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ECONOMIC STABILIZATION AND MOBILIZATION

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Dr. Richard B. Heflebower, Chairman, Department of Economics, Northwestern University, was born in Milliken, Colorado, 4 October 1903. He was educated at the University of California, specializing in economics of money and business conditions and the government control of prices. He received a Ph. D. in 1929. Dr. Heflebower taught at the University of Idaho and the Pacific Northwest Banking School, and from 1929 to 1943 he served successively as assistant professor, associate professor, professor, Economics Department head, director and dean at the School of Business Administration, State College of Washington. In 1939 he was president of the Pacific Coast Economic Association. During World War II Dr. Heflebower was associated with the Office of Price Administration, serving as acting director of the Food Division and as economic advisor to the deputy administrator for price. From 1946 to 1949 he was a member of the Senior Staff of the Brookings Institution, Washington, D. C. Since 1949 he has been Professor and is Chairman of the Department of Economics at Northwestern University; since 1950 he has been a consultant to the Economic Stabilization Agency.

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ADMIRAL HAGUE: This morning we have the last lecture of the orientation unit and the refresher economics course that you have been pursuing. Later in the curriculum you will examine in considerable detail the problems involved in maintaining the stability of an economy when that economy is called upon more or less suddently to absorb greatly increased military purchases. It is quite appropriate, therefore, that the subject of the lecture this morning is "Economic Stabilization and Mobilization."

You will recall that when we opened the course we promised that the speakers would be recognized experts in their respective fields. In our speaker this morning, Dr. R. B. Heflebower, Chairman of the Economics Department of Northwestern University, we are making good on that boast in a big way. For something more than a quarter of a century, he has specialized in monetary economics, business conditions, and price controls. His knowledge in this field was taken advantage of by the Government during World War II, when he served as an adviser in those fields.

In the latter part of the forties, he was a member of the Senior Staff of the Brookings Institution here in Washington. Since 1950 he has been a consultant of the Economic Stabilization Agency.

So you see Dr. Heflebower speaks with the authority of intimate knowledge gained from wider study in the field, plus the understanding derived from application of that knowledge. He has addressed three previous classes of the Industrial College. It is with the certainty of knowledge of the worth of the product that we present this morning Dr. R. B. Heflebower, Chairman of the Economics Department of Northwestern University.

DR. HEFLEBOWER: Admiral Hague and gentlemen: The problem that we deal with this morning involves questions of efficiency, of justice, and of the permanence of our social institutions.

Obviously, during a period of mobilization for common defense, we must put a strong emphasis on doing the job efficiently. Much of what I shall say has to do with alternative ways of mobilizing efficiently.

But it is also true that from the point of view of doing the job efficiently and from the point of view of the operations of our social system, there must be a feeling of justice in the way in which this job is done because, inevitably, in the process of mobilization, the relative, if not the absolute, economic position of various groups and individuals is threatened and in the end will be changed somewhat. Consequently, there are problems of people's attitudes which are fundamental in accomplishing efficiency, as well as in their attitude toward how our social system works.

Finally, we do not want to sacrifice any of our fundamental social institutions in the process of mobilizing, or modify them except where it is fundamentally necessary in order to accomplish our common defense.

Now, the basic nature of the problem of economic mobilization can be seen as involving a substantial shift in the way we use our resources. It is as though we had a pie which has to be redivided. It has to be redivided in terms of the types of materials which we want to have produced, that is, raw materials; the way in which we want to use our labor; and finally, the end products which will be produced.

But it is not only that we want to realign the way we use our present resources; we want to put to work any idle resources we have and, in both cases, to use those resources as efficiently as possible.

There are many discussions of mobilization which proceed on the assumption that it is merely a problem of reallocating the way we use our resources; but it has been true, even since Korea, that to some degree we are able to mobilize more total resources and put them to work than we had before the mobilization period. Accompanying the problem of a substantial shift is a corresponding shift in who pays for the goods and how they get the money; and that is the heart of a good deal of the difficulty, as we will see later.

Then, in connection with rearranging the way we use our resources, and aggravated by the problem of who pays for them and how they get the money, there is always a tendency for prices to rise. In part this stems from the fact that it is much easier to move resources from one use to another by paying more in the new use than by paying less in the old use.

Institutionally, it is very difficult to lower prices. It is quite easy to raise them. It is also true with the process of transferring money from the private sector to the public sector, so that the Government will have the money to pay for the sharply increased desire of goods and labor it uses, that the process of transfer nearly always involves an increase in total money, and therefore there is an upward pull of money on prices which results in what we call inflation.

Related to these problems of reallocating resources and changes in who pays for goods are the expectations of business men and consumers as to the future. People act not only on the basis of recent experience and current observation but at times and to varying degrees on what they expect to happen.

The peculiar thing about the mobilization period is that it gives people unusually firm expectations; that is that they are taking relatively little risk in making certain moves. For example, a businessman who attempts to increase his inventory of raw materials is running very little risk that later he might be able to get them cheaper, because chances of prices falling are almost nil. Chances are much greater that prices will rise. But even more important from his viewpoint than the fact that prices may rise is the fact that goods may be scarce. Consumer reaction is somewhat similar. While I think in ordinary times consumers take very few precautionary moves, our experience in the Korean situation shows, particularly when they have had recent experience with shortages, how they move in to try to get coffee in the cupboard, a new automobile, or what not.

Some of the controls which become necessary are made necessary by these precautionary moves of businessmen and consumers.

Then there are very difficult problems of judging the timing of certain developments. How quickly will we want people to move labor? How quickly will there be an increase in the outflow of money from the Treasury to the business community? When should we introduce this or their kind of control? In fact I would say that the problem of mobilization controls involves to an unusual degree the question of when to do what.

Actually, that is much easier, as we shall see, in full mobilization than it is in partial mobilization. In partial mobilization we do not know quite what Joe Stalin is going to do. Therefore, we do not know how to lay our plans. In full mobilization we can expect the worst and move ahead on that basis.

The nature of the mobilization problem can be made clear if we contrast three situations which are:

1. Business recovery.

2. An all-out war or close to it.

3. The kind of situation we have had since the middle of 1950.

The following four pages shows "What happens during a business boom and during mobilization."

Essential characteristics of the problem of economic mobilization for defense or war can be seen by comparing what happens to resource use and money sources and flows during:

1. A "business recovery"--1933 to 1937 and on to 1941.

2. "All-out war" which was close to our status in 1945 as compared to 1941.

3. A suddenly imposed, partial, but indefinite degree of mobilization for defense such as we have experienced since June 1950.

In a Business Recovery

There is a change in relative resource use and output. Percentages of privately used goods and services are as follows:

	Durable goods	Nondurable goods	Services	Total
1933	13	45	42	100
1937	21	46	33	100
1941	25	45	30	100

But this does not involve less of some goods or services to get more of others, for the "more" comes from aggregate increased output as shown by the percentage change from 1933 in output of manufactured goods, agricultural products, and nonagricultural employment.

	Durable goods	Nondurable goods	Agricultural products	Total Nonagricultural employment
1933	100	100	100	100
1937	227	134	112	122
1941	372	179	115	138

A fundamental aspect of a business recovery and the change in relative importance of goods and services produced is the change in the pattern of private expenditures toward "investment"--percentages given as follows:

	Consumer expenditures	Private investment
1933	100	100
1937	145	880
1941	178	1408

The money for investment comes from:

1. Setting aside or nonconsuming of income.

2. Activation of idle funds.

3. Net increase of money.

	Demand deposits adjusted	Money in circulation
	(Billions of dollars)	
1933	17.5	5.5
1937	22.0	6.6
1941	38.0	11.2

Accompanying this were percentages of changes in output and prices of the following:

	Gross national product in constant dollars	Wholesale prices	Consumer prices
1933	100	100	100
1937	143	130	111
1941	188	150	109

In All-out War

There is a more drastic shift in resource use:

1. The share of civilian use of goods represented by durable goods drops sharply. Percentages of gross product represented by durable goods, nondurable goods, and services are as follows:

	Durable goods	Nondurable goods	Services	Total
1941	25	45	30	100
1945	14	56	30	100

2. The share of goods and services produced for and going to the Government changes sharply. Percentages of gross output going to government purchases and to private purchases are as follows:

	Government purchases	Private purchases
1941	19	81
1945	39	61

3. But even in 1945 it is estimated that consumers' goods were about one-seventh more than in 1941. This, plus enormous use of war goods, made possible by increase in gross national output as measured by dollars of constant purchasing power--percentages are as follows:

1941	100
1945	133

The Government paid for the vast increase in its purchases by spending 39.2 billion dollars more than its tax and other revenue in 1945.

1. Part of this was absorbed by private savings.

2. But the increase of 19 billion dollars of bank credit indicates the extent to which the government deficit plus private investment exceeded money set aside by individuals and business.

Prices rose, even under controls. Percentages are given as follows:

	Wholesale prices	Consumers' prices	Price index used to deflate national income
1941	100	100	100
1945	121	122	130

The Kind of Situation We Have Had Since the Middle of 1950.

A limited mobilization beginning when employment is high, and the move is sudden, but its intensity uncertain, as after June 1950, brought the following:

1. Changes in public versus private share of gross output--percentages given as follows:

	Public or government share
First half of 1950	15
Under military plans of September 1950 (40 billion dollars for defense)	24
Augmented military plans as of January (1951 60 billion dollars for defense)	31
Highest point reached second quarter (1952 with 50 billion dollars for defense)	23

2. But the Federal Government debt (in billions of dollars):

a. Did not increase immediately after the Korean operations stated.

	Gross Federal debt
June 1950	257.4
December 1950	256.7

b. But has increased since:

December 1951	259.5
July 1952	263.1

3. Private finance was active:

a. Turnover per year of bank deposits.

1949	12.4
second half of 1950	14.0
1951	14.5

b. Bank credit rose (billions of dollars).

Increase June-December 1950	7
Increase January-December 1951	10
(about horizontal since)	

4. Prices advanced--percentages as follows:

	Wholesale	Consumer
June 1950	100	100
January 1951	115	107
June 1952	115	111

You will note that during a business recovery we experience a change in the relative importance of durable goods, of nondurable goods, and of services. Generally, as during the 1933 to 1941 period, there occurs a decline in the relative importance of time and in the relative importance of services, with a sharp increase in durable goods. In a business recovery added output of some goods does not, as full mobilization does, require that less of other goods be produced. Instead, alongside the sharp increase in the output of durable goods came an absolute increase in output of nondurable goods and the services, as idle machines and idle men were put to work. At this time the expenditures for investment multiplied many, many times; that is, for housing, which is a form of investment in the sense that we do not use it up in a short period, for farm machinery, for public works, and for business plant and equipment.

During such times consumer expenditures rise also, due largely to consumers getting more money because of added employment out of the investment of savings and expanding bank credit. The money for investment comes in part from the setting aside of savings of income, in part from putting to work funds that were previously idle; but even in a period like 1933-1941, there was an expansion of bank credit by the devices which Professor Rodgers explained to you.

I think we will pass over the changes in the annual output and prices from 1933 to 1941 and turn to the case of all-out war. After 1941 there was a far more drastic shift in resources within the civilian sector. The cut in the production of durable goods for civilian use was very sharp. The big shift in who bought the goods was from private purchase to that by the Government. Whereas in 1941 government purchases represented 19 percent of gross output of the economy and in 1945 it represented 39 percent, with a corresponding reduction in the percentage going to the civilian sector.

This change did not all come about by absolutely less going to civilians and more to the military, because there was an increase in total output. As near as this can be estimated, but with some margin of error, I think there was roughly a one-third increase in output of goods not going directly into the war effort, so that consumers were able to have more than prior to the war. Our experience from 1941 to 1945 was that we had both guns and butter.

The Government, in order to pay for this sharp increase in the share of the national output which it commanded, raised taxes but not enough and it borrowed from savings but not enough. Consequently, there was an increase of 19 billion dollars in bank credit in the year 1945, which was in addition to the private savings of the economy.

Related to this absorption of private savings and expansion of bank credit was a substantial rise in prices, with the indexes probably understating what happened. This increase of prices occured, by the way, even though we had many direct controls.

There are some important differences between what we have just considered and a limited mobilization period such as we have had since June 1950. The share of the gross product of the economy spent by the Government rose to a much lower point, but it is interesting to see the changes in the mobilization plans and the rate at which they have been realized as compared with size of the problem as it looked in September 1950.

Then the expected rate of military expenditures would have raised the Government's share of national output to roughly 24 percent of the total. After the reversals in North Korea, however, when the military program was expanded here and abroad, with our paying for much of the latter, it looked as though the Government would take about 30 percent of gross national product. Actually, the Government's share has never been above 23 percent, partly because gross national product rose more than expected, and partly because the actual rate of military take has never been so high as was expected.

In the early part of the Korean incident, the Government operated on a balanced budget. That is, the Federal debt at the end of 1950 was approximately the same as it was in June 1950. It has, however, increased somewhat in the last year. Even though the Government was not pouring more money into the economy than it took out, bank credit rose. Since the Government was not increasing its debt in the latter part of 1950, we would say that the 7-billion-dollar increase in the bank credit which occurred in those six months represented private borrowing in reaction to the military situation. Consumers and business motivated by expectations of shortages and higher prices borrowed from the banks more than current savings of the people.

In summary, we have compared three situations:

1. In the first as during the business recovery, there is some rearrangement in the relative importance of goods; but, the rearrangement comes through varying rates of increase in the output of durable goods versus nondurable goods and services, and the main source of funds to pay for increased output is private.

2. On the other hand, in an all-out war, we are able to have always some increase in total output; but, we do have to carry out a major rearrangement of the claims on the national output so that more of the goods go to the Government and less to private individuals, as shown by the last time we were in a full war. The Government is not able to, or did not, pay for this entirely out of tax revenues. It borrowed substantially and in excess of private savings. The residual was borrowed from the banks, which expanded the total money supply and was a major fact behind the increases in prices.

3. During a more limited military operation, a large part of the increases in military goods can be absorbed by increased output. Much depends, of course, on the amount the military needs and, with the rather modest increases in funds required, it is much easier to pay for them by increases in taxes. How far, depends on how far people and Congress decide to meet the problem head on.

This is the general picture of the problem of mobilization under varying degrees of increase of military needs. What are the major or basic ways of rearranging the way our resources are used and rearranging who pays for how our resources are used?

Let us contrast two extremes. One extreme is to substitute almost at once, and completely, the overhead direction of the Government for the give and take of the market. In peacetime the Government, only to a small degree, decides what shall be purchased and by whom, and who shall consume it. The extreme suggested here is to suspend that market process and replace it by overhead direction of the Government. The other extreme, which has been seriously proposed by some, is not to introduce any overhead direction during a period of mobilization--even full war, but to let the Government compete in the market for goods and services. You say, "Isn't that what we did during the Civil War, and look at what happened." But those who propose this extreme, demand that drastic controls over the total money supply be introduced so when the Government taxed or borrowed to get money to spend, there would be correspondingly less money for civilians to spend.

So while the Government spending might bid up the price of things, there would be a corresponding reduction in the price of goods bought by civilians, for private buyers would have less money to spend. Obviously this would involve very heavy taxation as well as controls over bank credit and other forms of money.

Those who have looked at these problems with both understanding and the discipline which comes from responsibility--a stabilizing influence as Admiral Hague suggested--would not propose seriously that either of these extremes be followed during a period of all-out mobilization. They realize that the amount of money which would have to be transferred by taxation from the private sector to the public sector so far exceeds that which tax systems can be devised to obtain and still maintain the morale and efficiency of the civilian population, that the Government will inevitably be forced to borrow.

As a noted English economist, Mr. Robbins, said, after viewing British experience: "Those who feel that war can be financed entirely out of taxation really are thinking of little wars of the liberal age, and not our modern conflicts which involve total mobilization of the economy."

Indeed there are two basic problems in taxes heavy enough to raise the bulk of the money needed, let alone balance the budget, when we are in all-out war. The first is that, in spite of everything we can do, tax revenues are going to lag behind expenditures. It takes time to get new taxes enacted by Congress, administrative machinery set up, and collections going. Beyond that there are serious problems of motivation. Why should a housewife work when a large part of the additional income is going to be taken in the form of additional taxes on the family income. Of course we have evidence already of the effects on efficiency of highly progressive business income taxes, such as excess-profits taxes.

In more modest ventures like that we have been in recently, the second point which I made has really no value. In other words, the amount of tax that would be necessary to balance the budget would not have an important effect on motivations. At least I would say that a tax system could be devised, one that was partly indirect, which would not discourage people from working.

Therefore, in the kind of mobilization which we have experienced since the middle of 1950, there is no excuse in terms of the economics of the problem for us not being able, with some lag perhaps, to have a budget balance or even a surplus.

How far can we go with monetary controls? Those who would take the second extreme view mentioned above would say, "If the Federal Reserve System and the Treasury will adopt the proper policies, interest rates would rise sharply, probably, and only those who really wanted very much to borrow money would do so. This would discourage a large part of the private borrowing that goes on." Others would argue that interest rates are not enough of a discouragement to borrowing; therefore we would need perhaps to make the total of bank credit fixed or to allow it to increase only by a small degree, so that a large part of the private investment and the private use of funds that goes on would be discouraged.

This is based on the argument that, when we get into a mobilization period, it is not desirable to have the Government decide by direct controls and various devices what plants shall be built, what housing shall be built, and whether veterans should have credit. Such controls are disliked whether they involve deciding directly who gets the funds or whether the control is through the availability of steel for construction, for example. No, they think we should let the market allocate steel and credit within the restraining influence of restrictions on the total money supply.

I have a good deal of respect for the people who take this view. My own reaction is that they have not faced up to the difficulties involved in such a drastic use of monetary controls for preventing inflation; that when we have war, we cannot rely upon interest rates, the decisions of bankers, or the decisions of the steel market to decide whether we want to have amusement parks or factories built. Markets are designed to react more slowly and less precisely.

If the mobilization problem is less serious, say such as that since 1950, or even a lesser expansion of military operations, then the case for relying almost entirely on fiscal and monetary controls becomes very strong for then we do not face the problem of drastic reallocations in the use of our resources. In such circumstances we can say, "If the man who wants to build a race track wants to pay 12 percent interest and 250 dollars a ton for steel, let him do it." We do not think too many people are going to build race tracks under those circumstances, partly because consumers are not going to have as much money as they would have if we did not have tight money controls.

The record of our monetary policy since June 1950 has been far from bold or forsighted. In the first year there was no deficit in the Federal Treasury, but we had a substantial increase in bank credit which represented a bidding of civilians against each other and against the military for materials and manpower. A wise policy would have severely restricted expansion of bank credit during this period of limited mobilization.

Monetary policy, as is true of fiscal policy, is fundamentally part of mobilization and inflation control, in both partial and full mobilization. In full mobilization, in my judgment, they could not by quite a margin do the whole job and we have to move into direct controls. In partial mobilization, and particularly as that mobilization extends over a period, as it has and promises to in the years ahead, the indirect controls of a balanced budget or surplus, of higher interest rates and restrictions on extension of bank credit, should carry the basic burden of limiting inflation. At the time we have reached now in our mobilization these controls should carry practically all the burden of control.

Now, because you men are interested not merely in partial mobilization but also in all-out war, I am going to spend a few minutes on direct controls. In that connection I want to build up what seems to me is a rating of the emphasis we should place on controls. The basic element of effective control is the indirect control of fiscal and monetary policy. Controls on the use of materials or their consumption, and wage and price controls, must always be viewed as occupying a secondary role; one which they cannot carry out effectively, even in the part they can properly be expected to play, unless the monetary and fiscal policy is carried out as effectively as possible.

Second, I would emphasize that production controls, that is, controls that direct the specific uses of materials and manpower, are more fundamental than are price and wage controls. The introduction of production controls rests on the assumption that we cannot get as prompt and as efficient redirection of the use of certain materials and the related manpower by the Government bidding against the private sector, and members of the private sector against each other as we can get by directing the reallocation of materials and manpower. We will, for example, have an adequate rate of output of airplanes if we direct the flow of materials to airplanes and restrict the use of those materials elsewhere. This is a question of the speed and the efficiency with which the redirection occurs, I think a large number of the economists would agree with me that the price system is better adapted to making slow adjustments than in making rapid changes in the use of resources. In all-out war we have to make a very high percentage readjustment and make it quickly. I personally, would have more confidence that this could be brought about more efficiently by the directing hand of the Government than by waiting for readjustment through the market.

Part of the reason is, there is a conflict in any business unit between long term and short term. You can offer a businessman higher prices for military goods or military sales to the armed forces than he can get in the civilian market and, unless there is some unusual pressure of some sort or other, he would be inclined to take the civilian market; that is where his long-term interests lie. If taxes are very high, he gains very little out of making a sale to the Army as compared to the value of maintaining trade connections for the long pull. This is not attacking the patriotism of businessmen. They have responsibility to maintain their businesses over the long pull.

Therefore, I would say that inevitably in all-out war, and to a degree in even the kind of mobilization we have had recently, some direct control over the use of material is essential.

We usually look upon these controls as getting goods for military use, but that is only part of their purpose. Another purpose is to cut down on the demand for certain materials and for the associated labor used to make finished goods from them for civilian use. If manufacturers of the civilian goods are unable to get materials, they do not need to hire manpower. Manpower is released, therefore, for military production, and the competition between military and civilian production for manpower is reduced. If we do not reduce that competition over manpower, the result will be an increase in costs which not only increases the cost but, even more materially, increases incomes of workers relative to the available supply of civilian goods, which augments the inflationary tendency.

Price controls occupy a role too, but, as an ex-price-controller I want to emphasize that it is very easy to overvalue the effectiveness and the part which price controls can exercise. When businessmen are expecting prices to rise, they hastily buy more materials so as to forestall, in their view, increases in price. By putting in ceilings we can wipe out such speculative expectation.

Those who administered allocations and priorities during the last war emphasized that true controls facilitated their program of voluntary compliance. They relied on voluntary compliance with allocations, which was greatly aided by the fact that the businessmen could not legally make more money by selling goods somewhere else than to the military.

There is a tendency for each type of control to be weak. There is a tendency for priorities and allocations to be weak, for price controls to be weak, and for monetary controls to be weak. Therefore, to a considerable degree, each one of them reinforces the other and the total becomes stronger as a result.

Those who argued for price control as an aid to voluntary compliance with allocations of materials during the last war held to that conclusion. Many argued the same way with respect to the rationing of goods and services: That the rationing system would have broken down completely had it not been that, when a person violated the rationing regulation, he could not get higher prices legally for selling his goods to someone other than the one with the ration ticket.

I want to illustrate one of the real difficulties of price control by talking about meat. If you want to understand price control's greatest impetus, talk about it in connection with meat, when there is of course no effective meat rationing.

The supply of meat is largely fixed at any given time. We cannot do much about the total production of meat, because that is based upon the previous production plan. What happens to the price of meat is almost entirely a function of how much money people have to spend on it and how much they do spend. It is not only true that when consumers have more income they will spend more for meat, but also there seems to be an almost irrational insistence that they get the meat. They will not play ball with the queues and other informal rationing devices, therefore, it is not possible to hold down the prices of meat very much without formal rationing.

Consequently, if we put price controls on meat and consumers' incom are such that they are willing to buy more meat at ceiling prices, they will then increase the consumption of meat and the retailer shops will become bare. The retailer in turn will try to buy more meat from the packer. The packer will try to buy more animals from the farmers, so the packers proceed to overpay for hogs and cattle. As a result of the increased price of hogs and cattle, they can't afford to sell meat at the prices set by the price control agency.

The price of meat is demand determined and unless people are willing to forego the consumption when it is inconvenient to obtain it, no commodity for which the price is determined by demand can be held below what consumers are willing to pay except by the establishment of formal rationing.

We have had price control on meat since January 1951. This leads me to state the fact that there has not been widespread black markets in meat indicates that prices would not have been much different if there had not been controls. The ceilings on the meat are at a price level as high as consumers have the income to pay. Ceilings have not, in my judgment, really held down the price of meat.

In all-out war, when the shift of the resources to the Government's case is so great that it cannot be paid for by taxation, and when it is not feasible to get all of the borrowing by the Government out of genuine savings, there seems to be an inevitable increase in total income. There is no doubt that a comprehensive program of price control has to come in, but it will work only if at this time one is prepared to impose consumption limitations on consumers or rationing where it is necessary to divide up the supply. That is when supply is less than people are willing to buy at these controlled prices, queues, dealer preference, or formal rationing must take on the dividing up job previously done by prices. I can spend just a moment on wage control but it enables me to make a point which I think is rather fundamental in talking to you men from the armed forces. Wage control is very much tied up with how we can best mobilize our manpower. From certain points of view, it looks as though we ought to direct the civilian use of manpower, as well as direct that men shall go into the Army. How shall workers be used? I am not going to talk about the question of justice. I am going to talk solely about a problem of efficiency.

I do not believe it is possible to set up overnight a system of manpower administration whereby we tell everybody where to work and have it operate efficiently. A great proportion of the decisions as to where men are going to be employed will still have to be made by the decision of the employees on one hand, and employers on the other hand. Of course, to some degree, the way we shift people from employment where we do not want them to employment where we do want them is to pay them more; any system of wage control that does not recognize that is going to fail. But it is inevitable that the fellow who is about to lose his employee wants to raise his wages, too. We have to introduce wage control to prevent him from holding an employee needed for an airplane plant. Then, as labor becomes scarce, this power to bargain increases and it is entirely possible that we would have a cumulative increase in costs as a result.

I want to emphasize that the increase in wages that occurs reflects not only the power of the unions but also the high demand for labor. I am not going to debate the division of that responsibility

One final point on wage control is that, while it does increase cost, from the point of view of the effect on prices of most consumer goods, the most important consequence of the increase of wages is the increase of incomes. This aggravates the problem of control of prices for such demand-determined commodities as meat, as we saw a moment ago. Meat prices rise primarily because consumers bid them up, not because costs of producing meat rise.

Once more as a summary I want to contrast the problems of all-out war with the kind of mobilization we have had since 1950. I will close with comments about the present and near future.

In the all-out war, the shift in the use of resources is so great that it cannot be taken care of by an increase of total employment and output. There must be, therefore, some substantial curtailment in the civilian purchases of goods in order to accomplish this effectively. A balanced program has to be worked out in which, to the maximum degree possible, the Government gets its money by taking money away from private individuals and businesses.

That will not be adequate in all-out war, but the effects of the Government's borrowing can be offset to a considerable degree by having the Government borrow from private savings. Therefore, it is important to have an increase in private savings, which involves a whole series of problems and which I have not discussed. Even more it involves a reduction in the private use of savings for private investment, so that private savings will be available for lending to the Government to the maximum degree.

It will not be possible, however, in terms of the effective direction of uses of some specific goods and the associated manpower and in terms of preventing the expansion of over-all demand, to accomplish the mobilization solely by the way we raise the money and the control over the expansion of bank credit.

It is necessary to move into direct controls over the use of meterials and possibly, in some cases, over manpower and in the end to introduce a comprehensive program of direct wage and price controls.

In a period of partial mobilization, however, the role of the direct controls should be much smaller, relatively, and should not, if the program is handled wisely, call for comprehensive direct controls. It may be necessary to control the use of a few materials so as to direct them to military purposes and to cut down on private demand for them. This can be either by direct controls over private investment or through the tightness of the monetary control. The expansion of private investment, including housing, where not directly related to the mobilization program, must be restrained. (I want to say parenthetically that I do not think we have done a good job on restraining private investment since the Korean incident.)

It may be necessary to introduce here and there some price controls because of the slowness with which the indirect controls, at least some of them such as the increase of the Government's revenues, get to work. The only excuse, in my judgment, for introducing comprehensive price controls in such a period is either because we do a very bad job on the indirect controls or because it is decided that it is necessary to introduce wage control. Wage control is not possible, politically and probably would not work economically, without corresponding price control.

If we had handled the problem ideally, I do not believe we would have felt it necessary to introduce comprehensive price and wage controls in 1951. Since we were pretty slow in anticipating the need for the Government to have a budget surplus and have tight monetary control, perhaps it was necessary in 1951 to introduce those controls. By now any deficiency in monetary controls and fiscal controls could have been worked out. I do not believe they have been worked out. The National Government is operating at a deficit and monetary controls are not sufficiently tight but what we have a very high rate of investment, including building, and there is some tendency for prices to rise again.

In my judgment general wage and price controls should be suspended; they have become quite ineffective. Beyond that there is no prospect of a serious upsurge of prices, or at least of a rise which could not be restrained by fiscal and monetary devices. There may still be need for a few direct controls over materials intimately related to the defense program.

I feel that we are being lax in our fiscal and monetary controls at present, but the results of that laxness will not be catastrophic. That we are lax, highlights a major difficulty of control in periods of partial mobilization. If we could deal with the needed controls solely as an economic issue and face up to the fact that we do not know whether military outlays will have to increase or decrease as a result of diplomatic and military developments, we could then make fiscal and monetary controls that err, if anything on the tight side. If we did and if military operations are less than expected, we would have some unemployment.

Unfortunately, the tendency in public policy is to err the other way. It is much easier to take a little bit of the drink of inflation than it is to take a little bit of the unpleasant drink of unemployment and deflation.

Lest you men think this is a problem faced only in a democracy, I want to close with a comment on a matter some of the officers and I were talking about before we came over here. One of the men who participated in the surveys of Germany after the war spent a good deal of his time studying their attempts to mobilize and control. He came back to report that Germany was not fully mobilized, as I recall, until well into 1943, and that in the process of trying to build up full mobilization in Germany they faced a number of problems of public reaction, even under that authoritarian system which is much like those we experience. In Germany there was resistance on the part of workers to moving from the places where they lived and the jobs which they had; there was resistance on the part of consumers to rationing and severe cutbacks in the level of consumption.

Certainly, in our system, these resistances cannot fail to be strong and to affect many parts of the program of controls during mobilization. While we are most anxious to be strong militarily, we must, at the same time, be most anxious to preserve not only the form of our political and economic institutions but also the people's confidence in them. Therefore, we must have policies which are understood. These are sometimes looked upon as merely political interference, but actually they constitute the pulls and hauls of contrary interests and views which are essential characteristics of the process of people working together.

COLONEL BARNES: Dr. Heflebower is ready for your questions.

QUESTION: Dr. Heflebower, you mentioned meat as an example of a commodity on which the supply was essentially fixed and therefore the price could not be controlled except by over-all rationing. Wouldn't that apply to any type of consumer commodities, such as cigarettes and things like that?

DR. HEFLEBOWER: That is a very good question. First of all, I am not sure that the supplies of many consumer goods are quite as fixed as meat. In fact many of them are those made from a raw material of multiple uses and more can be pulled into a particular use. The question, I think, really is: How important is the commodity in the consumer's diet and consumption and what will he do in the absence of his ability to get the commodity? I think there are a number of relatively unimportant commodities in people's lives, for which they would not go to the extreme of searching out a black market just to have them. There are many ways of rationing. There are queues; consumers can wait until another day with the hope of getting the article. I can think of a number of commodities in which shortage cuts down the consumption rate, but there are some--one example, like meat--in which that is not true.

I must emphasize that the situation in meat, both during the last war and our recent experience, has been made worse by the fact that we have not cut down on consumer incomes enough. This reflects our failure to do a good job in raising taxes and in preventing the expansion of money.

One point on taxation: There are two reasons why some shift from income taxes to other forms of taxation is to be argued for during a period of the sort we are describing. The first one is that, partly because consumer goods are the most difficult to control by direct price control, adding a tax on goods makes them higher, reduces consumption, and transfers money to the Government.

The second reason for regression in the tax system is that it prods for, rather than discourages, more work. Where a working housewife, for example, pays an income tax, working more raises her taxes. But when consumption taxes are being passed forward to her, they are like higher prices. So she has to work more to get more money to pay the higher prices, or consume less. That kind of tax, if not carried too far, can raise money, restrain consumption, and probably augment people's willingness to work.

QUESTION: Would you care to comment on the British system of meat rationing?

DR. HEFLEBOWER: As I understand the British system of meat rationing, it is a rationing of dollars rather than of points. That is, each consumer is allowed to buy so much money's worth of meat per week. Then she can buy whatever type or cut of meat she wants. Obviously, the money buys fewer pounds of high-priced cuts than of low-priced cuts. I think there is a great deal of merit in the British system. I have talked about it with Mr. Rowe, who set up our system in the last war, and I would agree with him that at the time we were called to ration, the whole system of controls had gone in the other direction. It was not feasible to set up the British-type system. If you want some real expert advice on rationing, you have the number one authority here in Washington, Mr. Rowe, at the Brookings Institution.

That leads me to comment that there is a much more comprehensive proposal. That is what is called "purchasing power rationing." Under purchasing-power rationing, consumers cannot spend their ordinary dollars for anything--at least they cannot spend them for certain categories of goods, such as clothing, to which the ration is very applicable. Instead the consumer must go to the bank or some other place and buy his weekly or monthly allowance of a special kind of currency, the only kind of currency with which he can buy clothing, or what not. Therefore, the amount of money people could spend for a category of goods would be restricted. Then there would not be need for either price control or point rationing on that commodity.

There is a lot of merit in that idea. Although it is a drastic change from anything we have conceived of before. There are also some bugs in it. I am not certain that Dr. Kress and Dr. Hunter would advocate this as an alternate to rationing.

COLONEL BARNES: Dr. Heflebower, you have been on this platform before, so you know what it means to be put on the spot in this discussion period. Admiral Hague announced that you had been a consultant to the Economic Stabilization Agency since Korea. I understood from your comments that you do not think much of what the Economic Stabilization Agency has been doing. Can you reconcile those two points?

DR. HEFLEBOWER: Colonel Barnes, there is a very easy out; that is, one's advice is not accepted. But you see, as an adviser to the Economic Stabilization Agency, I am not an adviser to the Congress, the Federal Reserve Board, and the Treasury. I have argued constantly, and I think if you look at the volume of readings edited by Wallace and Chandler, you will find I testified along this line before the Joint Committee on the "Economic Report." I argued for a substantial Federal surplus and I felt that, to a degree, this surplus should be obtained by introducing more regressiveness in the tax structure.

Secondly, I argued that we ought to cut loose, as we have to a degree, from the artificial control over the money market which the Treasury has pressed the Federal Reserve Board to carry out, so that there would have been a distinct tightening up in the money supply. This would have meant that borrowers at the banks would have had to pay more and would have had difficulty getting money from the bank. Some really effective control of this sort got going sometime in 1951. It helped but it was late.

The next point is that having not taken the moves that we should have taken earlier in 1950, it may have become necessary, and I was among the undecided group, to have introduced the comprehensive wage and price controls that were imposed in January 1951. The Advisory Committee of the Office of Economic Stabilization has not met in more than a year and I have not functioned as an adviser of the price stabilization agency since that date. I have, however, on two forums in

New York, gone on record for the suspension of general wage and price controls. I took this view as of the beginning of this year. That is fairly consistent.

QUESTION: You have undoubtedly heard in the past, this point argued very strongly. There comes a time when there becomes a general agreement that wage and price controls are necessary unless you introduce profit control and you have an ingredient to effective control. Would you have any comment on that?

DR. HEFLEBOWER: I have to make clear what is meant by "profit control." If by profit control you mean the specifying of a percentage of sales or assets which can be earned, or if that is set by what the individual company earned in a historical period, then you have what I understand to be profit control. If by profit control you mean the use of the profits of an industry as a guide to wage and price controls, then my answer is, that is not profit control but the inevitable criterion you have to use in price control in judging whether prices and wages should be increased or not.

Going back to the farmer we have a high degree of profit control, from the point of view of the efficient allocation of resources, because that is the effect of a high excess-profits tax. I think it is almost inevitable that even the most patriotic businessman will become careless when increases in profits are before taxes and not after taxes and when he is on what I call a marginal basis; that is, when increases of earnings mostly go to the Government.

Even the most patriotic of us may become careless when we are not under compulsion. There has never been a device to compel efficiency comparable to the income statement at the end of the year. There may be problems of justice; I am among the first to agree that problems of justice or the sharing of opportunities is an essential part of the process of agreement and of efficiency in our kind of society. Therefore I am not going to make a tirade against the excess-profits tax.

On the other hand price control must be governed by a profit criterion in the sense that the only effective guide to whether, as a result of increases in cost, the prices of a product of industry must be advanced is the effect of this increase in cost on the earnings of the industry's members. There is no other administratively effective guide. I could spend two hours explaining it, for I am convinced of it after my experience.

One final point which I think relates to the wage matter: Profits tend by their nature to be an aggregate concept which is affected by both the volume of business and the profit per unit of output. As such, profits reflect the net effects of increased output rate of higher costs, of greater or lesser efficiency, or what not.

On the other hand when we can get wage control, we do not use an aggregative measure. We are inclined to compare movement of the wage rates for a specific job against movement of the cost of living, whereas the typical worker works more hours than before. Therefore he gets an increase in dollar income even without an overtime premium. In addition there is a growth in the number working and a movement toward higher-paid employment. The result is, therefore, that, though wage rates in the sense of rates in specific jobs were to rise less rapidly than does the cost of living, real buying power of workers as a group increases. I think this is a rather fundamental point that has to be given consideration in judging how wages should be controlled and in judging how the burden of a defense program is distributed among various groups in the country.

QUESTION: We have heard of the important problem of any deflationary action by the Government. Would you care to predict whether or not there will come a time when defense bonds will buy, after interest, what the money would have bought in 1941, 1942, and 1943? If the answer is no, when is this particular piece of the public going to fall back on their recent experiences that you mentioned?

DR. HEFLEBOWER: This kind of business forecasting is not so dangerous as some other kinds. My view is that there will not be a substantial drop in prices. Furthermore, my view is that you do not want a substantial drop in prices. It is very much like the old question: "Wouldn't you like to have steaks at 35 cents a pound again?" You would obviously say, "Yes." If I also asked "Do you want the other things that go with 35-cent steaks?", I think your answer would be, "No."

Adjusting prices downward to any considerable degree will bring unemployment and if prolonged, social and political instability in a country. I do not think we want that. I do not think politically it will happen, for if the unemployment number became large, I think we would use full power of the government to correct it.

Beyond that I am not inclined to feel that the economic forces at work will bring about lower prices. We have, as the result of the greater share which the Government's expenditures are of the total national income, put in some resistances to deflation and unemployment. We have unemployment compensation and a floor on agricultural prices. If prices fell, there would be a search for export markets even at subsidized prices or attempts to keep up export trade by means that might be dressed up, forestalling communistic tendencies in certain countries. Things like that act as resistance to downward movements in the rate of output and therefore of prices.

My answer to your first question is, I do not think you are going to convert those 1941, 1942, and 1943 bonds into dollars that will buy what they did then. In answer to the second part of your question as to whether this will upset the American people, I will say I do not think the prospects of its upsetting them radically are very great.

After the mad rush to cash in E Bonds to buy goods, during the defense period we have had a high saving rate. People will have confidence that these bonds or the money from them will buy goods for the same prices that they are paying at the time they buy bonds unless there is a runaway inflation. Such a dire development comes only when an economy and even a society is breaking down. That will not occur where there is economic strength, which in part rests upon productivity and in part on the stability of the economic and political forces in our society. No I see no evidence of the depreciation of the people's confidence in their society comparable to that which is associated with the wild German inflation during the twenties.

COLONEL BARNES: Dr. Heflebower, you have backed the Admiral in his boast that we had a real expert here today. On behalf of all of us, I thank you for this really fine presentation.

(29 Oct 1952--250)S/rrb