardly be adequate to stop inflation in the long run as long as the money and credit floodgates are left open.

If the Federal Reserve is to be required to maintain a fixed pattern of interest rates established by the Treasury, then the System should either be discharged of its responsibility for controlling the volume of credit and money or be given new powers as partial substitutes for those that it is not permitted to use. The limited selective controls which the System now has over certain consumer, real estate, and stock market credit may be useful and desirable, although their effectiveness is certainly much more limited than is generally believed. Authority to increase reserve requirements of all commercial banks would be a partial substitute for traditional credit control powers to enable the System to immobilize new bank reserves arising from its purchases of Government securities in support of the market. Authority would also be needed to require all commercial banks to hold an adequate percentage of their deposits in a special reserve in Government securities, or at their option a like amount in cash. It would likely be essential for the Federal Reserve to have authority to require savings institutions such as life insurance companies, savings banks, and savings and loan associations to hold a certain proportion of their assets in Government securities in order to prevent them from selling in a market supported at pegged prices by the Federal Reserve.

All of these substitute powers would be necessary to compensate for the control over expansion in our money supply that we give up when the interest pattern on Government securities is frozen.

Selective Price and Wage Controls

Fiscal and credit action will have to be buttressed for the present with some rationing and allocations. They will be required to control the use of certain essential goods in short supply and of scarce or critical materials and finished products. To prevent the bidding-up of prices on these items, price controls will be needed. Such controls should be selective, however, and applied only in those limited cases where materials or goods are both essential and in short supply, and removed as soon as they are no longer in short supply or deemed essential.

Over-all price controls are unnecessary and should not be imposed upon the economy. Price controls cannot be successfully applied unless simultaneously accompanied by allocation and rationing. Price controls alone merely lead to black markets and racketeering, profiteering, and tax evasion. We know from past experience that even during war a comprehensive harness of direct controls unsupported by adequate fiscal and monetary policies did not prevent inflation, but only concealed and postponed the inflationary results. They deal with the effects rather than the causes—they sugar-coat the inflation, so that the public's will to accept the required taxes and credit restraints is weakened and destroyed. There is no substitute for adequate fiscal and monetary measures; with them, the need for direct controls is reduced to a minimum.

One of the worst features of trying to enforce a comprehensive harness of direct controls is that it so regiments the entire economy as to destroy our essential freedoms. It requires the establishment of a huge bureaucracy for policy making, administration, and policing—a most uneconomic utilization of an already short supply of manpower. This cannot be justified. Worst of all, such regulation and regimentation, undertaken for any extended period of time, will prove so intolerable that public revulsion will lead to withdrawal of essential support for a program necessary to defend the free world, prevent war, and assure the preservation of the value of the dollar.

Even though I have strongly opposed a general price freeze for the reasons stated, I still feel that it is essential that wage and salary ceilings be put into effect promptly, [allowing up to 10 per cent increase for those who have not had an increase by that amount since 1948]. On an over-all basis, prices are made up largely of wages and salaries, and prices cannot be kept down with continuing increases in wages and salaries. Labor should not object to wage and salary ceilings, so long as any excess profits of corporations are drained off through taxation.

Another reason for a wage freeze is that higher personal income taxes required to balance the budget will reduce the hourly take-home pay of labor, as they must do if they are to be effective. Union leaders are likely to press demands for higher wages to offset this reduction in take-home pay and to maintain labor's standard of living. To grant such wage increases would entirely defeat one of the major purposes of increased taxes, viz., the curtailment of purchasing power at a time when there is a scarcity of many civilian goods. Finally, due to the shortage of labor, employers, especially those subject to high excess profits taxes, will bid employees away from each other.

Not only should wage and salary ceilings be imposed, but all fringe benefits, including bonuses and pensions, should be rigidly curtailed. Escalator clauses should be excluded from all future wage contracts—they are built-in inflationary devices.

A 44-hour week, without overtime rates of pay, should, I believe, be generally adopted for the purpose of increasing total production and helping to maintain the standard of living without increasing costs. Increased production is, in the end, the primary solution to the inflation problem, provided it can be brought about without increasing costs and purchasing power more rapidly than the supply of goods.

Labor should be willing to accept wage ceilings and a longer work week at a time when both are so essential to the prevention of further inflation. After all, the defense of the dollar is more vital to labor than to almost anyone else.

Conclusion

In conclusion, let me repeat that a successful preparedness defense program must prevent war and must not lead to destructive inflation. Total war, with atomic weapons, would mean victory for none and destruction for all. Regimentation or further inflation, even if war is avoided, will ultimately lead to the destruction of our capitalistic democracy. Therefore, our foreign policy must be designed on the basis of what we can pay for currently, and our fiscal program must be supported by restrictive monetary and credit policies, together with only such limited direct controls as the situation may require.