ECONOMIC STABILIZATION CONTROLS IN
WARTIME AND RECONVERSION OBJECTIVES

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COLONEL McKENZIE: General Holman, gentlemen: In our studies at the College to determine the feasibility of requirements, you must have been impressed that one of the solutions which is possible--perhaps not most desirable, but at least possible--is a further curtailment of the civilian requirements. When we get into curtailment of the civilian requirements, we are impressed immediately with the fact that there may be shortages and that the only way we can overcome serious morale conditions, both amongst the civilian population and the military forces, is to insure an equal allocation of those supplies which do remain.

I do not believe that it requires any stretch of the imagination for this class, having progressed this far in our studies, to appreciate the importance of this entire subject of economic controls and reconversion in doing a better procurement job. This subject falls directly into the area of responsibility and interest of the procurement officer.

We are fortunate this morning in having as our lecturer a gentleman who was a price economist during the war, is a member of that distinguished institute, namely, the Brookings Institution, and, through his serious studies and practical applications in this field, is eminently qualified to discuss the problems of economic controls and reconversion.

I take pleasure in presenting to the College Dr. Richard B. Heflebower.

DR. HEFLEBOWER: Gentlemen, because of the short time we have and the size of the topic, I will have to speak largely in outline, hoping that the question period will bring out the points that are of most interest to you. Fortunately, I can build on the excellent address which Dr. Johnson of the National Security Resources Board delivered before you some time ago, and I start by endorsing everything he said.

In connection with the conditions that give rise to inflation and the problem of control, I shall stress only a few points. They are points which may have been less obvious to you from Dr. Johnson's discussion or from your own studies.

In order to understand inflation, it is important to see both the demand and the cost aspect of the problem. I emphasize the latter because there is a strong tendency, in both popular and professional discussion of the problem of inflation, to deal primarily with the demand side.

As Dr. Johnson so well brought out, the problem of economic mobilization is a problem of reallocating resources. And if the war starts in conditions comparable to those now existing, it means taking resources out of present employments and putting them in new employments, which is a much more difficult task than taking the idle resources of 1941 and putting them to work in directions that were desired.

It is true that we have to choose between how far we are going to use the market and how far we are going to use direct authority in this job of reallocating resources, but I think it is important to disabuse ourselves early of any idea that we are going to do the job solely by authority. In two very important areas at least, in my judgment, it is not possible to bring about the reallocation of resources primarily, or at least to any large degree, by authority. First, it is very clear that the job of reallocating agricultural resources has to be done primarily by changing the financial incentives of the six million American farmers. Secondly, to a very considerable degree, but probably not entirely, both the reallocation of our labor resources and the drawing of additional people into the labor force, must be done by financial incentives.

As a result two great elements of cost are going to rise, (1) food prices on the average will mount to reflect higher prices for agricultural raw materials. When financial returns among farmers are rearranged, it will not be done by reducing the price of some products and raising others. Instead, prices of products of which you want enlarged output will be raised and of those for which you want less will be held constant, but not reduced; (2) In a similar fashion, but perhaps to a lesser degree in the field of labor, you will not attract people into war industries by reducing wages in other industries. Instead it will be a question of financial incentive to move as against remaining in peacetime jobs.

If industry is to pay higher wages, and higher prices for raw materials, and to carry more expensive inventories, it must have more working capital. Such funds may come from the idle savings of the people, but the idle pool of savings at this time, for example, is quite low. Consequently, by one device or another the government's credit will be turned into cash by the banks. This happens even when individuals borrow money at the banks and buy corporation stocks or corporations borrow from insurance companies that sell government bonds which are bought by banks, as well as when the banks buy the bonds directly.

The total of the medium of exchange in the country will increase as bank loans and investments expand. You will have to accept on faith my statement that banks' deposits are not the result of how much you and I deposit with them. Instead these deposits are the result of the volume of loans and investments made by the banks. They create the deposits in the process of lending money.

Returning to the main theme, you see that I have tied in the increase of costs to the increase of demand. At the same time that farmers get higher prices on the average as a result of the process of reallocating resources or that labor's pay increases not only are higher but also incomes are enlarged. So that each phase of this inflationary problem has a cost phase and a demand or income phase, and these phases develop together. It seems that inevitably in a war we work things out so that much of the increases of income become increases of cost and most increases of cost become increases of income.

The one place where you might think that circle would be broken is at the point where prices for consumer goods have increased. How does that in turn become a cost? It is because the largest element of cost, wages, is related to the movement of the prices paid by consumers. We followed this policy during the last war and I strongly suspect we will in another war, whether from a sense of justice, or because of political necessity.

Here we find a major reason why the expenditures in the military sphere are very much a part of the general inflationary problem and why the amount that you will have to spend for military goods is dependent upon our success in stabilizing the general economy. If we do not succeed in minimizing this process of increases of costs becoming increases of income, which in time become increases in cost, and so on, progressively the ingredients of cost which go into military goods are going to rise. And remember that money costs in a modern war economy will never restrain what is done, because the money will always be available. Modern banking systems can create an unlimited amount of money if the laws are adjusted sufficiently. So there is no such thing as money costs acting as a restraining influence by themselves.

I want to build on the point that I have made about the interrelationship between the cost aspect and the demand aspect of wartime mobilization and the contribution they make to rising prices, by dividing commodities into two groups. We have a large area where prices in any given circumstance may be looked upon as demand determined that is, the price will be that at which the existing quantity will move. The largest single category of this sort is agricultural raw materials. To a considerable degree, mineral raw materials such as the nonferrous metals tend to conform to this pattern. At the other extreme, we have prices which at any given time may be called cost determined because the price is set by administrators of large enterprises according to fairly well-defined policies and in those policies they are governed primarily by movements of costs. We have an excellent illustration in the morning papers of the conflict between the two doctrines as shown by the current investigation of the retail selling of automobiles. The manufacturers have attempted to price automobiles on a cost basis. It appears that some of the dealers have been trying to price them on a demand basis.

In the process of inflation those prices which are demand-determined will promptly reflect the movements of demand. So you can always say that meat prices, in the absence of control by the Government, are those reflecting the level of consumer demand for the existing supply. There is no other explanation for what meat prices have done since controls were removed after the last war.

On the other hand, some other prices will tardily reflect the movements of cost and of demand, and when they do change they will first and foremost reflect the movements of cost. The largest ingredients of cost are labor costs both directly, and indirectly as an ingredient in what the industry has to pay for materials. Thus in the steel industry the prices of the leading manufacturers will advance in general conformity to their cost experience in the absence of control. However, their cost experience is in part related to demand, because steel scrap has a highly competitive market in which the price tends to be demand-determined. So you see, indirectly, the demand-determination of certain ingredients of cost get into the costs in the steel industry and tend to raise their prices.

With these two points as background, let us turn to means of controlling the inflations. Persons who have not thought very much about what modern war involves or who seem to have a nostalgia for a simple solution which overweighs their judgment often assert that the problem of wartime inflation can be solved by proper management of the tax and expenditure program of the Federal Government. Nothing can be more deceptive than to take a view of that sort. As one English economist has very well put it, such procedures might do very well for the little wars of the liberal age, but one point alone is enough to devastate the suggestion that fiscal means are sufficient to restrain the inflationary tendency during modern war. The lag which occurs between the receipt of the increase in tax revenues, even if we set up the most ideal, drastic tax structure, and the expenditure rate of the Government would be enough to start the whole process we were talking about a moment ago. But beyond that, we have to face the fact that in a democracy we will not have that kind of tax system, and, furthermore, that if we had that kind of tax system, it might so undermine the motivations of important groups in the economy that we would not have maximum productive effort forthcoming.

I make that argument vigorously because we must face to the fact that if we get into war, we must rely to a very considerable extent on direct controls in order to accomplish stabilization. That does not mean to deny that we can do a substantially better job of financing ourselves out of current receipts than we did in the last war. Furthermore, we must frankly plan to aim the tax structure to an increasing degree at the groups of which expenditures cause the inflationary movement. A war is not the ideal time to carry out social reforms.

In spite of the best that can be done, the relative positions of the various groups in the country will be rearranged and some economic institutions will be strengthened and others weakened. But, in my judgment, we must do a better job of taxing the rank and file of consumers than we did in the last war. Then we must do a better job of supplementing that tax structure--you cannot go all the way in taxes--by a really effective means of immobilizing additional parts of purchasing power in the form of savings. The ideal thing would be to take it all by taxes. Politically, and from the point of view of morale, it cannot be done. So savings programs must be developed to absorb a portion of the incomes of consumers over and above taxes and the available supply of goods at the existing prices. Such means minimize the pressure under the boiler, on top of which rationing and price controls will sit as an unsteady safety valve.

You are not interested in details of particular direct control programs. Much more basic is the degree of integration among the various programs. Dr. Johnson hit that point and hit it hard. It is fundamental to understand that price control is not separate from rationing, that price control and rationing are not separate from wage control, and that those three, in turn, are not separate from the program for reallocating the use of agricultural resources and of that part of industrial resources left to make civilian goods. In other words, all of these controls form an integrated program.

That means, first and foremost, that the organization must be built on an integrated basis and that the top group, which, for our purposes, we will refer to here as the Office of War Mobilization, must not be a peacemaking, adjudicating body among conflicting functional groups organized for price control, food control, or what not. It must be the fundamental policy-forming, supervising agency to see that those who are assigned particular commodity or functional responsibilities do their job in harmony with an over-all plan. Frankly, we did not do that in the last war.

Now I will turn to a few phases of price control which may not have been obvious to you. There is a very strong attraction for the businessman to the idea that price ceilings ought to be based on costs. He refers to costs by products and cost changes as the two criteria for price control.

I want to emphasize as strongly as I can that it is administratively impossible to engage in price control by relating prices to costs. That is true for two reasons. First, the task would be multiplied several times if an attempt were made to relate prices to costs of particular items or to changes in costs of particular items. There are millions of products and prices in this country. The administrative job is simply impossible. Secondly, it is an unnecessary and an improper basis for controlling prices.

(I could have stated before that the businessmen don't know what their own costs are, but we will pass that. This is obvious to any of you who have engaged in procurement. It is only the politician who thinks the businessmen know what their costs are.)

When a war gets going, the American businessman demonstrates his unique capacities in a number of ways, and one of them is his enormous adaptability to the conditions under which he operates. If war starts in a period comparable to what we had in 1941 and control is instituted by means of freezing prices as they are, then by one blanket act millions of ceilings are fixed--a task which would be insuperable if done product by product. Then businessmen are very adroit in rearranging what they produce according to cost-price margins of various products. They show an enormous capacity to absorb increases in direct costs without having to have a formal adjustment in maximum prices.

If we omit the areas using agricultural raw materials, we will find that a very surprising part of the products of American industry did not have their ceiling prices adjusted until shortly before the end of the war. This was true in spite of the very large increases in wage rates which occurred and the general downward trend in efficiency after the middle of the war period. The reasons for this ability to absorb cost increases lie largely in adjustments made by businessmen. They simplified their lines. They cut down on their overhead. They moved to simpler sales procedures. They did all kinds of things, most of which were in the direction of making better use of our resources than we could ever have done by overhead direction, most of the steps taken did not undermine basic price control, except in textiles and apparel. In a sense, businessmen helped themselves to certain forms of cost reduction or of price relief without imposing upon the price-control agency the impossible job of formally adjusting those prices industry by industry.

I do not mean to say that there are not enormous technical problems in price control. Actually, we did not solve a large number of the most difficult technical problems. We never learned how to put price control on gray-iron castings, for example, nor did we establish effective price control on textiles and apparel, except on items of a standard sort. I could go on and illustrate this point endlessly.

I hope that the National Security Resources Board, after it has thought through the more fundamental problems of mobilization policy and organization, will have time to address itself to these tasks. At the same time, it will be desirable for the Board to anticipate that the solution to many of the most difficult price-control problems may not be to work out more meticulous techniques for controlling a field but preferably to take some rather bold, broad approaches to the problem. One of these approaches, for example, might be, in the apparel area, to tell each American consumer, "You may have only so many dollars per year to spend for apparel." If that were done, the problems of price and production control in the civilian part of the textile and apparel industry would be greatly simplified because total demand would have been cut drastically. During the last war we wasted an enormous amount of resources making clothes for people who didn't need them but who wanted them just because their incomes were larger than they had ever been before.

I have not touched on wage control and I have time to make only one or two points on that subject. We must not be deluded into thinking that we can reallocate the use of our labor resources without bringing about a general increase in wage rates. Equally erroneous would be the idea that such task can be done principally by telling people where they are to work. We should be able, however, to think up better ways of drawing people into employments needed for war than by making some of the wage adjustments we made during the last war. That is basic wages are related to the over-all problem of stabilization in two ways: Wages are both costs and they are income; thus they work both ways toward inflation.

Any program which is worked out for dealing with the reallocation of labor and controlling the increase of labor income must be concerned with motivations and morale. This requires that the controls be used in such a fashion that workers feel they are being treated fairly, that labor is not going to get the short end of the war, and that the war is not being used as a means of undermining the substantial progress in the social and economic position which labor has gained. Telling people where they are to work clashes with American ideas of long standing. But, of course, so does most of getting ready for war in the modern era. So we have a problem of understanding, of education, and of trying to deal fairly, so that each one will see that he is making a contribution to the over-all, common effort.

We have a few moments left in which to talk about reconversion. At the end of the war we will find that prices and wages will have risen substantially, that price relationships among many commodity areas will have become out of line with their long-term positions, and that business and consumers will have an unusual accumulation of liquid assets. These are conditions we must have in mind when we talk about reconversion objectives.

Then there will be an accumulated shortage of durable consumer and industrial goods. That shortage will be not only an absolute one in the sense that people's automobiles are old and that machinery is worn out, but also a relative one, which we can illustrate very well by farm machinery. Much of the farm-machinery shortage of recent years is not due to farmers' machinery being worn out but to the fact that farmers have a lot of money; and when farmers have a lot of money, the first thing they think about is farm machinery. The same principle holds, to a considerable extent, of the demands of both industry and consumers for durable goods. They have a large backlog of liquid assets and, therefore, are in the market not only to replace their durable goods but to enlarge their stocks of durable goods.

Next, at the end of the war pipe lines generally are dry. That not only means that retailers' and wholesalers' inventories are low, but it also means that manufacturers' stocks of semiprocessed and raw materials are low.

Finally, at the end of the war there is a great reversion of viewpoint of the American people, generally in the direction of getting back to normalcy. Of course, peoples ideas of "normalcy" differ widely, but regardless of that there is a great impatience with controls. The average American does not like rationing nor does he like price control which prevents him from being able to lay his dollars on the line and get a steak when he wants it. And certainly the average businessman or the average workingman does not like direct price or wage control.

These are conditions of which we must be aware when we talk about reconversion.

I doubt whether there is any problem of reconversion objectives in the sense of what we want to end up when war is over. We want to get back to a social order that is essentially the same as we had before. We do not look upon the period of wartime control as one step more in the direction of state capitalism or state socialism.

The question then is as to how we move from a period of primary military production and incidental civilian production under government control chiefly, to one of primary civilian production under a free market. That involves two kinds of consideration. One is an evaluation of the situation which exists at the end of the war and during the transition period. The second is the program for removing controls.

Of the various aspects of the war-end situation which I summarized a moment ago, the one that I wish to stress is the underlying inflationary tendency. There is no doubt that at the end of the last war the fundamental error made in the thinking of those who had something to do with formulating the transition policy was a fear that we might have a deflation during the transition period which would be disastrous to workers, businessmen, and consumers. Added to that was a failure to appraise the fact that in certain areas, such as in food, the peak of demand comes after the war. In spite of such generalities as a strong inflationary tendency and a food shortage, we never know exactly what is going to happen in economic affairs. So we have to make up our mind now which way we are going to err. Are we going to err in the direction of fearing inflation or in the direction of fearing deflation? It seems to me that is the basic decision which has to be made. I regret to report that actual plans made at the end of the last war indicated a decision that we wanted to be certain that we did not err in the direction of deflation. In other words, we were so afraid that we might have a deflationary tendency that our basic plans were prepared for fighting a downward trend. We did not keep our guard up against the inflationary movements.

I want to argue two things: First, inflationary tendencies must be strong when pipe lines are empty and the men hired to fill them will be receiving wages weeks or months before their production activities put goods on the retail shelves; when consumers are on waiting lists for durables; and when there is the replacement of consumer demand, export demand to rebuild devastated areas (and if we are devastated next time, the immediate rebuilding job in our own country). On top of these influences, individuals and business have accumulated cash and bonds, and better credit than before the war. There is no really sound argument for anticipating any serious deflationary tendency at the end of a war.

But more than that, let us look at the technical problems of control in a war-end atmosphere. If the program for preventing inflation is once weakened, it cannot be rebuilt at the end of a war. Rationing, for example, has been withdrawn, it can be reimposed only with great difficulty and with doubtful success.

The same can be said of wage control and only in a lesser degree of the allocation controls in scarce materials. Even taxes once cut can be raised only over strong opposition. The whole psychology is the other way. The instruments to fight inflation cannot be mustered again if you once discharged them at the end of a war.

On the other hand, if, by remote chance, there should develop a deflationary tendency, it is very easy to implement the various devices. There is a backlog of public works because a considerable fraction of the population has been relocated. The Government has dozens of ways in which it can change its financial arrangements by cutting taxes and increasing expenditures. It is very easy in those circumstances to implement any devices necessary to prevent a deflationary tendency after it has developed and proved to be serious. But the devices to fight inflation, whether they are fiscal and monetary or whether they are direct controls, cannot be reinstituted.

Next, in the process of removing controls, we must think in terms of groups of controls; not simply by commodities, but also by phases of control. It does no good in a commodity like meat, for example, for which the demand is highly elastic, to withdraw rationing and say, "We will stabilize it by price control." If there is a marked shortage at ceiling prices, prices cannot be held. Nor if there is a strong upsurge of costs, including wages, it does no good in the majority of industries to say, "We can continue to prevent inflation by price control if we withdraw our materials allocations and wage controls." We must realize that, if anything, those controls which were used to buttress each other during the war are needed to buttress each other still more at the end of war. The will to abide by controls--that the voluntary cooperation which is really the gist of effective control of almost any sort--is weakened at the end of war. Therefore, the buttressing effect of a wage control on price control and a price control on rationing and an allocation on price control is needed even more at the end of a war.

Finally, the most difficult problem faced by the controlling agencies at the end of the war is that what was a simple single objective during the war, namely, the maximum use of our resources for the prosecution of military operations ceases to dominate policy and in its place arise multiple objectives. During war we do not concern ourselves about the fact that we were not producing enough of some unprofitable but nonessential commodity, because idle resources can always be used in the war effort. But such bothersome situations can no longer be disregarded at the end of the war for we then face the task of the return of our resources to their peacetime pattern in which "wantedness" is as valid a criterion as essentiality. No one sitting in Washington is capable of judging what should be produced in peacetime let alone of directing the return of America to that pattern. We must recognize that the chief instrument for restoring the peacetime pattern of the use of our resources and the peacetime relationships between costs and prices is through the decisions of businessmen, workingmen, and consumers in response to what they experience in the market.

We should not, therefore, undertake the major responsibility of guiding by authority the process of transition. The proper objectives of transition controls are simpler than that. In part these controls must assure us that certain uses of resources which are fundamental to our social well-being get the proper attention during the inevitably hectic days of transition when the market forces which have been in abeyance during the war are not able to function with full effectiveness. Secondly, we have to see that certain controls are used for a while to ease us over until we can get the pipe lines filled and get industry reconverted so that the inflationary threat will be minimized. Fortunately, in such times it is not necessary to tailor our controls so precisely that we give each businessman the exactly right profit incentive. He has a far more important incentive than immediate profits for he has the long-term position of his firm and his business to consider.

The problem of wartime mobilization and stabilization is enormous. But both the principles involved and their execution is a simple task compared to that of effecting a graceful transition to peace with a minimum of inflationary developments. We shall never be able to govern either type of period perfectly, but the chances are that we will carry out the second one, that of transition to peace, the less perfectly of the two.

I shall be glad to answer questions on either wartime or peacetime controls.

QUESTION: Sir, in order to remove the excess purchasing power of the great mass of labor, would it be possible or acceptable politically and to the public to have a very large income tax, a tax on wages, with some of that returned in the form of bonds? What I have in mind is a man going up to the pay window and drawing 60 percent of his pay in dollars, another 10 or 15 percent in bonds, with the remainder deducted as income tax, to dry up the purchasing power, rather than having a voluntary investment in bonds.

DR. HEFLEBOWER: This question goes to the heart of the fiscal management of the war. There is no question but that the more we can dry up purchasing power during war by a combination of the tax and savings devices the better. You are obviously proposing the savings device as a means of keeping incentives active at a time when the people are not allowed to buy as much goods as they have spendable income above usual savings.

We do, of course, face a postwar problem in proportion as our controls build up more and more liquid assets in the hands of consumers. I think that at the end of the next war, if it is one of great dimensions, we are going to have to face frankly the question as to what extent and how rapidly we will allow people to cash the liquid assets they have accumulated during the war. That is another part of the reconversion problem which we have developed.

I would say that the issue raised here calls for a fine judgment about what affects morale. Let us go as far as we can in taxes politically and yet keep up morale and then go as far additionally as we can by saving devices. At best we will not be able to do enough by the combination of taxes and savings. But the Government must be honest with the people all the time. I think we are going to have to tell bondholders frankly that, because we have the job of getting back to a peacetime economy with the minimum of inflation, we may have to restrain somewhat the rate at which they may cash their liquid assets at the end of war. Certainly it is of no advantage to the bondholders if we let everybody cash their bonds, and as a result they lose half their purchasing power through a rise in prices.

QUESTION: Doctor, one of my most distinct recollections as to the early days of the war is that there was a rabid resentment among the draftees against the labor unions and against the laboring people who were getting very high wages. I wonder if we ought to accept the premise that in order to get people to work for their country during war, they must have a large increase in wages.

DR. HEFLEBOWER: It seems to me that in all questions of this kind we have to combine the best of principle with the pragmatic. Now, speaking as an individual who was too young for World War I and too old to fight in World War II--unless you call working for OPA fighting--it seems to me that we must get over the principle that in a war everybody's obligation is to his country, that the most limited resource the country has is manpower, and that we must put people where they are most useful. That means that we may have a 21-year-old man running a machine in a factory rather than fighting in a front-line trench. We must get people to understand that. This will raise questions as to how far we should underpay the man who is drafted as compared to the civilian who remains at home. Beyond that there is the question of how far we can go, as a practical administrative device and as a means of keeping people's morale, in moving them physically from peacetime civilian employments to war production without considerable financial incentive.

For example, if a man has to move geographically, it might be much better to pay his moving expenses than to attract him by a big boost in his wage rate. Then, rather than raise wages generally because costs of living are rising in war centers, I think it is much better to use the increase of the cost of living in war centers as a basis for judging wages in these localities. There are many things we can do to cut down the amount of financial incentive we would have to give to labor.

I have not answered your question as to any single point, but these are some observations.

QUESTION: Doctor, could you give me the limits of the law of supply and demand during war and right after a war?

DR. HEFLEBOWER: During a war what we really do is to suspend the law of supply and demand in large part. When we suspend the law of demand, for example, and no longer let price do its rationing job (price is our normal rationing device inasmuch as it limits how much you and I will buy of each commodity), we then have to substitute some other kind of rationing device. In the industrial area we use allocations and priorities to a large extent, plus the voluntary allocations which big business will effect. But in the consumer-goods area, on commodities that are important and for which the demand is elastic, we have to institute formal rationing. For commodities which are not very important or for which the demand is of a different sort, we can get by with having price ceilings only; you and I will not upset the applecart just because we cannot find that item in the first store we go to or cannot find it at all.

So what we do by our program of controls is suspend a considerable portion of the law of demand. That also applies to certain phases of the law of supply, because we undertake to allocate, by authority, where goods will be used. In the agricultural area, however, we permit market forces to continue to dominate supply.

At the end of the war we are faced with the problem of making a graceful transition from suspended to reinstituted market forces.

About two years ago a book called "The Road to Serfdom," by Frederic Augustus von Hayek, an English economist, made a tremendous appeal to the conservative elements in this country. In that book Hayek warned that many other peoples were going to follow most of Continental Europe down the road to serfdom. That was a very effective attack on government controls. But in a footnote which his readers usually forget Hayek said that he was not arguing for the immediate reinstitution of free markets at the end of the war, because that imposed on the market, that is on the law of supply and demand, the task of quickly reconverting the economy, a task which it is not capable of doing. He feared that if controls were dropped too quickly, chaos would follow and confidence in the market system would be undermined.

QUESTION: We have heard a discussion of the national debt, and some of us did not quite understand what we were told. I wonder if you would explain the economic relations of the national debt to inflation and whether inflation is a desirable thing in servicing that huge sum.

DR. HEFLEBOWER: The key to understanding the first part of your question is the relationship of the banks to the national debt. Whenever industry or government undertakes to finance itself other than out of current receipts, that is, it undertakes to sell stock or to borrow and it makes no difference which, for our purposes, these funds may come from the current savings or the idle savings of the people. That we understand as an ordinary process. But in anything as large as the war or, I might add, the job of financing the increased capital requirements of industry after the recent war, there is not enough in those sources. So, by one device or other, these securities are bought by the banks.

Now, some people look upon a bank deposit in this way: "I took some money to the bank, and it has the money down there." You and I know that the bank does not have the money down there. The bank has only a small amount of cash. What happens is that the amount of total deposits banks have is a result of the amount of loans and investments made.

Let us take an easy case. Suppose they buy the bonds directly from the Government. How do they pay for the bonds? They do it by giving a deposit balance to the Government. The effect is to increase the total deposit balances of the banks, which the Government then begins to draw on. As the Government pays for machinery or meets its pay rolls, those payments become part of the total circulating medium of the civilian economy, thereby increasing the total amount of money, not in the sense of hand-to-hand cash primarily but in the form of bank deposits.

That is how, when the Government spends more than its income and borrows the difference, with part of the difference supplied by the banks, that the total money supply is increased. As the total money supply is increased, everybody has more money to spend. Therefore, you have that demand aspect of inflation.

Is that part clear?

QUESTIONER: Yes.

DR. HEFLEBOWER: The second point has to do with the desirability of using inflation as a means of wiping out a debt. In my judgment, to do that implies that the society is in a pitiful state. It has been done, more than once in history, although not usually by design. In Germany after the first World War, the people who had bought German government bonds during the war were paid five cents on the dollar in the new German Reichsmarks issued after inflation. If they had been paid the real value, they would have got only a fraction of one cent on the dollar. Why did that happen? Almost complete social disintegration had occurred in Germany and only under such a circumstance can a wild inflation occur. In my judgment, the raising of the price level, consciously, as a means of easing the burden of the national debt would be reprehensible.

Inevitably war debt burdens will be eased by rising prices. This occurs because despite the best of attempts at control, prices will move up, and those people who bought bonds during the war will not have a corresponding amount of purchasing power at the end of the war. The burden of debt, you see, at any given time, is not a burden on the total economy, except in so far as the transferring of funds from one group in the economy to another group in the economy creates difficulties. In so far as the presence of that large supply of liquid funds--and there is nothing more liquid than a government bond--it tends to give an instability to the total economy. When taxes are levied to retire a debt, money is taken from one man and handed to the one who owns the bond. In that sense, there is no burden on the total economy. There remains the problem of transpiring funds by taxation and that process may have adverse effects on the economy.

QUESTION: You have spoken about price controls here. I wonder if you would mention something about price controls on real estate, that is, as a method of preventing putting any money into inflated real estate values.

DR. HEFLEBOWER: We have to decide how much we are going to tackle. I spoke of suspending the law of supply and demand in certain commodity areas, but if we elect to suspend it everywhere we would take on an impossibly large administrative job. And, I might add, the job of controlling real estate values is a very difficult one unless the device of imposing a special tax is applied where real estate is sold for more than it was bought for.

The second point I would make is that when one pays more for real estate no additional wealth is created in the process; neither is any used in that process; nor any consumer goods diverted. Money is transferred to somebody else, who now has more of it.

So, aside from our feeling uncomfortable about mounting real estate prices and being embarrassed by what is going on, I am not certain that we ought to undertake that area of control. Frankly, I have not thought very much about that particular issue.

QUESTION: I believe you mentioned that once a control has been lifted, it is virtually impossible to put it back into effect.

DR. HEFLEBOWER: After the end of a war.

QUESTION: Yes. And that price control, rationing, and wage stabilization all ran together. There is some talk of putting price control into effect now without the other two running mates. What chance of success does it have?

DR. HEFLEBOWER: If we want to get over into the current situation, I would say that price control on meat at the present time would be one of the biggest fiascoes imaginable; that is, unless the prices were put at the level that the market has already established, and then there would be no price control at all. If you mean price control on steel, that is a different matter, because, as Mr. Galbraith once said, it is easy to control prices in an area where they are already controlled. By that I mean that the industry already has established prices which it sticks by, so far as the manufacturers are concerned, and which currently are below the clear-the-market level. That means, therefore, that the steel industry engages in a voluntary allocation program. Now, if you did not like the way the steel industry was fixing its prices, it would not be impossible administratively to impose price control there.

I think there are some very important questions of principle as to whether you would want to do it, whether you could do a much better job than the steel industry is doing itself, and whether it might interfere with the steel industry's desire by new devices to make a more effective use, perhaps, of its existing capacity. There are a series of questions that might be raised about imposing price control in that area. But in the consumer-goods area, particularly commodities of inelastic demand and necessities, if price control were to impose as was proposed some time ago, to force the prices down or hold them below the clear-the-market level, we would have one of the biggest fiascoes in American history.

QUESTION: In that connection, the one control we have left is rent control, on which we have heard many pros and cons. What would be your opinion as to the results if that were removed?

DR. HEFLEBOWER: It seems to me there are two issues with respect to rent control. There is no doubt but that in a number of areas rents are being held not only below the clear-the-market level but below what might be called a long-term level, based on current costs, incomes, and so on. At the same time we must realize that we are dealing with a facility in respect to which, in any short period, the supply is inelastic. We have to reach a judgment as to when we have increased the supply of this facility sufficiently so that we can afford to let prices move up, perhaps somewhat above their long-term level but not to a phenomenally high point? At the same time we must realize that when we hold a commodity price well below its long-term level, people use more of it. My guess is the available rental housing would go a lot further if rents were at the clear-the-market level or at their long-term level.

The second issue is whether there is a serious chance of rent control becoming a permanent institution. That is what has happened in France after War I. I contend that anything like that is foreign to our social system.

QUESTION: You mentioned, sir, the interdependence of the various types of control during war and then the problem of checking inflation at the end of war. How can we gradually slacken off controls if they are so interdependent, in order to get, we will say, a deflationary trend?

DR. HEFLEBOWER: You didn't mean "deflationary trend," did you?

QUESTIONER: Yes, sir. I had two questions. The first one was as I gave it to you. The second thought came in as to how we can get a deflationary trend with all of the conditions existing at the end of a war.

DR. HEFLEBOWER: I want to answer the second first. We do not want a deflationary trend. In other words, any idea that at the end of the war we would want to move back to our prewar level of prices is wrong. What we would want to do is prevent a further inflationary trend of substantial importance.

QUESTIONER: In view of the fact, sir, that deflation can be controlled by capital expenditures and so on, why isn't that better inasmuch as you stated that an inflationary trend could not be checked?

DR. HEFLEBOWER: I think, then, we are in agreement; that is, if we have to err in either direction, let us run the risk of setting up some deflationary elements, because we can check them fairly easily. We are agreed on that.

Now, as to the practical problem of how we are going to remove these controls by "packages," remember I warned that doing a good job of removing these controls is infinitely more difficult, in both principle and execution, than installing them or operating them during the war. But I am thinking in terms of this sort for, say the building-materials area. It does not do any good to maintain price controls if we have taken off the allocations control or use priorities. It may be better in a case like that, as a practical matter, if there are certain kinds of housing that we want, to take off price controls and give use priorities to certain types of construction. We had such poor experience with this phase of our job at the end of the last war that we do not have any really well-thought-through set of principles to enunciate.

I fear my answer has not been very satisfactory. The broad principle can be stated very easily, you know; but when we get down to cases, it is very different.

QUESTION: In view of the present situation, why do we still have to have farm subsidies?

DR. HEFLEBOWER: I am glad to answer that question. First, I want to make it very clear that up until recent months the so-called support programs for agricultural commodities have had no important influence on the prices we have paid. I think we supported potatoes and wool--the inevitable wool--and that's about all.

COLONEL McKENZIE: That's right.

DR. HEFLEBOWER: The second point is that we learned during the war that support prices were the most important device we had for redirecting the use of agricultural resources. My guess is that our total agricultural production today is larger because those support prices are there; we have minimized the farmer's risk.

Then the promise was made to the farmers in the early days of the war that in the event they submitted to price control--and this was written into law--these supports would exist for two years after the first of January following the official declaration that the war was over. President Truman hurriedly declared that it was over in December a year or so ago. That was both a moral commitment and a legal commitment.

Now we go on to the next point. Looking ahead a year or two, when that commitment has run out, we ask, "Why do we have a minimum support on agricultural prices?" I fear that is too large a question for us to discuss here. I just want to make one point, that we must not confuse the general principle as to whether Congress should try to provide some floors under agricultural prices with the peculiar kinds or levels of floors that it provides. And, as you know, there is a tendency for every floor to be pushed up against the ceiling. That is the basic difficulty in the agricultural support program.

GENERAL HOLMAN: Dr. Heflebower, this has certainly been a very fine morning for us. Your contributions this morning to our understanding of wartime economic controls have been very important. For the faculty and the students, I wish to say that we are very appreciative.

DR. HEFLEBOWER: Thank you.

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