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## ECONOMIC STABILIZATION

17 May 1948

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THE INDUSTRIAL COLLEGE OF THE ARMED FORCES

WASHINGTON, D. C.

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## ECONOMIC STABILIZATION

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DR. YOSHPE: Gentlemen, today you are officially launched on your final problem, namely, the preparation of an economic mobilization plan. Of the 35 elements, controls, and functions for which you must account in this plan, few, I think, are more important than that cluster of elements that go to make up economic stabilization. Uncontrolled inflation is like a malignant cancer in the human organism. Its wild growth and rapid spread quickly impair the proper functioning of the body and rapidly destroys it.

To emphasize the importance and place of economic stabilization in a mobilization program, we have set aside this hour for Dr. Heflebower, a member of the Senior Staff of the Brookings Institution. He will endeavor to give you a comprehensive picture of the importance of economic stabilization, its scope, the interrelationships of the various controls involved, the relationship of these controls to other controls in the economy, and the organizational and administrative aspects of handling a stabilization program in time of war.

Our speaker is especially well-qualified to talk on this subject. As you have gathered from his biographical sketch, he has a sound background in the field of economics, with particular application to agriculture, farm taxation, and government control of prices. Not only is he an economist by profession, in an academic way, he also has had very practical experience in the administration of the agency that was basically responsible for price stabilization in World War II. He was the economic adviser to the Deputy Administrator for Price in the OPA.

This combination of academic background and practical experience, gentlemen, enables Dr. Heflebower, I believe, to give you a sound, objective, and highly analytical picture of the place of economic stabilization in the war economy. I am very happy indeed to introduce to you Dr. Heflebower of the Brookings Institution.

DR. HEFLEBOWER: Colonel Neis, Dr. Yoshpe, gentlemen: As the months go on since one participated actively in wartime control, he finds that his views change. I hope they have become calmer and more judicious. While my present work does not call upon me to think continuously about our wartime experience, the conversations with one of my colleagues who is engaged in a study of food controls in the late war and with people in Washington, who are dealing with the problems, recall them to my mind from time to time.

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period of low economic activity or a period of high economic activity?" That is not only a very practical question, it is one that helps to cast in a bold light a great deal of the major characteristics of wartime control. It also helps us, I think, to see how easy, relatively, it was to do the job the last time.

It is much easier to shift unemployed resources than employed resources. Less effort is required to direct into channels you wish additions to your resources, such as imported goods, new facilities, or manpower called into the labor force, than it is to shift those resources when they are already employed. Obviously, therefore, resources are more easily shifted if we are coming out of a depression.

I might add, parenthetically, that there is another reason--which may not have occurred to you--why it is less difficult to mobilize following an extensive period of depression. Particularly if the war is going to be serious, one of the things that has to be done and will be most difficult to do is to reduce by a substantial margin the real living standards of the people. It is much easier to prevent the living standards from increasing than it is to positively decrease them. There is no question in my mind but that the mobilization for World War II was more easily accomplished because it followed ten years of hard times and only one or two years of fairly good times. The people were not then enjoying the living standards that our technology had made possible. All we had to do was to keep them from enjoying such living standards. It was far more easy than it would have been with the 1947 level of income which then would have had to be reduced.

The fundamental problem, therefore, is one of shifting the use of resources and stimulating the available supply of resources and directing them all into the activities needed for the prosecution of the war. Accompanying a major shift of resources and accompanying a stimulation of the total supply of resources inevitably is a tendency for prices to rise sharply. I say inevitably not only because if left to themselves prices would rise sharply, but I add that I do not believe it is possible to carry out the wartime mobilization effectively without some increase in the general level of prices. The extent to which that is necessary varies considerably by commodity areas.

On the demand side, there is every reason for prices to rise. It is not merely that the Government itself is spending money right and left. The mere fact that the Government is going to spend money right and left and that people understand fully the economic consequences of war means that individuals and businesses also are inclined to spend liberally.

Two or three times back in the thirties we tried to prime the pump by deficit financing on the part of the Government, but the prime didn't catch. But when it was clear that we were preparing or were likely to become participants in a major war, the prime caught very quickly.

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will be further purchasing power supplied through the increase of bank loans directly or indirectly to buy government bonds. I do not have time to go into the explanation of how bank lendings create funds. You will have to take it as an established principle on which there is no dispute among economists.

The first effect of this increase in total funds is to raise those prices which we can call "demand determined," that is, the price which tends to reflect the demand for the available supply. In such cases the supply is almost completely inelastic, such as, for example, meat, and the price in any reasonably short period will be pulled up to the extent that the demand expands. These prices will move up promptly and sharply unless controlled.

It is also true that because the sharp increase in the total flow of funds through the economy by the expenditures of Government, of business, and of consumers, demand will not act as a restraining influence on the advance of those prices which are moved by businessmen in response to cost changes. There is a substantial part of the economy in which prices are the result of the conscious decisions of businessmen. This applies primarily to the heavy industries--the metals, and so on. In those areas the tendency of businessmen is to change prices according to the movements of direct costs. While some qualifications to this principle need to be introduced when total demand is moving up sharply, it is significant that demand does not in the context discussed here restrain the decision of businessmen to advance what we may call "cost-determined prices."

On the cost side forces are at work which also tend to raise prices. First, we have the fact that there are important shifts in the use of our resources that can be brought about only by pecuniary incentives. I shall develop a little later the relationship between price increases and the readjustment in the use of our agricultural resources. You have had one discussion of the problems of labor. I shall refer to that a bit later briefly, but my guess is that you will never bring about a mobilization of your labor resources in the direction that you need them in a war without some significant increases in the level of wages and the take-home pay. Therefore, certain elements of direct costs will move up because they are necessary adjustments in the process of reallocating the use of certain resources.

Then the demand-determined prices to which I have referred are to a considerable extent raw materials. That certainly is true of the raw materials of the farm. There is also a good deal of evidence that our nonferrous metals on many occasions have functioned as demand-determined rather than cost-determined prices. There is a great area in between demand-determined and cost-determined in prices which are apt to move upward under favorable circumstances, particularly if still higher levels of cost or the imposition of controls is anticipated. We see, therefore, that demand-determined prices of the sort I have been referring to are themselves

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Obviously, however, the most important effect of rising prices on costs is the effect of higher prices on wage rates. Much has been made in the history of economics on the tendency of wages to lag behind prices. That may have been true at one time, but my guess is that, left alone, that is rather ancient history now for such comments refer to a period when labor rates were determined largely in a competitive market. We now see that unionized labor has become one of the most effective organizers of their own markets and have been very effective in preventing any marked lag of wage rates behind rising prices. During the late war the take-home pay of labor advanced more than prices, and certainly one of the major economic consequences of the war was a radical redistribution of the national income in favor of those who work in factories and those who farm.

I do not mean to get into the question of whether or not wartime controls should be used for the purpose of bringing about certain desirable social ends. I think it is inevitable in spite of the best of plans that some rearrangement of the relative positions of the various economic groups will be the result of a war and a period of wartime controls.

In many ways, however, the most important effect of uncontrolled inflation is on the war cost itself and on the cumulative character of the war costs. There is no such thing as war costs being restrained by a lack of money, because we have too many modern ways of augmenting the money supply. There is only one real way in which a war can cost too much, and that is if we do not have the materials and manpower to meet our requirements. Rising prices and rising costs will in no way prevent our financing a war. But what rising costs and prices will do is to make necessary financing of a larger share of the war by increasing bank credit. The rising costs and rising prices, therefore, force the Government to borrow more and more money, which means that the income redistribution effects of rising prices, the postwar consequences of rising prices, and the postwar consequences of enormous supplies of liquid assets in the hands of the people will be all the greater.

Equally important is the effect of sizable increases in prices on wartime morale. I have read a little--I am sure not so much as you have--of some of the studies that have been made of Germany during the war which lead one to believe that they had not been nearly so effective as we had thought in mobilizing their people and their resources or in getting people to produce when people were not getting much in return in the form of goods.

Finally, a high rate of inflation will seriously interfere with the mobilization of the use of our resources. I have referred already to its effect on the available supply of goods since it encourages the withholding of the supplies from the market. But it is also true that it will

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were looked upon as separate functions to be carried out by separate administrative agencies. Such coordination as was provided, rather belatedly, was among functional organizations. Since that time, and to a degree during the war itself, there has been a great deal of discussion of the merits of commodity organization so that price, production, and use control for food, for example, would be under one agency; control for industrial materials under another agency; and so on. However, if I understand the argument correctly, few would include wage control within this commodity organization. In other words, it would remain in a functional organization alongside the grouping on a commodity basis of production, use, and price controls.

One of the arguments for a commodity organization of control has been that business would then have to deal only with one agency to solve its production, allocation, and price problems, instead of having to deal with two or possibly three agencies. A second and very important point was the failure during the late war to provide effective coordination among functions, the extent to which "buck passing" existed, and the extent to which Government agencies sided with economic groups in controversies with other agencies. The OPA was inclined to represent the consumer group, for example, and the only strong organized consumer group, of course, was organized labor. In a similar fashion the War Food Administration, looked at at least by those dealing with it from the price control side, at times appeared to represent the interests of agriculture, and the War Production Board was accused often of representing the interests of industry.

On the other side, and an argument against commodity control, particularly as used by those who have to do with the problem of stabilization, is the inevitable tendency for those charged with the responsibility for production control to attempt to "buy their way out" of each particular production problem by price increases. There probably are very few individual production problems when looked at just by themselves that cannot be solved by a little price increase, but of course inflation consists of the sum of a series of little price increases. Then there was the problem of similarity of treatment between those to whom you have given a little price increase and those to whom you have denied a little price increase. There is a basic principle in American law and American social institutions that calls for equality of treatment. One of the major difficulties of breaking down price control along commodity lines is to provide equality of treatment to those whose prices are being controlled by separate agencies.

In that connection I want to insert a point of contrast between the work of the War Production Board and OPA that may not have occurred to you. If I understand correctly the role of the War Production Board, it was to take everything away from everybody and then give back parts of it. In other words, having made one bold move and said, "What you are to

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than do prices in the nonfood area. For a great many other reasons which I do not have time to expand here, it would be much easier to carry out the functional control in the industrial areas.

Now I want to hasten on to certain other problems, such as the role of the top-level group. Theirs is a task of coordination if you look on it as a limited role, but is a major job of policy formation and supervision if you look upon their responsibility as active leadership. During the late war the belated introduction of coordination at the top was done primarily as a peace-making, judicial operation. At times, particularly under Judge Vinson, there was an attempt to turn it into an active role. I think it is clear, if there is anything at all clear about the problem of top-level organization for a war mobilization, that the top-level group must look upon their job as an active policy formation and supervision job. It cannot be a passive, judicial role if the job is to be done correctly.

I regret that I cannot spend much time on wage control. It is such a big job in itself. I would like to refer simply to two parts of the relation of wage control to price control. The first is the fact that not only are wages the greatest single element of cost, which is an old point, but that their effect on costs is a lagging effect. It is a lagging effect for two reasons: If the price of raw materials rises, it is several steps before that higher cost could finally affect what consumers pay. But there is another reason why there is a lagging effect of rising costs and that is outlays are for materials or services of different lengths of life. When the figure that wages represent two-thirds of all costs is used, it is only true if the labor element in government costs, equipment and facility costs, and so on are included. Higher wages affect an increasing portion. Those costs begin to be real costs as the war goes on. As equipment with a short life has to be replaced its price is higher and as government expenses rise, particularly as state and local government expenses go up, direct taxes may have to be raised. Probably in most wars the labor element in most facility costs does not become a real cost in accounting, as accounting now is operated, until after the war. So that labor does not represent in most industries, therefore, two-thirds of its price, looking at the war period, but it certainly represents far more than the wage rate paid in a particular operation. It is a cumulative and lagging element, as it is reflected in the final costs of finished goods.

Second, because wages represent by far the greatest portion of all income, what happens to wage rates dominates the movement of total consumer incomes. Furthermore, it is not rates of pay but take-home pay which is important, and take-home pay goes up far more rapidly than do wage rates.

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impose general price controls. But it may be necessary, either as a means of supplementing direct production controls or as a means of preventing certain prices from getting out of hand, to introduce specific controls in those areas most directly affected by the war. And I think in general the program in 1941 in this country was an advisable one.

On the other hand, as mobilization becomes more complete and certainly as actual hostilities break out, the case for general control becomes stronger. I was not one of those who participated in the discussions in 1940 and did not enter into the national-level discussions of price control until 1943, at which time all the basic decisions had been made. I believe, however, from my conversations with many who did participate in those discussions that, now looking back, they would argue for earlier imposition of general price and wage control than was actually done during the late war. They feel that while watching the situation currently, conditions get bad more rapidly than one is aware of and more rapidly than controls can be instituted. Therefore, I think the judgment of those people would be that it is better to introduce the general controls before there is conclusive evidence that they are necessary.

At this point I want to distinguish between imposing price ceilings and adjusting price ceilings. That is an important distinction, both as to the method and as to the standards applied. A great many argue that the freeze is a very unsatisfactory method of price control and I think I could help document the case against it. On the other hand, let us be realistic. If we have reached the stage where direct price control must be imposed on sizable segments of the economy, it is impossible to do so by any other means than the freeze. It is not possible to work out specific regulations in a given industry, such as dollars and cents ceilings, and get them promulgated and understood in that relatively short period of time.

But it is equally true that if a freeze is imposed, those administering it must be prepared instantly, and I must say better prepared than we were last time, to engage in a process of adjustment. War preparation or war itself is a moving scene and the freeze is a rigid thing, except in those cases where an industry has various devices to help itself adjust. Therefore, if wide-scale freezes are installed, one must be prepared instantly to introduce the necessary adjustments. Otherwise, there will be interference to a marked degree with necessary realignments in the use of resources to carry out its basic mobilization program.

I urge you not to get the idea that working out standards for adjustment or the administering of them is an easy task. Standards can be worked out quickly which really let the horse out of the barn. Anybody can work out standards for adjustments or give authority to individuals

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holds prices lower than would the unit-cost method. Had we used a cost approach or a cost increase approach to price control during the late war, the profit record of industry would have been one of which industry would have been ashamed--and it would not have been the result of conscious price-gouging on part of industry--and the increase of prices would have been such as to have broken the whole stabilization program.

Even the idea of using cost increases, such as the proposal which Senator Taft put forward, as a test is an impossible one. It is not quite so bad as to attempt to measure current actual cost but it again assumes an almost impossible administrative task. Beyond that, it assumes that the price relationship of 1940 or 1941 will get the production pattern wanted in 1944. If there is anything true about war economy, it is that from industry's point of view the relative desirability of producing various goods in a price freeze changes when we move from a buyer's market to a seller's market. Such a period is one of rising direct costs and of falling overhead costs. As such it is often to the advantage of industry to shift its volume in directions that are unfavorable to what is needed in the war effort. And if the basic control amounts to an attempt to perpetuate the price pattern of peacetime, to that extent, inflation will be augmented and wartime mobilization handicapped.

The task, it seems to me, is to sue the profit test primarily but to do a far better job than was done during the late war in rearranging the relative profitability of the various products. It means some bold steps have to be taken on the basis of rather poor data to rearrange the profitability of various textile items, various apparel items and various mineral product items so that those needed most will not be the least profitable.

Next I want to mention in passing some difficult problems which may not have occurred to you. What are we going to do about unimportant commodities? There are thousands, if not millions, of them. There is a very strong temptation to just exempt them. But let me warn you that in total they will use a substantial part of our manpower, our materials, and our production facilities. If they are exempted, how will we prevent an undue proportion of your material and manpower from being diverted in those directions? Even more important, how are we going to appeal to appeal to those who are doing what we want them to do when we are letting those whose contribution to the war is unimportant go scot free? And yet to impose direct control on these minor industries is an onerous task, and they can take about as much time of the controlling agency as is required for the steel industry. It is a knotty little problem--and it is not little. It has really an important impact on the problem of war-time control.

Second, how far are we going to go in interfering with the usual practices of business? How far are we going to control the price of poultry if we do not control who can become a poultry processor, a fish

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going to have the final say? Isn't the paramount problem really economic stabilization? Isn't that where the final say should be, and how would you do that?

MR. HEFLEBOWER: First of all, I think we have to view wage control and manpower problems generally as part of the top-level policy making. Secondly, your question refers to whether it should be handled primarily as a stabilization problem or as another problem. I think we can make a mistake if we look upon wages only as an aspect of a stabilization program. Of course, it is true the income aspect and the cost aspect of what we do in the wage field is tremendous; but first and foremost we have to get men into spots where we need them, and get them to work efficiently, and for long hours, and so forth.

We must not permit our desire for stabilization to interfere with the effective mobilization of manpower and the holding up of the morale of the working man. My own judgment is that we did not need to be as liberal in pecuniary incentives as we were in the late war to accomplish this objective. We do have to keep parallel with our stabilization plans our plans for moving men from steady jobs into jobs with uncertain futures-- that is really what we do--for getting them to work long hours, and for calling women and the aged into the working force. I doubt whether that could be done without giving wage increases, particularly to people that work in the war effort to encourage them to leave their jobs and maybe their homes and their communities, and to incur the high costs of working in wartime centers.

What is at the heart of the optimism pervading the American people now? It is because the incomes are good. Prices are rising, but incomes are good. It has a boom effect. We all know our money income is going up some. I think we have to keep this psychological fact in mind, too, in labor mobilization plans.

DR. ASHTON: There seems to be a divergence of attitude on the part of a number of government agencies with respect to price controls in different types of industry. I have specific reference to the regulated industries, such as transportation. For example, when it appeared that, whenever these agencies went before the authorities for an increase in prices to meet increases in cost, other government agencies, notably OPA and Agriculture, regularly appeared against any such increase in price.

DR. HEFLEBOWER: I will be glad to answer that. OPA's interest in that was, first, that any increase in railroad rates was an element of cost. But more difficult than that, it was an element of cost which was particularly difficult to handle under a freeze-price system. You perhaps understand what I mean.

Second, OPA felt that there was a tendency by both regulatory agencies and utilities, and of the railroads themselves, to use the direct-cost

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I am just trying to raise some questions that ought to be considered in that connection.

My own feeling is that as a matter of right a man out of uniform has no more rights than a man in uniform. Unfortunately for my own satisfaction, I was too young the last time and too old this time, so I have never been in uniform. I do not think those out of uniform have as many rights as those men getting shot at.

QUESTION: Would you comment on the feasibility of continuing OPA for a longer period of time than it was continued after the late war?

DR. HEFLEBOWER: Had it been possible to have the act renewed promptly and without serious modification, I think it would have been desirable and feasible to have continued it about a year longer. The forecasts of certain acute shortages, such as for tires, and apparel were borne out by later experience. The effect of price control on production was largely a publicized piece of hokum. Its effect on total production was very minor. The effect on allocation of production was bad in some cases.

The critical question of whether it would have been feasible to have extended price control for approximately a year longer turned largely on whether it could live in spite of the mistakes that had been made. The mistakes that were made were of two sorts: First, meat rationing had been suspended too soon and that raises the question as to whether price control over that important area had been lost for practical purposes. Even with an effective, prompt extension of price control, it would have been debatable, considering that 1946 was an election year, whether meat price control could have been held until fall. If meat control were to have been suspended, it would have been impossible to have held any large part of the remaining food field.

The second thing, of course, is a basic error that was made in the plans for the postwar period by the Government--and I feel to a large extent by American industry--and that was the fear of a postwar depression, from which came the conclusions that incomes had to be supplemented. I personally have never been able to understand how such erroneous forecasts could have been made, but they were made and were the basis, unfortunately, of government policy. Through the pressure of powerful groups the excess-profits tax was repealed, wage-control dropped, and rationing suspended. OPA was left sitting by itself trying to control the whole mess by one weak tool, price control. It is like most of the mistakes in preparing for a big war, trying to prepare for the transition, the big mistakes were made early.

I repeat that I think there was a fair chance that another year of price control would have been feasible had price control been extended promptly, and such extended control would have facilitated the transition.

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is in excess of supplies at prevailing prices--my feeling is that the primary reliance should be placed here on the voluntary action of business. However, I think you are referring to some of the problems of the present rather than of general mobilization. Remember these needs are for products of concentrated industries. I intend no critical connotations by using that term, and such industries would obviously prefer to act voluntarily rather than to have rules imposed on them. We got through the war, I think, in the fats and oils field largely without compulsory allocations, but by use of voluntary allocations. It worked very well because they know if it did not work well, they would have compulsory allocations.

I think that the hands of the Government would be stronger right now if it had more legislative power to deal with these problems. But I do not see at the moment any reason for a comprehensive program of direct controls either over prices or over resources use. I would add, however, that if resources use and material use do not accord with high national policy, then we must take action as a government to see that it does.

DR. YOSHPE: On behalf of the faculty and the student body, I want to take this opportunity to thank you, Dr. Heflebower, for a very stimulating and provocative discussion.

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