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THE ROLE OF THE FEDERAL RESERVE IN WARTIME

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Mr. Thomas B. McCabe, Chairman, Board of Governors of the Federal Reserve System, was born in Whaleyville, Maryland, on 11 July 1893. He attended Wilmington Conference Academy, Dover, Delaware, and was graduated from Swarthmore College in 1915, receiving his A.B. degree in economics. He holds honorary degree of LL.D. from Swarthmore College, 1947; Hahnemann Medical College, 1948; Drexel Institute of Technology, 1948; and Trinity College, 1949. He advanced from salesman to president of the Scott Paper Company during the period from 1916-1927 and has occupied that position since 1927. During World War I he served in the U. S. Army and advanced from a private to a captain. He has been a class "C" director of the Federal Reserve Bank of Philadelphia since 1937; deputy chairman, 1938; and chairman of the Board and Federal Reserve Agent, 1939-1948. Former chairman of the Chairmen's Conference of the Federal Reserve System. Chairman of Special Committee for two years to study executive officers' positions and salaries in the twelve Federal Reserve banks. In 1948 he became member and chairman of the Board of Governors of the Federal Reserve System. He has been a member of Business Advisory Council for the Department of Commerce since 1940 and was chairman from 1944-1945. He served in 1941 as deputy director of the Division of Priorities, Office of Production Management. During 1945 he served as Army-Navy Liquidation Commissioner and was awarded the Medal of Merit in 1946.

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GENERAL HOLMAN: No matter how expertly we may be able to plan for the mobilization of our manpower and material resources, we cannot for a minute overlook the problems of financing a war. Economic stabilization is a very important aspect of the mobilization process. It is quite true that the man in uniform does not have the direct responsibility for war financing, but the influence of his planning does have a great deal to do with the tax burden and the cost of a war. It is for this reason that the Industrial College is so acutely interested in all the problems of financing a war.

Our subject today is "The Role of the Federal Reserve System in Wartime." The college is greatly honored to have with us to discuss this problem the Chairman of the Board of Governors of the Federal Reserve System, Mr. Thomas B. McCabe.

Mr. McCabe, we feel greatly honored to have you with us this morning and welcome you to this platform.

MR. McCABE: Gentlemen, it is a pleasure to be here. I have looked forward eagerly to coming here today, because it affords me a chance to be back in familiar territory and to see many old friends. When I was serving as Army and Navy Liquidation Commissioner in 1945 and 1946, I had the privilege of working with some of you here in Washington and of visiting others of you in Army and Navy bases throughout the world.

I will never forget the many acts of courtesy and helpfulness which you accorded me in Europe, in the Middle East, in India, and in the Pacific. Some of my most pleasant recollections are of nights spent in your billets in places farthest from the civilized world. Some of my most cherished friendships date from my own period of military service in World War I.

We used to think of the military as a class apart. We used to think of military problems as highly specialized problems outside the scope of general civilian background. Now we know that every military problem may have aspects that require evaluation on the broadest basis possible. Equally, we know that problems such as we deal with at the Board of Governors are frequently shot through with military considerations. It is gratifying that the armed services have grasped this fact and are moving to train leaders capable of upholding this new concept of the role of the military in world affairs and in a democracy like ours, which has always had an abhorrence of wars and the makings of war.

We are justified in having confidence in what you will produce here. The training programs have proved their value. Never before in American history have we witnessed such a succession of military leaders competent in their art and capable of dealing at the highest level with political, diplomatic, and administrative problems. The names of Marshall and Eisenhower are only two of a long list of highly gifted, broad-gauged personalities that emerged from the armed forces during World War II. They are a product of your system of selection and of your postgraduate training program. This is a distinguished accomplishment.

In the present crisis two great questions are of supreme importance to our people at home and to adherents of human freedom throughout the world. The first is, How can we build up our defenses to meet the threat of world aggression by the Communist forces? The second is, How can we maintain the value of the American dollar?

You can't have a defense program without a sound dollar. I am convinced that you can't have anything that approaches a peaceful world without a sound dollar. Since I an not qualified to discuss military problems, I want to confine our attention to the second of these important questions, which is so much in the center of every citizen's attention these days. I want to show you what the role of a central bank like the Federal Reserve is in helping to preserve a sound dollar.

Since the Federal Reserve System has the statutory responsibility of regulating the volume, cost, and availability of money and credit, it is of importance that all of us have a clear understanding of its history, purpose, and its present objectives.

The role of the central bank in this country, and, in fact, in other countries of the world, has often seemed to be a mysterious one. The "Old Lady of Threadneedle Street" was never fully understood--what lady is?--but for generations the Bank of England has commanded the admiration and respect of the English-speaking peoples of the world. I welcome the opportunity to talk to a thoughtful group like this on this subject, which I feel you want to understand and which is so vital to the preservation of our kind of a free-enterprise, capitalistic economy.

The Federal Reserve System was established by the Congress in 1913 as a unique creation in the history of central banking. The legislation was given highest priority early in the first Wilson administration following a succession of money panics that focused public attention on money and credit problems. It represented the first central banking authority in this country after the charter of the second Bank of the United States had been allowed to lapse in 1836.

The act provided that the Federal Reserve should have an independent status in the governmental structure, reporting directly to the Congress. It set up a Board of Governors here in Washington, and a decentralized network of 12 regional banks and 24 branches located so as to serve every commercial area in the country. Thus, as you can see, in terms of the current talk about dispersing government agencies in the event of atomic warfare, we are already "dispersed." Operations could be interrupted at any one of these points without seriously interfering with the work of the system as a whole.

Profiting by the early experiences in this country of sharp public reaction to dominant private ownership and control of a central bank, the Federal Reserve Act provided for an efficient and effective combination of both public and private management. The Board of Governors is primarily responsible for the formulation of broad credit and monetary policies. In order to insure the independent and nonpolitical character of the System, Congress provided that the term of each member of the Board should be for 14 years.

The individual Federal Reserve banks, the stock of which is owned by the banks belonging to the System, have primary responsibility for the relationships with the member banks and with the business community in their own locality. Moreover, management of the individual Reserve banks and their branches is under the immediate direction of the more than 250 men who serve on their boards of directors.

To balance the public and private interest, some of these directors are appointed by the Board of Governors and others are elected by the commercial banks belonging to the System. These directors represent a cross section of the best leadership in American industry, agriculture, education, and finance. For example, the Board of Governors appointees for the New York Bank are Judge Patterson, former Secretary of War; Robert Stevens, a former colonel in the Army, who had a distinguished record in handling procurement in World War II; and William I. Myers, now Dean at Cornell University, who is familiar to many of you here for his outstanding work in reorganizing the farm mortgage system during the depression. We count heavily on the Reserve bank directors to give us a first-hand, region-by-region appraisal of economic conditions, and of the effect of our various actions, as well as for advice on policy matters.

I repeat what I have said many times--that I am thoroughly convinced that the authors of the Federal Reserve Act gave us a monumental piece of legislation, a system tailor-made for the economic expansion of our country. The System might be compared to a great pyramid, with its base in the grass roots of our economy, and its apex in the Board of Governors. The breadth and strength of the pyramid are in its base, with the member banks and the Reserve banks as elevations in the slope toward the top.

I am more convinced than ever before of the truth of that statement--in regard to the effectiveness of this system. For more than 10 years I served on the board of the Philadelphia Federal Reserve Bank, and for almost three years more I have served with the Board of Governors in Washington. It has been a great experience to observe the intricate workings of our credit and monetary machine and to view its relationship to the national economy.

So much for how the Federal Reserve is organized. Now, let's see just what some of the things are that we do.

First of all, I am sure you are familiar with the more or less routine functions we perform, such as supplying coins and currency for circulation, clearing checks, holding member banks' reserve balances, transferring funds from one section of the country to another, and serving as fiscal agents for the Treasury in the issuance of savings bonds and other government securities.

These necessary and important housekeeping functions account for most of the staff of the Reserve banks. These are the facilities provided for the accommodation of the member banks and for the public generally. Most of them involve heavily increased loads in wartime, particularly the issuing of government securities.

The most important facility from your point of view is the operation of the V-loan program, recently reinstituted under authority of the Defense Production Act of 1950. One of the principal problems of the military procurement agencies during the period from 1941 to 1945 was that of finding sufficient productive capacity to manufacture the tanks, planes, ships, and guns and their component parts that were required. In large part this was a problem of building new factories and facilities. It was also a problem of expediting production in existing plants by contractors and subcontractors who had the necessary technical competence and physical capacity but lacked sufficient working capital to get under way.

In March 1942, an entirely new mechanism, known as the V-loan program, was devised to facilitate this special type of financial assistance for war contractors. The armed services were authorized to guarantee extensions of credit by private financial institutions for war production purposes. The Federal Reserve banks acted as fiscal agents of the armed services to bring together the producer, the financial institution, and the guaranteeing war procurement agency. The procedure resulted in greater participation by the private banking system and consequently lessened both the need and pressure for direct government financing.

Total disbursements of loans under the V-loan program exceeded 12 billion dollars. Over 90 percent of the number and one-third of the amount of these guarantees were on loans to businesses classified as small and medium-sized. The program was not only effective from a procurement standpoint, but it was also financially self-supporting. In fact, net revenue to the Treasury from the guarantee program amounted to more than 23 million dollars.

Important though these activities may be in our daily business and commercial life, and in expediting the military procurement program, the primary responsibility of the Federal Reserve is the formation and execution of monetary and credit policies. In normal times these are designed to assist in promoting economic stability. I used the word "assist" advisedly, because you realize that many other governmental policies, such as military and fiscal policies, have a most important influence on economic growth and stability, particularly in a war period. I also used the word "promoting" rather than "controlling" or "regulating" because we can only influence economic decisions; we do not directly control them. This is an often misunderstood aspect of central bank policies.

The traditional role of the central bank in establishing monetary and credit policies is one which has evolved over the centuries as society, after a series of painful experiences, learned that in a complicated economy "money does not manage itself." Monetary policies are directed toward adjusting the volume of credit and money in accordance with the needs of the economy so as to avoid overexpansion or contraction of production, employment, or prices.

If the supply of money and credit is too low in relation to the output of goods, central bank actions are designed to make credit more easily available at lower cost, so that its use in expanding consumption and investment will be encouraged. On the other hand, if the supply of money and credit threatens to be excessive in relation to the availability of goods or our ability to increase the supply of goods, then contrary actions are in order and the credit reins are tightened. The use of credit must be restricted and discouraged.

The power to influence materially the amount, availability, and cost of money has far-reaching implications that are political as well as economic. That is why historically there has always been in many countries of the world a struggle for control of the central banking authority. Obviously, if those in power in a country can dominate the functions of its central bank, they likewise can control the cost of obtaining money to run the government and may be quite tempted to substitute low-cost borrowing for adequate taxation, thus paving the way for inflation.

That is why, in all countries, central banks are set up as separate institutions, frequently with private ownership and varying degrees of private control. They are not organized as a subdivision of some government department.

This separation is generally continued even where central banks have been "nationalized," that is, brought under public ownership. It has continued even in cases where autocratic or socialistic governments have gained control and have removed any vestige of private ownership or operation.

Here in this country the Congress in establishing the Federal Reserve deliberately sought to insulate it from predatory and partisan pressures. At the same time, the act clearly recognized that central banking was to be regarded henceforth as a public function, to be exercised in the general public interest and subject to public control.

There are bound to be divergent views as to what is and what is not in the public interest. Trying to reconcile the necessity for public control and yet avoiding the danger of domination by political forces is the dilemma which central banking authorities the world over constantly face. In my opinion, the Congress resolved this question for the United States by setting up the Federal Reserve as an independent agency; but there is not the slightest doubt in my mind that Congress would radically alter the System's organization if it pursued policies against the public interest, as interpreted by the people's elected representatives.

Now let's turn our attention to the effect of war and threats of war on the policies of the Federal Reserve.

In a period such as we now face, when our industrial output will have to be maintained at "forced draft" for a considerable period of time, the focus of our monetary and credit policies must be to help preserve the value of the dollar and at the same time assure full and adequate financial support for the war effort. What significance is there in our operations and in the functioning of the economy in proceeding periods of defense preparation and war that will throw light on the monetary problems we face in the months and possibly years to come?

The overriding problem which the Government faced during World War II was the problem of how to raise the staggering amounts of money that were required. I cannot overstate the importance of the methods by which public funds are raised. If the job is done properly, the whole effort to stabilize the economy and preserve the soundness of the dollar is made immeasurably easier. If it is done badly, it is no exaggeration to say that it is possible to destroy the very society which we are struggling to preserve.

The experts in monetary and fiscal policies are agreed, for example, that failure to consider adequately this aspect of war finance was a contributing factor to the complete disruption of the German economy following World War I. Germany failed to tax adequately to meet its war expenditures. It left to its central bank, the Reichsbank, the problem of raising the necessary funds on a credit basis. This negligence, plus military defeat, contributed to the ruinous inflation that wiped out the basic values of German society during the postwar period and laid the foundation for Hitler Nazism.

In our own country, the present complications in debt management and monetary policies are in no small measure related to recognized deficiencies in the financing of World War II. Our tremendous Federal debt, which is presently five times the size it was in 1939, is today the dominating influence in our money markets.

Only about 40 percent of the total cost of World War II was raised by taxation. As the President stated so clearly this past fall, "We borrowed too much and did not tax ourselves enough."

Responsibility for determining what share of our total expenditures will be met with tax revenues ultimately falls to the lot of Congress. The administrative agencies, however, must bear a responsibility for pointing up the importance and long-run implications of a given tax program.

To the extent that tax revenues fall short of the Government's need for funds, the difference must, of course, be raised by borrowing. Again, the basic responsibility for determining the types of securities to be offered, the maturities, the interest rates, and the buyers to whom such securities will be offered lies with the Treasury.

The Treasury in raising the necessary funds in World War II was naturally and properly concerned about keeping the cost of borrowing low. This minimized the burden of servicing the resulting debt. The Federal Reserve's principal concern as the Nation's monetary authority was to see that the means used to raise funds were as noninflationary as possible. The Treasury also had a long-run interest in this same objective.

To the extent that the funds did not come from taxation or borrowed savings, they had to be raised through the banking system. In other words, the banks were used to create credit to make up deficiencies in the funds that were needed to finance the war.

In this process the Federal Reserve was confronted with a dilemma. On the one hand, the System had to supply the banking system with the reserves needed to support bank credit expansion. On the other hand, it was the System's responsibility to try to neutralize the inflationary potential of this newly created money. There was no satisfactory method by which it could be completely neutralized. The most that could be done was to slow its impact.

As it turned out, about one-third of our total expenditures in World War II was financed through the borrowing of savings directly from the public and one-fourth through borrowing from the banking system. The government securities purchased by the banking system provided the basis for a substantial expansion of credit and consequently in the money supply. The total money supply doubled from 1941 to 1946, rising from roughly 75 billion dollars to over 150 billion. It now stands at approximately 175 billion.

This dammed-up supply of money, plus the unprecedented accumulation of government securities by businesses and individuals, broke loose in the postwar period as soon as the harness of direct controls was removed. Low-interest-bearing government securities were converted at supported prices by many holders, as opportunities for spending and for investment in higher-yielding private assets became available, adding further to the supply of money in the economic system.

The inflationary problems of the postwar period, then, resulted in large part from the expanded money supply and also from the sales of government securities by insurance companies, banks, and other lenders to the Federal Reserve System.

The resultant inflation and depreciation of the value of the dollar during the postwar period is something with which you are all familiar. Those of you in procurement are keenly aware of the increased cost of rearmament, and the fact that appropriations have not gone so far as you expected when they were first approved.

It is incumbent upon all of us concerned with the financing of the defense program that looms before us to profit to the fullest from our experience in financing World War II. If I may summarize the main lessons of that experience: First, we did not tax enough; second, the funds we raised by borrowing, though they may have been saved at the time, did not remain inactive after the war. Too many individuals and institutions that held them liquidated their bonds and spent their cash as opportunity presented itself.

In this new effort we must tax more adequately and devise means to tap the savings of the public in such a way that in the aggregate they will stay put after the war and will not re-enter the spending stream, creating market demands in excess of the ability of the economy to supply.

In the past six months the Federal Reserve has taken a series of steps designed to restrict the expansion of credit. In my judgment, the combined effect of the System's program has been to exert a definitely deterrent influence. While there is no way to measure the effect of these policies on the purchasing power of the dollar, I am nevertheless convinced that our actions have been decidedly beneficial.

The five specific actions taken by the System began with the Board's approval of an increase in discount rates at all Federal Reserve banks. This tends to deter member banks from borrowing from the Reserve banks in order to acquire additional reserves to back up new extensions of credit to their customers, and has secondary effects upon lending rates.

Second, open-market operations of the System have been directed toward discouraging sales to the Federal Reserve of short-term government securities--another method by which member banks obtain additional funds for credit extensions.

In the past two weeks the Board has also raised the reserves required of member banks to levels equal to or above the requirements that prevailed during most of World War II. The effect of this increase will be to raise the required reserves of member banks by a total of approximately two billion dollars, which, under our fractional reserve banking system, could otherwise be the basis for about a 12 billion dollar increase in bank credit in the banking system as a whole.

In addition to these moves, the Board has also used its temporary authority under the Defense Production Act of 1950 to regulate consumer installment credit (Regulation W), and the extension of credit to buyers of new homes (Regulation X). Unlike the general controls which tend to affect the supply, availability, and cost of credit, these selective controls work to curtail the use of credit by cutting down the effective demand for certain specific goods.

In spite of these restrictive measures, the economy has experienced a sharp rise in prices and an unprecedented expansion in credit. This reflects the decided contrast between the basic economic conditions prevailing last June, when the Korean incident began, and those existing at the time of Pearl Harbor. Employment and production were at near peak levels when we began to step up the defense program this time, whereas in 1941 there was considerable slack in the economy to be drawn upon. The absorption of this slack was a substantial cushion for the inflationary impact of the war program that is not available to us now.

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The problem of war finance is much more complicated and much more urgent today than it was a decade ago. It requires a complete reappraisal of what is involved in financial mobilization for a full-scale defense effort, an examination of how to mobilize our financial resources so as to provide adequately for huge defense expenditures and still preserve the value of the dollar.

War finance should be examined with the same care that we devoted in 1941, 1942, and 1943 to an examination of the problems of physical mobilization, of how to find materials and manpower to produce munitions in unparalleled volume without sacrifice of the physical health and well being of the population. That examination at that time developed novel approaches to the problems of munitions production, from the standpoint of manpower, of materials, and of contract placement. The resulting outflow of munitions was little short of miraculous.

In my judgment, we were not nearly so successful in the mobilization of our financial resources.

A complete reappraisal of this problem is the next order of business our society should face. We at the Federal Reserve can contribute to fresh thinking, but we cannot alone evolve a full-scale financial plan that is adequate; nor have we the power or influence to assure its adoption. One thing we know--the problem cannot be solved by minor adjustments in fiscal policy, in debt management policy, or in credit policy; it is more complicated than that.

I hope the decks can be cleared so that this appraisal will promptly become the number one preoccupation of our people and of our Government. To date, first priority has necessarily been given to a reassessment of our international position and to the development of the military programs and the procurement programs made necessary by that new situation. Now that these programs are being translated into contracts and armed strength, it is imperative that we give top priority to the overriding financial problem of our time--the preservation of the value of the dollar.

Our Nation is now engaged in rebuilding the defenses we allowed to crumble in the exhilaration of a victorious ending to World War II. We are re-creating the military might we had at the time I had the unhappy task of serving as Liquidation Commissioner, to which I referred at the outset of my talk this afternoon. If we had not done such a thorough job then, our task today might not have been so great; nor would the sacrifices of those who achieved that victory have to be duplicated to so great an extent by others who follow in their footsteps today on the battlefields of Korea.

I shall never forget the visit of Kenneth Royall, the then Under Secretary of War, and myself to the tiny island of Iwo Jima just a few months after the Marines had captured it in an historic struggle. The first night we were there the commanding officer showed us several reels of motion pictures taken during the battle for that island stronghold. There was stark reality in seeing those epic films right on the spot where the fighting had taken place.

About midnight we walked out of the quonset hut that served as the commanding officer's billet and over to the edge of the sheer cliffs to view the splendor of a calm moonlight night on the Pacific. It was one of the most beautiful and awe-inspiring scenes I have ever witnessed, and one that I can never forget. The contrast between the dramatic pictures of that bloody battle and the stark stillness of the scene before us seemed unrealistic and unbelievable.

Just a few hundred yards away was Mt. Suribachi--the sugar loaf of now historic fame--rising out of the sea. Just behind us were the graves of the gallant men who had stormed the rugged slope to clinch possession of that prized military objective. Thousands of our finest Marines had given their lives on the very land where we stood that night. There was the mute evidence of the price that this country is willing to pay for freedom and for the preservation of those things we hold dear in our civilization.

I think it is this picture of Iwo Jima that gives me confidence that the American people will face the problem of the dollar, that they will take the measures necessary to deal with inflation, and that they will win. It is not insoluble. It is not beyond our capacity to appraise.

Inflattion is not inevitable. It is true that sacrifice will be necessary to preserve the dollar, but we have demonstrated willingness to undergo supreme sacrifice once we understand the end in view and the need.

I can have little patience with those who say that the American public lacks the courage, the will, and the vision to comprehend and to conquer evil forces, whether abroad or at home, that would destroy the institutions which are the source of our incomparable strength and of the hopes of free peoples throughout the world.

COLONEL HARDENBERGH: Mr. McCabe is now ready for questions.

QUESTION: Mr. McCabe, you say you have had certain selective control measures in effect for the last six months, but that you cannot measure their effect upon the value of the dollar to any great extent. If you can't measure the results, how can you determine whether the measures are adequate?

MR. McCABE: I didn't say that they were adequate. I do say that we have some measure of their results. For instance, take the mortgage credit expansion from 20 billion dollars at the end of the war to over 40 billion dollars now. After Regulation X went into effect, the housing starts dropped from 142,000 in the highest month to 85,000 in the last month for which we have figures, which I think was November. So we do see in that field that there was quite a considerable drop.

In the automobile field, judging from the cries that we got from the automobile dealers throughout the land and the finance companies, you might have thought we were completely destroying that industry. There is no question that the sale of automobiles did go down considerably. I think that if we hadn't had the second scare in Korea, they would have gone down more.

I just cite those two things as instances where we do have some indication of the results of the measures that we took.

Now, many of the bankers told me three months ago that if we increased the reserve requirements, the result would be to throw the economy into a tail spin. One of the large New York bankers told me in October that there was no doubt in his mind that if we increased the reserve requirements at that time, we were going to bring on a depression. Well, we did increase the reserve requirements just recently. We would have increased them sooner except for the fact that we had to stay with the Treasury during the latter part of November and December on its refunding program. With its enormous refunding program, maintaining an orderly market for government bonds was a compelling factor at that period of time. I think our action is going to slow down bank loans some. To what extent I don't know.

We have an enormous purchasing power in this country. If you take the national income, plus the liquid assets of the people, we have a perfectly enormous purchasing power. So, to answer your question, we have enough evidence to show that what we have done has had an appreciable effect, but not enough.

I think we have to come to grips with this problem to an extent that we have not come to grips with it as yet. I was in attendance at a conference in Washington just before I came over here and I was advocating with all the force at my command that we take real measures to get into the causes of inflation. When we deal with price and wage controls, we are dealing more with effects than we are with causes. I think we must come to grips with the causes and come to grips with them quickly.

Among the causes of inflation are expanded income and expanded savings. They create a demand that is largely an unsatisified demand. Sooner or later--and the sooner the better--we will have to come to grips with the source of this expanded income. That means siphoning off the excess income, and siphoning it off substantially through taxation. Second, we have, I think to be more drastic in our control measures. There are other things that might be done, but I think those are the two principal ones.

But I do say again that we have enough evidence to show that inflation would have been much worse than it is today if we hadn't taken those measures.

QUESTION: When our servicemen come back from this war, they are going to find that the cost of living has gone up and that their savings have shrunk in buying power. In spite of anti-inflationary regulations, they will find it very difficult to get a place to live. Do you have any solution worked out to correct this inequity, so that servicemen, veterans, coming home will not feel unjustly treated, as they did after the last war? It is especially bad after this second war--one war right on top of another.

MR. McCABE: I can't solve their basic problem. I have great sympathy with them in the matter of purchasing a home. Under what was considered a stringent regulation on mortgage credit the veteran was a very decided preference on the lower-priced homes. In addition, there is a provision in the regulation that allows the administrator to take into consideration hardship cases. My experience with the Veterans Administration is that they are very liberal in their interpretation of that provision in the regulation. I don't recall directly the figures, but in purchasing a home for $10,000 the veteran's preference was something like 10 percent on the down payment. He has preference on the maturity. So that he does have a very decided preference in the purchase of a home.

Now, under the regulation on automobiles, all our records show that the lower income groups of veterans predominantly buy second-hand automobiles. As a result of Regulation W the price of a 1949 second-hand car a few weeks after the regulation went into effect dropped something like $350. So, even though the veteran got a little shorter time in which to pay for that second-hand car, the price advantage there was very substantial.

QUESTION: In your answer to a previous question you mentioned that it is desirable to siphon off not all, but a large portion of the income of the people in the Nation. But it is not politically expedient for a Congressman to pass a law to increase taxes now, because he may not get back in office in the next election. Do you think it possible that Congress will go along and pass higher taxes, that is, taxes that will be really severe?

MR. McCABE: First of all, I didn't say "most of it" or "a large part." I was thinking more in terms of increased taxes in some percent like, 5, 10, or 15. I don't know exactly what it would take.

You have asked the 64-dollar question there. Whether Congress is going to have the courage to do the thing that ought to be done is a big question.

I was interested in looking at what we did in World War II in the way of taxes. In looking back now I think it is perfectly disgraceful that we did not have the courage then to pay a larger portion of the cost of the war from taxes. I have some figures here that I can show if you want to see them. They show the volume of savings accumulated during World War II, which ran away up over 100 billion dollars. I could show you to what extent we taxed the people. As I said before, we paid about 40 percent of the cost of the war in the form of taxes.

What we will have to do is get groups like this--and you have influence with your own groups, your friends and families--to go throughout the country and bring pressure on Congress to recognize this problem as the number one problem. I put the problem of inflation ahead of your military problem, because I don't feel that we have a snowball's chance of defeating one of the better prepared nations if we should come to grips with it in the next five years or three years or two, unless we have a strong economy. The greatest enemy of a strong economy is inflation.

I just don't think our people realize that; they are intoxicated. We like a little inflation. It is like drink; we like a little of it. The laboring man is handling more money today than he ever handled in his life. He is interested in handling more money. The retailer is handling more money. He likes it. He doesn't like the prices he has to pay; but as long as he gets more, he says "All right."

We haven't as yet realized the price of the intoxication that we are enjoying at the present time. The people of France know what the pay-off is. The people of Germany found out what the pay-off was. Anyone who has been in China knows that the Chinese people know it. I think it is the greatest enemy that we have facing us today.

QUESTION: In the next year or so we are going to have a tremendous increase in the numbers and amounts of maturing "E" bonds coming up. That amount of money coming into the hands of the public and being spent is going to make a very large increase in the inflationary pressure. Do you have any thoughts or recommendations as to how we can combat that problem?

MR. McCABE: Yes. Of course, I think we have to revise all our thoughts in regard to maturing government obligations. My own feeling is that we have to entice those "E" bond holders to exchange that maturing obligation for a more attractive obligation. They are working on that now. I don't know what they will come up with, but it is very, very important.

QUESTION: From my reading assignments I learn that there are legislative limits to the actions that the Federal Reserve Board can take. What anti-inflationary actions remain available to the Federal Reserve Board that they have not taken because of the legislative limitations?

MR. McCABE: In this last increase of 2 percent in the reserve requirements we used up our statutory authority completely, with the exception of the area of the central reserve city banks, that is, like the New York and Chicago banks. We could move there another two points. The question there is just what authority we will ask of Congress. Unquestionably we will ask Congress for some authority in that area.

The Federal Reserve could increase the discount rate further. But, since the banks are not borrowing in any substantial amount from the Federal Reserve, that would have nothing more than a slight psychological effect. Furthermore, it would hamper us to some extent in retaining an orderly market for government bonds.

The most effective instrument that I think we haven't used today other than selective controls is to allow the rate on short-term governments to rise. We call that a penalty rate. It penalizes banks that bought short-term governments in such large amounts in selling them to the Federal Reserve. As the rate goes up, the price goes down. Therefore when they sell to us, at times they have to sell at a loss; and they don't like to sell at a loss.

Now, the question of raising that further is, of course, complicated by the fact that we have to support the government bond market. We have to make sure that the Treasury refundings are successful. We feel that the increase of the short-term rate has been an anti-inflationary move and that any further move would be more anti-inflationary. But there are different points of view in the Government on that particular thing.

There are other things that we will have to ask for, other legislation. On the selective controls we could undoubtedly get tougher.

QUESTION: I would like to pursue that question further that you just discussed a moment ago. If your primary interest is a sound dollar, why, then, do you consider it so important that short-term government bonds not be allowed to seek their natural level? Why can't you raise your rate? It certainly will have a more concrete effect in restricting credit than nearly any other thing that could happen.

MR. McCABE: We have allowed it to rise. Then, of course, right after we allowed it to rise, we ran smack into the Treasury refunding; and we had to stay there and help maintain an orderly market until the refundings have taken place.

QUESTION: But why? Why not let it go up and let the Treasury work out its own problems, get out and sell its bonds to the people in the street?

MR. McCABE: Well, there you have asked one of the most important questions that we have to answer. I can't give you a cut-and-dried answer to that. I will say that it is the number one problem that we are facing.

QUESTION: It looks like the only solution to the sound dollar.

MR. McCABE: I think it is a very important problem.

QUESTION: It seems to be a rather general theory now that it is impossible to raise enough from taxes on a pay-as-you-go plan to finance the mobilization effort that we are about to undertake. I can see perhaps that psychologically that may be true, but from a strict economic viewpoint I can't understand why that is true. All it amounts to is draining off enough money to compensate for the goods that are being put into the military effort instead of the civilian market. I wish you would explain why this theory is true that we cannot pay for the mobilization effort on a pay-as-you-go basis.

MR. McCABE: I think it is a fallacious theory. It takes us right back again to the experience of World War II, when our liquid savings and liquid investments of the people, the liquid assets of the people, increased to 140 billion dollars. I have the figures right in here. We know that the liquid savings of the people today have increased. We know that the people never enjoyed such incomes as they do today.

I think it is perfectly possible to pay for this effort on a pay-as-you-go basis. The tragic thing now is that we not only have the actual expenditures for defense, but we have the anticipated expenditures, which are very inflationary in character. My feeling is that taxes ought to go up sufficiently to cover the anticipated expenditures as well as the actual. I think that right at the start we should siphon off through withholding taxes a very substantial part of the income. And I would do it not only through withholding taxes. If I had my way, I would increase taxes in all directions. I would not only increase the present taxes, but I would put on new ones.

What I mean is this, if the American people want military security, the question should be put to them plainly: "To what extent will you pay for security? We will give you just as much security as you want and as much as you will pay for." The people don't quite understand that yet. It hasn't been put to them as simply as that.

I honestly believe that if you could gather all the American people in this room and put the question to them squarely, in the right way, you would get a vote of confidence to go ahead and tax them sufficiently to pay for security. But what we have now is what I would call a lack of courage to meet the issue. I think every man in this room who knows the critical situation that we face from a military standpoint would be perfectly willing to pay his share toward that security. That is the thing we have to sell to the public.

My gosh, when you go down to Miami today, as I understand from some people who have just returned from there, the display of wealth to be seen is astonishing. I am not just talking about wealthy people either. Some people who go down to Florida for the winter tell me that the display of wealth down there is just unbelievable. I think I would be willing to take a little of that for security.

QUESTION: Your remark just now brings me back to a previous remark about the courage of a Congressman with respect to raising taxes. I think that he pre-empted the 64-dollar question and this might be the 32-dollar question. You have testified certainly many times before congressional committees. Are you in a position to let us in on the state of mind of Congress with respect to raising taxes?

MR. McCABE: Well, I haven't talked to the leaders recently. I will let you in on one thing, however. When they were considering the latest tax bill, I went over and called out of the committee one of the chairmen and pleaded with him with everything I had, for them to make that tax bill at least 10 billion or possibly 15 billion, instead of the 4 or 5 billion that they came out with. I gave him all the reasons that I have given to you today. He told me quite frankly that he agreed with me completely, but that there wasn't a chance of getting the majority of the committee to go above the amount that they came out with.

I believe Congress today is more conscious of this fact than ever before. You remember, Senator Taft expressed himself pretty forcibly the other day on it. I think if you asked on the Democratic side also,

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you would have just as much support as Senator Taft expressed the other day. I think we have to put a lot of pressure on those men to let them know that the people back home will support them. They are going to do what the people back home want.

COMMENT: They seem to have pretty good pipelines in general.

MR. McCABE: Yes. But the pressure is not strong enough yet on the part of the people.

Now, in the hearings on the excess-profits tax bill the heads of some of the big corporations told me that they were perfectly willing to have the total amount of their tax increased, that they didn't object to straight taxes, but they didn't like the excess-profits tax. I think you would find that American business is ready and willing to take its share of any increase that was put on it. I think it would be one of the first groups to accept it. But there has to be a lot of pressure from back home put on Congress to make them realize it.

COLONEL HARDENBERGH: Mr. McCabe, on behalf of the Commandant, the staff and faculty, and the student body, I thank you for a most informative lecture and discussion period.

(12 Feb 1951--650)S.