MONEY AND PUBLIC FINANCE

12 September 1951

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GENERAL HOLMAN: There was a time in the history of warfare when a war chest, well filled with gold or other valuables, was a principal form of economic preparedness for war. Today the role of hard money, of cash in hand, is not quite the answer to war finance. Nevertheless, public finance, backed up by sound fiscal policies and careful planning, is a very vital factor in economic mobilization.

This morning we are fortunate in having as our speaker on this important phase of the economics of war, Professor Lester V. Chandler, of Princeton University. He will address us on "Money and Public Finance." He brings to us a broad background of experience as an economist, a writer, as a wartime government administrator in the fiscal field, and as an educator.

It is indeed a privilege and a pleasure to introduce Dr. Chandler and to extend to him a hearty welcome to the Industrial College.

DR. CHANDLER: Gentlemen, one of the greatest threats to a nation's unity and strength, and even to its international security, is economic instability, involving widespread deflation and unemployment on the one hand or serious inflation on the other. The great world-wide depression of the 1930's amply demonstrated the dangers of serious unemployment and deflation. Social and political stability were impossible when millions were unable to get work and were losing their homes, farms, and businesses. Puzzled, frustrated, and angry, these people of many countries lost faith in their political and economic systems and were ready to follow any movement that promised greater economic security. The depression prepared the fields for the seeds of totalitarian movements.

Inflation is no less real as a threat to our unity and strength. As the cost of living rises and people see the purchasing power of their money disappear, a host of disturbing forces are unloosed. Those whose money income and wealth are relatively fixed in terms of money find their purchasing power evaporating. The aged discover that their pensions, annuities, and savings are inadequate. Government employees, teachers, ministers, and many others find themselves slipping down the economic scale. Endowed hospitals, schools, and churches can no longer maintain their former positions. Labor contracts are reopened more frequently and every controversy leaves a legacy of discord. People may lose their incentive to save and attention is diverted away from production and toward speculation. It is highly doubtful that a nation can long maintain its unity and its political, economic, and military strength under conditions such as these. A fair degree of economic stability, avoiding both serious deflation and unemployment on the one hand and serious inflation on the other, is necessary if we are to be a strong and unified nation.

It is in this context that I wish to discuss money and public finance. Monetary and fiscal policies are inevitably and inescapably major determinants of the behavior of the economy. Inappropriate monetary and fiscal policies can promote and aggravate economic fluctuations, whereas appropriate monetary and fiscal policies can be powerful stabilizing forces. I should like, during the remainder of my time, to discuss the relationship of monetary and fiscal policy to inflation. I shall omit a discussion of deflation and unemployment, not because I consider it unimportant, but because of lack of time and because it is inflation that is usually the great threat during periods of war and rapid mobilization.

Our experience during World War II will serve as an excellent case study of the relationship between fiscal and monetary policy on the one hand and inflation on the other. In broad outline, the inflation during the war and postwar periods was brought on by a combination of a large rise of government expenditures, inadequate taxation, and a huge borrowing program, together with a very liberal monetary policy.

You will remember that before we began our rearmament program in 1940, the Nation was still in the throes of depression. Millions were unemployed and industry was running in low gear, solely because of an inadequate demand for its products. There can be no doubt that the dynamic factor breaking the depression deadlock and leading first to recovery and then to suppressed and open inflation was the rise of government expenditures. In early 1940 Federal expenditures were running at an annual rate of about 8 billion dollars; at the peak of the war effort in early 1945 they had reached a rate of about 100 billion. This twelvefold increase raised government expenditures to a level higher than total public and private expenditures for output during any year between 1929 and 1940. Federal expenditures during the six years following June 1940 totaled more than 383 billion dollars; they were two and a half times as great as all Federal expenditures during the preceding century and a half. A future full-scale war would probably require an even higher rate of expenditures, not only in absolute amount, but also in relation to the value of national output.

In order to see how this rise of expenditures brought on inflation, it will be useful to look at them from three points of view.

1. As the Government's money demand for output.--Almost the entire increase represented an increase of the Government's demand for goods and services. A part of the increase was, of course, used to pay for the services of military personnel; but a larger part was used to demand output from private industry. As government demands rose,

business enterprises at first responded largely by increasing real output and employment, but as bottlenecks in production began to appear, the pressure for price increases became stronger and stronger.

2. As the market value of output taken for government use.--By the time the war effort had reached its peak, the Government was taking nearly 45 percent of our total output; this meant that only 55 percent was left for civilian purposes.

3. As the Government's contribution to private money incomes.--All of the Government's expenditures were received as money income by the private sectors of the economy. Thus, the Government's contribution to private money incomes rose from about 8 billion dollars a year in 1939 to about 100 billion dollars in 1944.

In short, the rise of government expenditures during the 1940-1945 period, as in any other period of war and rapid mobilization, tended to induce inflation by adding directly to the effective demand for output and by reducing the proportion of total output available for civilian purchase at the very time that the rise of expenditures was contributing increasing amounts to private money incomes and spending power. This would inevitably lead to inflation unless measures were taken to reduce private spending power to the required extent.

The best way to do this is to increase tax collections. The effect of taxation, in fact the prime purpose of taxation, is to reduce the amount of money income left in the hands of individuals and business, and thereby to reduce private spending power in order to offset the inflationary effects of government spending. However, as shown in table 1, taxation was highly inadequate. The four tables were taken from "World World War II statistics relevant to the inflationary process."

Table 1. Federal expenditures, income, and deficits

(In millions of dollars)

Fiscal year ending June 30	Cash expenditures	Cash income	Cash deficit
1941	$14,060	$ 9,371	$ 4,689
1942	34,585	15,291	19,294
1943	78,979	25,245	53,735
1944	94,079	47,984	46,095
1945	95,986	51,051	44,945
1946	65,683	47,784	17,899
Total	$383,372	$196,716	$186,656

Tax collections were much increased, partly by raising tax rates and partly because of the rise of money incomes; but they were far below government expenditures. For the six years following 1940 the total deficit amounted to nearly 187 billion dollars, and the annual deficit for the fiscal years 1943-1945 averaged more than 45 billion dollars. These deficits measured the net contribution of the Government to private money incomes after taxes—the amounts contributed to private money incomes by government expenditures in excess of the amounts extracted from these money incomes by tax collections. Thus war finance was a great pump-priming operation, injecting large net amounts into private money incomes at the very time that the rise of military requirements held down the amounts of goods and services that could be made available for private purchase.

Up to this point we have talked only about the direct inflationary effects of the rise of government expenditures and the inadequate tax policy. But war and mobilization, as well as deficit financing, also tend to produce, in at least two different ways, an inflationary expansion of private spendings. In the first place it creates the expectation of boom, inflation, and scarcities, and leads individuals and business firms to hasten to buy in order to get in ahead of scarcities, price increases, and hoarders. In this respect conditions were unfavorable to inflation at the outbreak of World War II. For one thing, our people were not at that time fearful of inflation. We had not had an inflation for 20 years, and for a decade people had been engulfed by deflation. It was hard to visualize a real inflation. Moreover, as a result of the long depression, our people and business did not hold large amounts of money and liquid assets with which to buy. In another war period we might not be so fortunate in these respects. For example, if we should go into a war in the near future, people would remember vividly the decreased purchasing power of their dollars during the past 10 years, and they already have huge amounts of money and liquid assets with which to buy.

In the second place, the type of war finance that we have described tends to increase private spendings by increasing the amount of money income left in their hands after they had paid their taxes. This was certainly true during World War II. As their net incomes after taxes rose, both individuals and business firms tried to spend them for goods and services, and we escaped a galloping inflation during the war period itself only by imposing a comprehensive harness of direct controls. Business tried to spend increasing amounts for inventory and equipment and was held in check only by price controls and by various orders limiting the availability of manpower and supplies for these purposes. Consumers tried to spend more and were held in check only by wage and price controls, rationing, and the shortage of consumer goods. Thus throughout the war period price inflation was largely suppressed by a comprehensive system of wage and price ceilings, but there was always heavy pressure on the ceilings and at times they threatened to give way under the strain imposed by excess spending power.

Table 2. Private savings

(In millions of dollars)

Calendar year	Personal saving	Corporate net saving	Other private saving	Total
1940	$ 3,691	$2,398	$ 9,916	$16,005
1941	9,760	4,921	8,270	22,951
1942	25,579	5,136	11,114	41,829
1943	30,197	6,153	11,031	47,381
1944	35,407	6,128	15,442	56,977
1945	27,981	3,803	16,750	48,534
Total for six years	$132,615	$28,539	$72,523	$233,677

The above table shows the tremendous increase of private savings generated by the deficit spending policy during World War II. People and business firms were prevented by price ceilings and scarcities from spending all the increased money incomes that they were receiving and were virtually forced to save the remainder. Despite excess-profits taxes and higher income tax rates, business firms were enabled to save abnormally large amounts. Consumers, with great increases in their money incomes and unable to spend all the increase because of price ceilings and scarcities of consumer goods, also saved abnormally large parts of their incomes. It is estimated that during the six years following mid-1940 personal savings amounted to the huge sum of 133 billion dollars and that total private savings amounted to nearly 234 billion. Thus at the end of the war the private sectors were far richer in terms of money than they had been at the outbreak of the war.

Two facts concerning this huge wartime accumulation of savings are worth emphasis. The first is that the ability to save such large amounts of money was due almost entirely to the deficit financing policy, as the Government paid out such huge amounts in excess of its tax collections. If tax collections had been as great as government expenditures, people would not have been able to save so much. The second fact is that much of this saving did not represent the voluntary choice of savers, but was forced by the combination of price ceilings and scarcities of civilian goods. There seems little doubt that people would have spent much more for consumption in the absence of price ceilings, and that we would have had much more inflation during the war period itself. Moreover, since many of these wartime savings were "forced," there was at least a presumption that people would try to spend some of them when compulsions were removed.

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Let us now look at the methods used to finance the huge government deficits during the war period.

Table 3. Government deficits and government borrowings

(In millions of dollars)

Fiscal year ending June 30	Federal net cash borrowing	Net increase in debt held by		
		Nonbank holders	Commercial banks	Federal Reserve banks
1941	$ 5,431	$ 2,143	$ 3,600	$ -282
1942	19,652	12,869	6,300	461
1943	60,250	28,498	26,200	4,557
1944	56,757	32,913	16,200	7,699
1945	49,474	27,173	15,800	6,891
1946	7,439	5,431	200	1,991
Total for period	$199,003*	$109,027	$68,300	$21,317

*Includes $12b borrowed to increase Treasury's general fund balance.

Total borrowing during the six years following June 1940 amounted to 199 billion dollars, of which the sum of 187 billion dollars was required to cover the deficit. In other words that part of government expenditures not covered by tax collections had to be covered by issuing valuable securities to the public.

Many economists advised the Treasury to cover all or most of its borrowing needs through compulsory loans. Two principal advantages were claimed for such a policy. The first was that compulsory lending in accordance with a formula based on income and the number of people in a family would distribute more equitably any sacrifice involved in lending to the Government.

The other was that if people were compelled to lend, the Government could make the securities less liquid and could regulate their cashing. In the end, however, the Treasury relied almost exclusively upon a voluntary lending program; people retained the option of lending or not lending, subject only to social pressures. A special attempt was made to borrow from nonbank lenders so as to minimize the increase of the money supply, and nonbank buyers did increase their holdings by 109 billion dollars.

But the reliance on voluntary lending had at least two important consequences. One was that in order to sell the securities, they were made almost completely liquid. Billions of them were made cashable on demand at the Treasury, and as a matter of policy all were made redeemable on demand at the Federal Reserve. People could cash their bonds and spend the money without any penalty except the loss of interest. Another consequence was that sales to nonbank buyers were highly inadequate, so that nearly 90 billion dollars worth of securities had to be sold to the commercial and Federal Reserve banks.

The commercial banks increased their holdings by more than 68 billion dollars, paying for them largely by creating new money in the form of checking accounts. When the Treasury spent this new money, it swelled the money holdings of the public. The Federal Reserve added more than 21 billion dollars to its holdings, thereby creating new money and adding to the reserves of the banking system. In fact, the Federal Reserve passively adapted its policies to the needs of the Treasury, standing ready to create or to enable the commercial banks to create, all the money that the Treasury needed beyond its tax collections and its borrowings from nonbank sources. It was largely through this process that the public's holdings of currency and checking deposits nearly tripled between the end of 1939 and the end of 1945, rising from 36 billion to 102 billion dollars.

Table 4 shows the great increase in the public's holdings of liquid assets during the war period.

Table 4. Private holdings of liquid assets

(In billions of dollars)

	End of 1939	End of 1945	Increase, 1939-1945	Holdings at end of 1945 as a % of holdings at end of 1939
Currency	$ 5.8	$25.5	$19.7	440
Demand deposits	20.9	60.2	39.3	288
Time deposits	26.3	47.7	21.4	181
Savings and loan shares	4.0	7.2	3.2	180
U. S. Government securities	12.0	86.9	74.9	724
Total	$69.0	$227.5	$158.5	330

The huge amount of deficit spending permitted the public to save abnormally large amounts, and the Treasury's borrowing policy was such as to permit these savings to be held in highly liquid forms, cashable on demand and without penalty. Some of them were in the form of highly liquid governments; the remainder were largely in the form of currency and bank deposits. The dangers inherent in such abnormally large accumulations of savings spendable at the option of their holders should be evident.

The upsurge of inflation after the end of World War II is largely explainable in terms of the processes that have just been outlined, though the inflation was accentuated by accumulated shortages and postwar monetary policy. At the end of the war our people had accumulated huge amounts of savings, most of them in highly liquid form, and inflation was being suppressed only by price and wage controls. The Nation therefore faced a difficult decision. It could continue to try to suppress the inflation by continuing price and wage ceilings, or it could remove these direct controls and risk an open price-wage spiral. You know the course that was followed. Price and wage controls were first weakened and then relaxed, and soon after June 1946 these were completely abolished. After that prices rose rapidly, so that by the autumn of 1948 the cost of living was about 75 percent higher than in 1939 and wholesale prices had doubled.

Now we come to a crucial question: What financial lessons should we have learned from World War II and other similar experiences? Perhaps the clearest lesson is that large government deficits after full employment and capacity levels of output have been approached are bound to create inflationary pressures. Rising government expenditures increase the demand for output and add to private money incomes at the very time that increasing amounts of production are being diverted away from civilians and toward government use.

Inflationary pressures are inevitable if measures are not taken to reduce private money incomes and spending power. For this purpose there is no substitute for adequate taxation. Only by adequate taxation can we both reduce the private capacity to exert current inflationary pressures and hold down the ability to accumulate abnormally large amounts of savings which will sooner or later become dangerous. Not even a program of promoting private savings during a mobilization period can guard against inflation both currently and during later periods. Moreover, direct controls over prices and wages cannot be a substitute for adequate taxation. Even if they are highly successful in achieving price stabilization during the mobilization period, they force people to accumulate abnormally large amounts of savings and these are likely to cause trouble later.

In fact we would be wise to recognize that direct price and wage controls might not work as well in a future war period characterized by large government deficits as they did during World War II. As already stated, many conditions during World War II were favorable to a successful functioning of direct controls during the war period itself. National unity and morale were high after Pearl Harbor, and it was considered highly unethical to deal in black markets. At the beginning of the war people had relatively small holdings of money and other liquid assets. There was not a general fear that money would lose much of its purchasing power. In fact, remembering the prolonged depression of the 1930's, many expected that prices would actually fall after the war. Also important was the expectation that the war would be short and would be followed by a period in which plentiful supplies of civilian goods would be available for purchase. With these prospects, most people were not too reluctant to save unusually large amounts for use in the postwar period.

There is, however, a real danger that future wars or periods of high mobilization will not be accompanied by conditions so favorable to the successful use of direct controls. The dangers may be especially great if the period of large military requirements promises to be indefinitely prolonged and if national morale is not high. After 10 years of inflation, confidence in the purchasing power of the dollar is not so secure as it was in 1939. Moreover, people already hold very large amounts of money and other liquid savings with which to make their demands effective. If under these conditions we were again to embark upon large and prolonged deficit spendings, thereby adding still further to private money incomes, it is not at all certain that price and wage ceilings would long remain effective. Black markets could well become the rule rather than the exception. And even if price and wage ceilings could be successfully enforced during the period of high mobilization, so much suppressed inflationary pressure might be generated that it would be dangerous to relax the direct controls. We would then be faced with the unpleasant alternatives of taking off the direct controls and risking open inflation or of continuing the whole harness of direct controls for an indefinite period.

I do not mean to imply that direct controls are useless and should not be employed. My point is rather that direct controls cannot be an adequate substitute for adequate taxation as a means of preventing inflation; that direct controls are likely to work better if accompanied by adequate taxation; and that an inadequate tax policy, which permits undue increases of private spending power, may sooner or later lead to a breakdown of price and wage controls.

This prescription of adequate taxation as a method of preventing and controlling inflation runs head on into the argument that tax rates high enough to balance the budget at very high levels of government expenditures will damage production incentives. It is argued that if tax rates are so high as to take away a large part of each additional dollar earned, laborers will not work sufficiently long and hard, and that business firms will lack incentives to operate efficiently. Some conclude from this that it is better to risk suppressed and even open inflation than to tax heavily enough to prevent inflation; that, even if additional civilian goods cannot be made available currently, it is wise to allow people to accumulate large amounts of savings for future use as a reward for their efforts.

No one can deny the importance of this argument. Incentives are important; and at some stage the further increase of tax rates may have an intolerably damaging effect on incentives to work and to operate efficiently. In my opinion the incentive aspect is so important that it may not be feasible to collect enough taxes to cover all government expenditures when the Nation is engaged in an all-out war and the Government is taking upward of 50 percent of our entire national output. Rather than raise tax rates to the level that would be required to cover such a high level of expenditures, it may be wise to risk some degree of inflation. This is a personal judgment, with which some economists would disagree.

But having admitted that the effects of taxation on incentives should be considered, I want to sound some warnings concerning the use of this argument. It has been terribly abused and employed indiscriminately to defeat almost every type of tax proposal to which any group is opposed. I believe that we have never yet reached a level of taxation which would seriously impair production incentives if the tax laws were properly framed with this consideration in mind. This applies to both World War II and the present situation. I believe that tax collections could have been much larger during World War II without serious damage to incentives. I see no excuse for failing to cover all government expenditures by taxation under present circumstances.

What is needed in this area is a much more rational approach to the problem. We need to find out precisely what are the incentives that are allegedly damaged by taxation, discard the arguments that turn out to be spurious, and then tailor our tax laws in such a way as to protect those incentives which really are endangered. For example, it is frequently alleged that laborers will not work overtime if the extra pay is subject to higher regular income tax rates. If this is found to be true--and I am by no means convinced that it is--we might protect this incentive by segregating overtime pay and taxing it at special rates.

We should also recognize that large and prolonged deficit financing, which is the alternative to adequate taxation, may also have its deleterious effects on incentives. People may be willing to work hard and efficiently in order to accumulate savings for use only after the emergency period is over if their total accumulations are still rather small, if they expect the emergency period to end within a short time, and if they expect their accumulated money to continue to maintain most of its purchasing power.

There can come a time, however, when people are no longer willing to work in order to accumulate money which can be used only later and when accumulated savings act as a drag on the willingness to work. This stage had been reached in many European countries at the end of World War II. Owing to the combination of large deficit spendings by their governments, price ceilings, rationing, and scarcities of civilian goods, these people had accumulated very large amounts of money savings. Moreover, they could not foresee the time when they would be able to convert their money into goods, and they feared that in the meantime their money would lose its purchasing power. Under these conditions they lacked incentive to work in order to add still further to their money balances. We must face the possibility that large and prolonged deficit spendings in this country could lead to similar results.

In short, the incentive consideration in fiscal policy is not only legitimate but very important, but it should be considered rationally and not used irresponsibly and indiscriminately to prevent the enactment of taxes. We should remember that suppressed and open inflation are also types of taxation, and that they also have their damaging effects.

Up to this point I have discussed the role of fiscal policy in inflation, and the use of taxation as a device for curbing private spendable incomes and checking inflationary pressures. I should now like to turn our attention to monetary policy.

War and postwar inflations are usually financed, at least in part, by large expansions of the money supply in the form of currency and checking deposits. Aided and abetted by an easy money policy on the part of the central bank, the banking system creates large amounts of new money, which are injected into the spending stream to swell the rate of expenditures and accentuate inflationary pressures. This creation and injection of new money occurs through two principal channels. The first is through bank lending to the Government to cover at least a part of its deficits. In effect the banking system buys government securities from the Treasury and creates new deposit accounts for it. The Treasury then spends the money and it comes into the hands of the public to increase its spending power.

The best way to avoid this process of creating and injecting new money into the spending stream is to collect adequate amounts of taxes so as to avoid or at least diminish the need for government borrowing. And if the Government must borrow, every effort should be made to borrow from nonbank sources so as to avoid the creation of new money. It is not at all clear that for this purpose we can safely rely on voluntary lending during a future period of high mobilization or all-out war. The use of some form of compulsory lending to cover all or most of the Government's borrowing needs deserves the most serious consideration.

The second process of creating and injecting new money into the spending stream is through an expansion of bank credit for private use. Inflationary periods are usually characterized by a large private demand for credit. Business firms foresee favorable profits and rising prices and want to borrow large amounts to purchase inventories and add to their plant and equipment. The construction industry likewise demands large amounts of credit to swell spendings for labor and building materials. Consumers add their demand for credit to get in ahead of price increases and scarcities.

If the banking system is permitted to expand its credit and create large amounts of new money for these private purposes, inflationary pressures will be accentuated. The inflationary effects of rising government expenditures will be augmented by private borrowing and buying. Private deficit spending can be just as inflationary as government deficit spending. An adequate inflation control program needs to include an effective limitation of the money supply. To permit the supply of money to expand in response to the demand for it is to add fuel to the inflationary fire.

Since World War II we have not followed policies that would enable us to place restrictions on the money-creating activities of the banking system; and this was never more evident than last year, when a considerable part of the inflation was financed by an expansion of bank credit. This inability to place effective limitations on the money supply is due largely to the types of debt-management policies that have been followed by the Treasury and the Federal Reserve.

You will remember that at the end of World War II, owing to the large wartime deficits, the Federal debt had risen to more than 250 billion dollars. These securities were widely held by individuals, business corporations, and all types of financial institutions. Moreover, every type of holder was perfectly free to sell or redeem these securities at whatever time and in whatever amounts he wished and then to spend the money for any legal purpose. The Treasury, and many others, did not want to see interest rates rise or government securities prices fall below their par value. They thought that a rise of interest charges on the national debt was undesirable and that a decline of government security prices would have adverse effects on the Treasury's borrowing operations and on the capital position of the security holders. They therefore prevailed upon the Federal Reserve to stand ready to buy at practically fixed prices, which were usually at or above par, all the securities that were offered to it. Thus the prices of government securities could not fall below the levels at which the Federal Reserve stood ready to buy all that were offered to it.

The effect of this debt-management policy has been to deprive the Federal Reserve of its power to place an effective limitation on the money supply. In its role of passive buyer, the Federal Reserve had to buy and in return create new money and new bank reserves and new lending power for the banking system and others. A business firm holding government securities could sell them without penalty; and, if no other purchaser would take them at prices at or above those maintained by the Federal Reserve, the Federal Reserve would have to buy them and issue new money and bank reserves in payment. The same was true of other holders. Individuals, banks, insurance companies, savings and loan associations, and others could without penalty unload their government securities on the Federal Reserve and then spend or lend the newly created money as they saw fit and without regard to inflationary consequences. And every dollar's worth of purchases by the Federal Reserve added a dollar to the reserves of the commercial banks, who were thereby enabled to increase their loans and investments by a multiple amount. Thus the policy of stabilizing the prices and yields of government securities, while their holders retained the freedom to sell them at will, has had the effect of depriving the Federal Reserve of its power to restrict the volume of money available for private spending and to make the money supply passively responsive to the demand for it. To follow such a policy in the midst of a very high demand for credit cannot fail to be inflationary.

In recent months the Federal Reserve has retreated somewhat from this type of passive easy money policy, permitting some rise of interest rates and permitting government security prices to fall somewhat, thereby penalizing those who try to cash their government securities. It is not at all clear, however, that the passive easy money policy has been more than temporarily abandoned. One of the major problems that we face in the financial area is that of developing debt-management policies that will permit the monetary authorities to re-establish their power to restrict the creation of money during periods of inflation. We cannot afford to permit an uncontrolled monetization of the huge government debt during inflationary periods.

I have so far dealt only with the relationship of fiscal and monetary policies to the inflationary process. I would like to add a few words concerning the relationship of these policies to the process of mobilizing our economic resources for defense or war purposes—the process of diverting labor, facilities, and materials away from civilian types of output and toward the purposes considered essential for national security.

I think there can be no doubt that inadequate taxation and the availability of large amounts of cheap credit for nondefense as well as defense purposes tend to create reluctance to convert to defense production and to slow down the process of economic mobilization. If individuals and business firms can borrow easily and cheaply, and if tax policy is such as to leave them with large excess incomes, their demand for civilian goods is likely to be very high. In the face of such lush markets for civilian goods, many business firms are likely to be reluctant to hold down or curtail their civilian output and to take on defense orders. Or, if they take defense orders, they may promote them with less vigor than they do their civilian work.

It is, of course, possible to use direct controls to limit the amount of labor and materials used for civilian purposes and even to order firms to devote at least certain portions of their capacity to defense work. I think, however, that most of you who have had procurement experience will agree that these direct methods alone leave much to be desired. Better defense production results are likely to be achieved if competing civilian demands are held down; and the best way to do this is through taxation and limitation of the availability of money for private spending. I do not mean to imply that taxation and credit restriction can alone accomplish the task of diverting sufficient amounts of production away from civilian and toward defense purposes; direct controls over materials, facilities, and manpower are likely to have their function, especially during rapid mobilization. My point is rather that direct controls will have to be relied upon to a lesser extent, and those that are employed will work better, if tax and credit policies are restrictive enough to hold private spending power in line with the amounts of goods that can be made available for private purchases.

I have not had time to do more than touch upon some of the important issues in the realm of fiscal and monetary policies. I shall conclude by reiterating my opening statement that our ability to maintain our national unity and strength will depend to no small extent on our avoidance of intolerable degrees of economic instability.

We have good reason to hope that we have developed both the will and the means to prevent depressions of the type that plagued us during the 1930 decade. There seems to be less reason for optimism regarding our will to prevent both suppressed and open inflation. We do not know how large or how prolonged our defense program will be. While hoping for a happier outcome, it would be foolish not to be prepared for a large and prolonged effort, keeping always in mind the danger of full war.

Large and prolonged deficit spending by the Government, and a continued easy money policy, could lead to disastrous results. They could build up inflationary pressures to a point where we would place the entire economy in a harness of direct controls, and it is doubtful how long these controls would remain effective in the face of strong inflationary pressures and in the midst of the types of attitudes that are likely to prevail in periods short of all-out fighting war. Adequate taxation and restrictive monetary policies can do much to prevent the creation of inflationary pressures, minimize the extent to which direct controls are employed, increase the effectiveness of the direct controls that remain necessary, perhaps shorten the period during which controls will be needed, and hasten the return to a basically free economy without the danger of serious inflation.

QUESTION: You mentioned the question of credit as having an inflationary effect. As I gathered it, the members of the Federal Reserve System are required to maintain a certain balance with the Federal Reserve in relation to the amount of loans that they extend. Would you care to comment on the degree to which that balance contributes to inflation?

DR. CHANDLER: Member banks, those banks that are members of the Federal Reserve, have to maintain with the Federal Reserve balances equal to at least a certain percentage of their deposits. It is a very complicated arrangement but it averages around 20 percent at the present time.

The Banking Act provides that the percentage cannot be fixed below a level that averages out to 10 percent of deposits nor above a level which averages out above 20 percent of the deposits. Within the limits of 10 and 20 percent the Board of Governors of the Federal Reserve can increase or decrease the reserve requirements of member banks. At the present time they are almost at the upper limit, and the Federal Reserve has very little power left under the existing legislation.

On several occasions the Federal Reserve has asked for the power to raise those requirements to still higher levels. It got a slight increase in those powers of the Board for 10 months--from about August of 1948 to June of 1949. But that law lapsed and it now has no residual power to raise these requirements. Whether or not new legislation will be proposed I don't know. I know it is being discussed.

I should also mention that there is under discussion a large number of reserve requirements of a different nature, which might be in the form of government securities, that would force the banks to hold government securities equal to at least a certain percentage of their deposits and would thereby prevent them from selling those government securities, which the Federal Reserve would have to buy and create additional reserves.

My own guess is that the situation will have to be somewhat desperate before Congress would yield to that and for two main reasons: First, of course, the banks don't like higher reserve requirements--and they are not without political power. Second, the nonmember banks, which number almost 50 percent of all banks although they hold only about 15 percent of total deposits, do not have such high reserve requirements; and if the reserve requirements of the member banks were raised, it would increase still more the discrimination against member banks and in favor of the nonmember banks. The Federal Reserve, therefore, is asking for legislation which would enable it to increase the reserve requirements of the nonmember banks as well as the member banks. But that again raises a whole host of problems, such as States' rights.

QUESTION: In view of the size of the national debt, isn't it virtually necessary for the Government to pursue an inflationary policy? Otherwise there is practically no hope of ever paying it back or even carrying the interest.

DR. CHANDLER: I would like to comment on that. I do not believe it is either likely or desirable that all this debt will be retired. In order to pay off the debt, it would be necessary to have a surplus of tax revenue over government expenditures.

If you wanted to retire the debt over some short period of time, it would mean the collection of taxes of something like 200 billion dollars in excess of government expenditures. To me it seems highly unlikely that we shall have an economic situation strong enough so that within any short period of time we could collect that quantity of taxes in excess of government expenditures without bringing about a serious decline in the demand for the output of industry. It is therefore rather unreal to think of retiring the national debt.

Now, if we assume that we do leave the debt outstanding, the burden of carrying the national debt is in effect the burden of levying taxes to cover the interest on the debt. That interest is now running in the general neighborhood of five and a half billion dollars a year. Possibly it may go up to six if we get a significant rise in the interest rate. So let us say six billion a year.

The annual value of the gross national output, the gross national income, is running at somewhere around 325 billion dollars a year, as you probably know. So that the charge on the debt would be 6 billion out of 325 billion, which is not very large.

I would say that the ability to service the debt would depend on, (a) preventing a serious decline in the price level, which would raise the purchasing power of the dollar and (b) preventing widespread unemployment, which would lower the national income.

But I don't see that the carrying of the national debt necessitates continuous inflation. There are some people who believe that inflation is perhaps a fairly good method of decreasing the burden of the debt, in effect taking away from the people money which they should not have earned in the first place. This is the cruelest kind of taxation we can possibly get.

In the first place, it hits those savings which were accumulated in a noninflationary period, as well as those accumulated in inflationary periods. John Smith, who accumulated some dollars in 1936-1939, is hit by inflation just as truly as the fellow who profiteered or otherwise made an undue income during the war.

In the second place, such taxation doesn't hit those who don't hold fixed dollar savings. For example, a war profiteer in the war period could escape this kind of taxation completely by putting his money into real estate possibly in common stock instead of bonds.

QUESTION: The Government is almost obligated to prevent a major deflation, isn't it, when the size of the carrying charges amounts to some substantial share of the national output?

DR. CHANDLER: I would go further than that. I would say that the Government is obligated to prevent a major deflation for a reason that is much more important. That is, you can't have a major decline of prices without widespread unemployment, and I don't think that the temper of the people of this country, or of any other country, is such that they would take widespread unemployment without demanding widespread changes in the existing social and economic system.

QUESTION: Why was such limited use made of a general sales tax in the last war, and what are the prospects of using such a tax in the future?

DR. CHANDLER: The primary objection, of course, to a general sales tax is that it is so regressive in its impact on the various members of the community. In effect it is a tax on spending without any personal exemptions. It is based on the absolute amount of spending, with no regard to the number of people in the family or factors relating to ability to pay. And for that reason it is very much opposed by all those people who don't want to have a large part of the tax burden fall only on the low income groups.

I would guess that the prospects of having a general sales tax in another war are not much brighter than they were during World War II, and that the same economic and political objections would be raised again.

There is, of course, the question of whether you should raise revenue through a sales tax or whether you should do it through personal income taxes with exemptions. One might possibly do away with exemptions completely and say that all income received would be taxed at graduated rates.

I think myself that the economists perhaps did not do the Nation a service in emphasizing the regressive effects of a sales tax if the alternative is inflation. If that is the real alternative, then perhaps a sales tax would do less damage than inflation. But economists tended to assume that we were going to have more taxation and that the real choice was between a sales tax and other type of taxes.

COLONEL BARNES: Will you explain to the class in general what is meant by "constant dollar value"? type of Bond?

DR. CHANDLER: The basic idea is to put out bonds that would have a par value, but with an escalator clause depending on the cost of living. If, for example, the cost of living index went up to 225, a $100 bond would have a face value of $225. The purpose would be to assure people that the money they put into these bonds would retain its purchasing power, because they would get enough extra dollars back to balance any increase in the cost of living.

There is little doubt that such a device would somewhat increase people's willingness to save and buy these bonds.

They have in them, however the inherent danger that they might become highly inflationary. If the people who held those things did in fact cash them in as the inflation proceeded, they would get back progressively larger amounts of money to spend. So the escalator clause in the bonds could be a way of escalating the spending power of people who cashed the bonds, thereby aggravating inflation.

One way out would be to place severe restrictions on people's ability to cash them. However, that would automatically cut down their willingness to buy bonds, and so we might be back in the same difficult position again.

QUESTION: By restricting the capacity to cash the bonds and setting up certain levels of securities that the banks will have to hold, aren't we then actually endangering the proposition that you put forth--that we don't have to pay off the national debt; that we are just borrowing from ourselves, so what is the difference? We can go on borrowing forever. Actually then you are just borrowing from a certain few, who fail to invest in bonds and stocks. Is there a real danger of that sort of thinking--that we are borrowing from ourselves and that we can go on forever and we don't have to pay off the debt?

DR. CHANDLER: I would like to make two comments. One is that, of course, commercial bonds and public utility and corporation bonds are no more impervious to inflation than are government bonds. Of course, they can be more so. Anything that is fixed in terms of money is just as bad off as government bonds are.

However, I don't want to leave the impression that because we borrow from ourselves and owe ourselves the debt, the creation of debt is not dangerous. It is extremely dangerous. The principal danger lies in the process of creating the debt, which involves deficit spending. I don't think any of us want that in an inflationary period.

QUESTION: It seems to me from reading the papers that we are in an inflationary spiral now and nothing, according to what I read, seems to be checking it. Would you care to comment on whether it is going to be left that way or not?

DR. CHANDLER: For about six months now we have had a definite lull in inflation. The cost of living index, taking the average, is slightly lower than it was at its peak in January. The same is true after the wholesale price index.

This is due largely to a combination of things. One of them is the large increase of output that we have been able to accomplish since pre-Korea. Output has probably increased more than 30 billion dollars in real terms, excluding the rise of prices. This is approximately a 10 percent increase in real output.

For one reason or another the take of the services has not been as great as expected. As a result, there are now more goods and services for civilians to purchase than in the pre-Korea period. When the Korean outbreak began, there was a rush to produce as much as possible. You remember the rush of consumer demand, the retailers' rush to add to inventories. The wholesalers did the same thing. The manufacturers didn't mind increasing their inventories. They rushed to increase them as fast as possible. Even during the latter part of 1950 they were able to add significantly to their inventories, and still further additions have occurred in the early part of this year.

Another thing that has helped hold down inflation in recent months is the fact that a lot of people got themselves into an illiquid, financially embarrassed position during 1950. They rushed out and bought automobiles, washing machines, and so forth, making relatively small down payments, and obligated themselves for large monthly carrying charges. Then during the early part of this year the tax collections—which is a seasonal factor—drained off large amounts of income. So consumer demand fell somewhat.

Another factor was the freeze of prices and wages in late January. It suffered somewhat of a thaw later. But that did tend to allay fears of a runaway price and wage spiral, and cut down somewhat the intensity and the urgency of demand.

Along with that we had the imposition of Regulation W, which increased down payments and shortened periods of repayment. Those things and the Federal Reserve policy of permitting a decrease in the price of government securities, which decreased the willingness of the insurance companies and others to make loans, have tended to reduce demand.

This combination of things has produced a lull that has lasted up to the present time. We still have large inventories of several types of goods. Some people think the inventories are large enough to protect us for quite a period. I doubt the validity of this forecast.

If defense requirements should go from around 30 billion to 65 billion dollars sometime in 1952, and if the output doesn't increase more than the 10 percent that is projected for that period, serious inflationary pressures may be generated. First, there will be a decrease in the availability of goods for consumption purposes. Second, there will be further rises in consumer income unless we get a really strong tax bill out of Congress.

That is a combination that I am afraid will lead to a resumption of the inflationary process, though some of the best forecasts from people in business don't agree.

QUESTION: Apropos of your prognostication, how do you view the relaxing of the financing requirements for the construction of small houses up to $12,000, which outside Washington is quite a sizable home?

DR. CHANDLER: If they would place adequate restrictions on other types of home construction, it might not have inflationary consequences. On the other hand, decreasing the down payment and lengthening the period for repayment in general cannot fail to cause some increase in the demand for houses, which would be inflationary in the housing field and probably in other fields as well.

I would say exactly the same thing about the relaxation of Regulation W. Cutting the down payment and lengthening the period of repayment simply makes it possible to add to total demand.

Congress was probably guilty of some shortsightedness when it didn't pass the bill that was requested. It is probably true that the need for the bill was not apparent at the moment. But let us look forward a little. Suppose that another increase in consumer demand comes later this year. The Federal Reserve doesn't have any more power to increase the down payments and reduce the period for repayment as a way of holding down demand.

COLONEL BARNES: Dr. Chandler, our time has run out on us, unfortunately. On behalf of all of us I thank you for a magnificent job. You have certainly demonstrated the reputation that you have of making complicated theories easy to understand.

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