

PANEL DISCUSSION

on

What Effect Would an Extended Period of
International Hostilities Have on Our Economy

The Effect on Financial Institutions of the USA

by

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as Mr. Cary said -----

Since our major economic problem arises from the great expansion in our defense effort, it might be well to contrast our present situation with that existing when we made our last large defense effort just a decade ago.

The first important difference between 1941 and 1951 is that concerning the size and duration of the effort. During the Second World War we built up our armed forces to a peak of about 11.6 million men. In contrast the present program calls for $3\frac{1}{2}$ million men in the armed forces. At the height of the Second World War, 40 per cent of our gross output of goods and services was being used for defense. In contrast the present program calls for about 16 per cent. In other words the present program though large is very much smaller than the maximum we reached in the Second World War.

In 1941 the probable duration of the war was variously estimated at between, say, four and six or seven years. At the present time we face the prospect of large defense expenditures for the incalculable future - certainly for years, possibly for decades.

These differences between 1941 and 1951 may be summarized roughly by saying that in 1941 we faced unlimited expenditures for a limited period, whereas today we face large but limited expenditures for an unlimited period.

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The second contrast is the rate and level of economic activity in the country. In 1940 we had between seven and ten million unemployed. Today we have virtually full employment. We have a tight labor market before the great expansion in defense takes place. What is true of the labor market is, broadly speaking, true generally. Our economy, to be sure, is larger than it was a decade ago, but there is much less slack in it.

Another contrast relates to what might be called the psychology of our citizens. A decade ago they were motivated largely by the experiences of the '30's which were dominated by depression and deflation. Today they are motivated by the experiences of the '40's which were almost continuously inflationary.

A final contrast is our experience with direct controls. In 1940 we had relatively little experience with them. We learned a lot about them both while they were in effect and after they were removed. We learned, for example, that they do not solve the problem of inflation but at best merely postpone its effects. We also learned that - even with the best will and the highest intelligence - they are extremely difficult to administer fairly and impartially.

With this background we are in position to analyze the economics of defense. The first fact is obvious. I state it only because it seems frequently to be forgotten in the heat of discussion. This fact is that the real burden upon our people arises from our decisions to defend ourselves against communistic aggression. This defense requires the use of manpower, materials, and services. Men, materials, and services that are used for these purposes obviously also cannot be

used for something else. In real terms, therefore, we must "pay as we go." There are no financial rabbits in the hat whereby we can avoid this burden. We will not have any more goods and services to consume no matter how much money we create or how high our money incomes go.

The importance of finance arises from the fact that financial policies are the tools by which the burden is distributed among the people. We are going to make major shifts in the use of our real resources; we should make corresponding shifts in finance.

We may visualize our real problem somewhat as follows: We propose to expand our defense and foreign aid programs by about \$34 billion a year to a total of \$52 billion. We also want to build and equip plants so as to enlarge our productive capacity. We should, of course, expand current production as much as possible, but we cannot expand enough immediately to meet the two needs that I have mentioned. It follows, therefore, that we must reduce our consumption of goods and services. This reduction will not, of course, be uniform across the board. It will come primarily in consumers' durable goods.

That, briefly, is the nature of our problem. How should our financial policy be adjusted to meet it?

It is important to begin with another obvious truism, namely, that current income is always enough to buy current output because they are merely two ways of looking at the same thing. However, current expenditures are not limited to current income. The Government, business, and consumers may spend more than current income by borrowing and spending future income. Business and consumers may also spend beyond current

income by spending past savings. When this is done expenditures exceed current income - and hence output - and prices are forced up. This is the basic nature of what is called inflation. If inflation is to be controlled, current expenditures must be limited to current income.

The Staff of the Joint Committee on the Economic Report has just compiled the views of many individuals and groups on how to deal with this problem. I should like to quote from the letter with which the Staff Director submitted these materials to the Committee:

"On January 12, 1951, there was transmitted to this committee a statement (reproduced in full in appendix H) representing the consensus of more than 400 economists (likewise listed in appendix H). As they see the situation:

"Large expenditures on military programs and foreign aid, with their inflationary impact, may be needed for a decade or more. Faced with this long-run inflationary prospect, we recommend that the increase in total spending be continuously curbed in three principal ways, and that these constitute the first line of defense against inflation:

1. Scrutinize carefully all Government expenditures and postpone or eliminate those that are not urgent and essential. ...

2. Raise tax revenues even faster than defense spending grows so as to achieve and maintain a cash surplus. Merely to balance the budget is not enough. If the inflationary pressure is to be removed, taxes must take out of private money incomes not only as much as Government spending contributes to them but also a part of the increase of private incomes resulting from increased private spending of idle balances and newly borrowed money. ...

3. Restrict the amount of credit available to businesses and individuals for purposes not essential to the defense program. ...

"Selective controls over consumer credit, real estate credit, and loans on securities are useful for this purpose and should be employed. But we believe that general restriction of the total supply of credit is also necessary. This can be accomplished only by measures that will involve some rise of interest rates.

"If general inflationary pressure is not removed by fiscal and credit measures, we face two alternatives: (1) Continued price inflation, or (2) a harness of direct controls over the entire economy which, even if successful in holding down prices and wages for a while, would build up a huge inflationary potential in the form of idle cash balances, Government bonds, and other additions to liquidity. Such accumulated savings would undermine the effectiveness of direct controls and produce open inflation when the direct controls are lifted. ... Either of these alternatives is extremely dangerous. A prolonged decline in the purchasing power of the dollar would undermine the very foundations of our society, and an ever-spreading system of direct controls could jeopardize our system of free enterprise and free collective bargaining. ...

"In sum, fiscal and credit measures are the only adequate primary defense against inflation, and can minimize the extent of direct Government controls over wages, prices, production, and distribution. ...

"Somewhat in contrast to this point of view is that given classic expression by the Secretary of the Treasury on January 18, 1951. In a speech (reproduced in part in appendix D, item 1) delivered before a meeting of the New York Board of Trade, the Secretary stated:

"The Treasury is convinced that there is no tangible evidence that a policy of credit rationing by means of small increases in the interest rates on Government borrowed funds has had a real or genuine effect in cutting down the volume of private borrowing and in retarding inflationary pressures. The delusion that fractional changes in interest rates can be effective in fighting inflation must be dispelled from our minds.

"The 2-1/2 percent rate of interest on long-term Government securities is an integral part of the financial structure of our country. ... It dominates the bond markets - Government, corporate, and municipal. ...

"Any increase in the 2-1/2 percent rate would, I am firmly convinced, seriously upset the existing security markets - Government, corporate, and municipal."

At another point the Committee Staff reproduces an earlier summary of the reasons advanced "for the policy of holding down the yields and supporting the prices of Governments in the face of inflation.

- (1) Such a policy holds down service charges on the Federal debt. ...
- (2) The maintenance of relatively stable prices on Governments helps to maintain confidence in the public credit and facilitates Treasury

sales of securities for both new financing and refunding purposes. ...

(3) The maintenance of stable security prices protects investors against capital depreciation and prevents any loss of public confidence in financial institutions, including banks, that might result from a serious decline of these prices. (4) Any marked decline in the price of Governments would be communicated to other parts of the credit market and might bring about unemployment and deflation by interfering with the flotation of new securities. ... (5) Any feasible rise of the yields on Governments would be so ineffective as an anti-inflationary measure as not to be worth its cost. ..."

The Report then continues:

"Both points of view have their supporters, both inside and outside the Government, among economists, and among businessmen. The top economic agency in the Federal Government, the Council of Economic Advisers, after citing the summary given above, concluded:

"...We think these reasons are valid and so cogent that they require that debt-management policy must be dominant and that we must look for other ways to restrain dangerous inflation rather than subordinate the debt-management policy to traditional central bank operations."

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Moderator - Thomas J. Mowbray

Charles A. Cary, V.P., E. I. duPont deNemours Company	- Business
Karl R. Bopp, V.P., Federal Reserve Bank of Philadelphia	- Banking
Senator John J. Williams, Senator from State of Delaware	- Political Aspects
Claude L. Benner, Pres., Continental American Life Insur.Co.	- Entire Economy