MONEY AND THE MONETARY SYSTEM

29 August 1955

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INDUSTRIAL COLLEGE OF THE ARMED FORCES

Washington, D. C.

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MONEY AND THE MONETARY SYSTEM

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DR. KRESS: General Hollis and gentlemen: We have had two discussion groups and now this morning we begin the first of the morning lectures. We will discuss the content some more in the discussion groups this afternoon. Our speaker, Dr. Charles R. Whittlesey, professor of Finance and Economics at the University of Pennsylvania, will come around to as many of the discussion groups as he can before his train goes, I believe at three o'clock. He has very kindly consented to do that.

It used to be quite commonplace to introduce a speaker on money and banking by saying that he knows everything about money except how to get it for himself, but that isn't true of our speaker this morning. You will notice he is consultant and has been consultant to big banks and trust companies, and, as we say in the vernacular, "That's nice work if you can get it." His "Principles and Practices of Money and Banking" is in several editions. He is not only a theoritician but is also a practical man.

Dr. Whittlesey, it is a pleasure to welcome you to this platform for the second time and to present you to the Class of 1956.

DR. WHITTLESEY: I must say I don't recognize the gentleman who has just been introduced to you. I was told to draw more upon personal experience in this discussion of the problems of money. The trouble is that, as in the case of most of us, my experience with money has been much more limited than I should have wished.

The Nature of Money

I want to start by speaking of the nature of money. This may seem somewhat academic but it is necessary in order to provide the basis for what follows which will deal more immediately and directly with problems of the present day

There are three major types of money. The first is pocketbook money. Pocketbook money is what we ordinarily think of when we speak of currency or common money.

The second type is checkbook money. It consists of bank deposits against which checks are drawn. It serves the same uses and has the same effects as pocketbook money but it is far greater in volume. For reasons that will come out later, it is also much more significant to watch and to understand.

The third major type of money is reserve money. Examples are the gold at Fort Knox; gold certificates held by the Federal Reserve banks, and deposits placed with them by member banks which are behind the checks that you and I draw on our own banks. We never see reserve money, but it is there. It is a basic element in the economy. It is the fulcrum by which authorities of the Federal Reserve attempt to influence the monetary system and accomplish whatever they desire in the way of greater stability in the economy. Reserve money embraces standard money upon which our monetary system rests.

I repeat that there are three types of money, the common or pocketbook type, the checkbook type, and reserve money. All are important; all have to be regarded as money for one simple reason--that they perform the functions of money.

A well-known British writer once said that "Money is one of those concepts which, like a teaspoon or an umbrella but unlike an earthquake or a buttercup, are definable by the use or purpose which they primarily serve." Money can be defined only in terms of its use, not of its outward characteristics or appearance. Money, then, is anything that regularly and typically performs the functions of money. It may be gold or it may be paper. It may be any of a thousand things, as it has been at different times of history. But if it regularly and typically performs the functions of money or any significant number of them, then it is money, regardless of what it is made of.

I would have you note that some books, including the textbook you are asked to read in this course, define money in terms of a medium of exchange. It says, "Money is anything widely used as a means of payment." That would embrace the first two types of money I mentioned but would leave out the third and basic type of money, reserve money. That is a functional definition, that money is anything widely used as a means of payment, but it is not enough because it leaves out gold and gold certificates, the most basic of the three types.

In order to be regarded as money, the substance or commodity must perform the money function regularly and typically, not just

occasionally as happens in the case of barter. I might, for example, swap my necktie with Dr. Kress's and give him a dollar in addition. The dollar, obviously, would be a medium of exchange; so also would my necktie, just as truly as the dollar. But no one would say that neckties are money. The dollar is money because it regularly and typically is used as a medium of exchange. That is not true of my necktie, so we can't call it money. Similarly, credit instruments may be used to discharge obligations or to make payments, but they do not generally do so. They are ordinarily used as a source of income, a type of investment. For that reason, we don't classify them as money any more than we should classify a necktie as money.

Functions of Money

Let me turn from the definition of money and the nature of money to the functions of money. The first is one which I have already mentioned. The medium of payments function which includes such exchange transactions as at a newsstand, at a department store, or between giant corporations. The medium of payments function also includes contractual settlements such as payments for wages, taxes, insurance premiums, interest and dividends, where no goods are exchanged but money is nevertheless used as a means of making payment.

A further aspect of this medium of payments function is that money broadly speaking is the basis of spending in the economy. It is money payments that constitute markets in our society. Markets are not places or people; markets are money paid. It is monetary expenditure that constitutes effective demand for the goods and services which the economy turns out. Money makes the mare go. Money also, through payments in exchange for goods and services, makes the entire economy go. If we have boom or depression, if we have inflation or deflation, it is because monetary expenditures relative to what is offered for sale are too great or too small. If we have full employment and price stability, that is another way of knowing that the level of monetary expenditures approaches the ideal.

Note that all of this is involved in the function of money as a medium of payments, which is much broader than just saying "medium of exchange." I would call your attention to the fact that the chief feature of this aspect of money, its behavior, is that it is active. It is money being used to do something, a motivating force in the economy.

In the second function of money you will note an immediate contrast. Here money is passive, not active. As the standard of value that is a

medium for stating values, money is a pricing device, a basis for quoting prices. We can't have prices without having money and we can't have money without having prices.

We speak of ourselves as living in a money economy or a price economy. The two are the same thing. Another aspect of this function is that money is an accounting medium. It is the means by which we keep records. The more elaborate, integrated and complex the economy becomes, the more important this aspect of money becomes. A further aspect of the standard of value function is that money is a medium for making agreements, including contracts for the payment of wages, loans, insurance policies, Government bonds. It will be observed that, as the basis for pricing, for keeping records, and making contracts for the future, money plays a passive role. It is a standard for expressing value just as a pound is a standard for expressing weight.

The third monetary function is the reserve function. Monetary reserves include the reserves of central banks and of commercial banks. It is these reserves that regulate or limit the issue of checkbook money. Reserves are the governing wheel that prevents the money system from behaving erratically or from falling to pieces entirely as has happened in extreme cases of inflation.

The fourth function of money is as a storehouse of value. Money may serve as a medium for accumulating and storing wealth. This was a very important function in the Middle Ages. It is still important in periods of revolution, warfare and distress, such as we have seen fairly recently in the Orient. For the most part, particularly in this country, we use savings accounts, insurance policies and investments as a means of storing up values for the future.

Finally, money has the function of serving as a cash balance, a source of liquidity. We need to distinguish between this and the previous function. In this fifth role money is not, as in the previous case, storing up value for the future but is providing ready purchasing power at any moment, not at some time 10 or 15 years from now or when we retire. It enables us to meet contingencies, to buy opportunely in the stock market or elsewhere, to have ready command over goods and services. Money is the one perfectly liquid asset, the one thing that can always be sold and that thereby gives the holder command over goods and services throughout society. While money has little power to satisfy wants directly, in contrast to food and clothing, it has the quality of being able to command those things that do satisfy our wants directly.

This feature of liquidity has been called the most important single fact about money. Because it is a reserve of purchasing power which can be spent instantly or withheld, money is an important factor in increases or decreases in demand for the products of society. By facilitating changes in the level of expenditures it helps to cause the economy to swing up or to decline.

In summary, it may be observed that the institution of money may be looked upon as an economic mechanism, a device for accomplishing certain ends. These ends include exchange, pricing, paying, contracting, and so on. The gold standard was a particular model or type of monetary mechanism. So is the present monetary system in this country which is pretty well insulated from control by gold. These monetary systems or any others should be judged, like any other piece of machinery, on the basis of how well they fulfill the basic monetary functions. It is illuminating always to think of money as a mechanism.

Monetary Principles

Now I am going to offer three principles which are basic to an understanding of the operation of this machine and of its management and administration by the constituted authorities. The first is the principle of deposit creation. As a result of businessmen or the Government going to banks and borrowing from them, banks set up on the asset side of their books accounts denoting ownership in these investments and loans. On the other side is placed, at the disposal of the borrowers or the sellers of investment securities, credits in the form of demand deposits. Thus commercial banking consists of dealing in debts, whereby banks give their promises to pay in the form of demand deposits and in return acquire loans and investments. It is by this process that the principal element of the money supply, checkbook money, is created.

It is no longer true that the major part of the money supply of this country is turned out by the Government in mints and printing and engraving establishments. A much larger part is created through the operation of the commercial banking system. No individual bank can do it, but all banks collectively do precisely that. It is the modern philosopher's stone, a means by which money is created out of nothing more substantial than credit. I regret to have to ask you to take it so much on faith without giving as full an explanation as it deserves.

Let me turn to the second principle. If you remember anything from your elementary course in economics, it is probably the quantity

theory of money. It proceeds from the so-called equation of exchange, usually written in this form: P, for prices, equals the amount of money, written M, multiplied by V, the velocity of money, rate of its use, divided by T, trade or transactions. In short, $P=\frac{MV}{T}$. The quantity theory of money says that the level of prices is determined by the quantity of money, the rate of use of money, and the volume of transactions.

It can be expressed this way: The price level tends to vary directly with the quantity of money and its velocity, and inversely with the quantity of transactions. An increase in the volume of money or its rate of use in the market place tends to force prices up. Increased production, good crops, and so on, tend to hold prices down. In its earlier formulations, the quantity theory of money assumed that V and T did not change very much, and that M was determinant, more or less to the exclusion of the other two factors. Currently the tendency is to emphasize V, velocity, the rate of use of money more than was once done.

The present concern over inflation that you can encounter in reading the papers is likely to reflect fears relating to the volume and use of money and credit. Consider likewise the steps being taken by the Federal Reserve today to slow down monetary expansion and discourage lending. These are designed to prevent rising prices. They may be interpreted in terms of the quantity theory of money that is one of the principal guides by which the monetary authorities of the Federal Reserve conduct their policies.

The third basic principle is known as the principle of total effective demand. Briefly it is that at any given time there is some ideal level of monetary spending at which the economy will be fully employed with no tendency for prices to change in an inflationary or deflationary manner. It assumes the existence, ideally, of some most desirable level of spending by the community, i. e., individuals, businessmen, and the Government, which will produce full use of the resources of the economy without giving us either inflation or deflation. By implication, there is some other level where spending isn't enough and we have deflation or where spending is too much and we have inflation. It is that ideal level that the authorities undertake, by their instruments of credit control and by any other devices that they have, to insure, in order to promote stability and a full utilization of resources in the economy.

The principle of total effective demand has become in the last 20 years the single most basic idea in the administration of the economy and also in making forecasts and interpreting business conditions. I

am sure that it will be discussed at considerable length subsequently in this course.

I turn now from these basic principles, but I am going to come back to them in a few moments to show you something of their application.

Distinguishing Features of Modern Money

There are three features that distinguish modern money from money that existed in any previous period of history. The first is the subordination of the commodity aspect of money. Gold and silver are today relatively little used. Even in the reserve role where we still have gold, gold does not control our monetary system. It is more accurate to say that our monetary system controls gold. The commodity aspects of money have been subordinated throughout the world to an extent that was never true in the past.

The second distinguishing feature is the predominance of bank money, that is checkbook money. It is said that 90 percent of all business carried on in the United States is not by common money, pocketbook money, but by checkbook money. That means that most of our money is created by the lending and investing operations of commercial banks.

It is through the checkbook money created by banks that the credit operations of businessmen and the Government have a dominant influence on the money supply and thus on the functioning of the economy. Credit, as you know, is a highly unstable quantity. This means that our monetary system is tied to that which is unstable. Instability of credit tends toward monetary instability, and monetary instability contributes to fluctuations in the economy. These facts establish a need for some monetary authority to control and restrict the instability inherent in a monetary system so largely based upon credit.

This leads to the third characteristic of modern money, the rise of monetary management. It is a recognizable fact that monetary management has become of decisive importance in our monetary systems of the present day. Older conceptions of an automatic monetary system no longer apply.

Monetary management involves two critical relationships. The first is the volume of money in relation to goods and services exchanged, that is, M in relation to T. The second is the flow of money expenditures in relation to business activity. This involves attempting to influence the amount of spending to prevent its becoming so great that we have inflation

or so small that we have depression. In brief, monetary management today is based on the quantity theory of money and the principle of total effective demand.

We have three principal agencies for administering monetary management in this country. In our grandfathers' day the monetary authority was conceived of in terms of the Mint and the Bureau of Printing and Engraving, together, perhaps, with the Comptroller of the Currency, which was the administrative office under the Treasury for chartering and examining national banks. How is it today? We think of the 12 Federal Reserve Banks which date from 1914; of the Treasury, which is now a tremendous monetary influence in the economy and which has completely transformed its scope and importance in the last 15 or 20 years; and, thirdly, we think of the International Monetary Fund which didn't exist before 1944. The three agencies of monetary management today are the Federal Reserve System, the Treasury, and the International Monetary Fund.

Monetary Policy

Monetary policy, of course, is what monetary management does. We may think of it as consisting of the attempt to influence monetary phenomena and monetary relationships in ways to improve the functioning of the economic system. That is the job which the International Monetary Fund, the Federal Reserve, and the Treasury in its role as part of our financial control system, are expected to do. It is apparent that monetary policy signifies the abandonment of the search for an automatic system such as the gold standard was once thought to provide.

The objectives of monetary policy include a variety of different things. One is price level stability. Another is stable exchange rates with foreign countries. Another is full employment. Full employment means a high and stable level of business activity. This has become the prime target of monetary management today. And a fourth objective is economic growth. Economic growth was not discussed ten years ago as one of the objectives of monetary policy. It runs repeatedly through Federal Reserve discussions at the present time.

There are other objectives of monetary policy but these are the most important. Currently the principal objectives are stability of prices, full employment, and economic growth.

Turning now to methods, the primary focus of monetary policy is upon reserves. The Federal Reserve doesn't go out directly and try

to increase or reduce the quantity of money. By means of open market operations and other controls at their disposal they seek, rather, to increase or decrease the quantity of reserves on the ground that reserve money is the governing factor, and they will control the quantity of money by controlling reserves.

The focus of monetary policy is primarily on monetary quantities in the form of reserves, but it may also be upon monetary expenditure, i. e., the flow of money payments. At times, as during war, the authorities have imposed restrictions on the use of consumer credit and for a short time on real estate credit. Currently there are restrictions on stock market credit.

Credit controls of the latter type which regulate the use of money are called selective instruments of control. Those methods which are focused on reserves are known as the general credit controls. The latter are quantitative; the other is primarily directed toward behavior.

So far we have been discussing monetary policies of the central bank, i. e., of the Federal Reserve. In addition we have fiscal policies under the administration of the Treasury. These include taxation to influence business expenditures, debt management, and other things for which the Treasury is responsible.

Monetary Problems Today

In turning now to monetary problems the first problem is to know how to narrow the subject. I don't want to attempt to touch on so much that it becomes confusing but at the same time I want to take up certain points which you will recognize in the course of study as you proceed and in the reading you do in papers and magazines as being of current significance.

The first two which I shall mention are frequently encountered but are not, in my opinion, of major significance. First is the problem of a return to the old-fashioned gold standard, sometimes called the gold coin standard, the standard where money is fully redeemable in gold. This has been described as a proposal to substitute for the inscription on coins "In God We Trust," the inscription "I Know That My Redeemer Liveth."

Support for a return to the gold standard, with provision for the redemption of coin in gold, comes chiefly from those who long for the

good old days. It appeals to the more extreme conservatives who feel that somehow by going back to former ways we can restore the stability of former days. Some of those who support a return to the gold coin standard have an interest in the gold mining industry.

This proposal is not, in my opinion, to be taken very seriously. We have had in every Congress for years bills providing for a return to the full redemption of our currency in gold. There has been no general support for them nor does the movement show any sign of gaining strength. In my opinion, it is unlikely, and even if done, it would not be of very great significance in your lives and mine.

Secondly, there is the alleged problem of chronic inflation. It is said again and again that the dollar inevitably depreciates, currency becomes of less and less value, prices have a constant tendency to rise and rise and rise. You are familiar with that argument. What does the record show?

If we look at the index of wholesale prices from 1800 to the present time, we come across a remarkable fact. The purchasing power of the dollar in 1925, after the inflations of the Civil War and the First World War, was as great as it was in 1800-1810. The same was true as late as 1941. Make no mistake about this. This comparison is based on statistical studies as careful as can be humanly made. It means that 1,000 United States dollars would buy as big a heap of things at wholesale--iron, wheat, nails, cloth, cotton, and everything else that goes into the wholesale price index--in 1941 as it would have bought 140 years before.

The idea of a chronic and inescapable tendency for the dollar to become less and less valuable, for it to depreciate, is contradicted by all records of American history. In this country the four great periods of inflation were associated with war, the War of 1812, the Civil War, the First World War, and the Second World War. There is no case of significant peacetime inflation in the history of this country.

In the last three years, as you know, wages have gone up appreciably. Does this mean that wholesale prices have likewise gone up? By a coincidence, the wholesale price index in August of this year stood at 110.1. The average for 1953 was also 110.1. exactly the same to the tenth of a decimal point. A further coincidence, which is really too good to be true, is that the index for consumer prices in June, the latest figure, stood at 114.4 and for the year 1953 it was also 114.4. For both

necessarily mean rising prices. The record refutes the idea that the dollar constantly depreciates percent. I don't coincidences, but they should, suggests instead that, if we succeed in avoiding war, and maybe even if idea that money cannot be trusted, that inflation is inevitable. It we don't, we can hope to maintain stability of the dollar. That is going to be largely influenced by the success of monetary authorities in maintaining those crucial monetary relationships, M in relation to T, spending in relation to business activity.

Let me leave those two questionable issues and go on to the real problem or problems of monetary management and policy. What we find is not just one problem but a whole cluster of problems. I am sure you will hear more along this line tomorrow and maybe later on in connection with your study of economic stabilization. It is the real heart of monetary problems today.

The first such problem is "Who is going to do the monetary managing?" You will remember that during the last few years a great deal of discussion has appeared in the papers about the conflict between the Treasury and the Federal Reserve, a conflict involving complaints that the independence of the Federal Reserve System was being violated by actions of the Treasury. The outcome of that incident was an agreement, the so-called "Accord of 1951," between the Treasury and the Federal Reserve System, which established a basis of cooperation between these two main authorities in domestic monetary policy.

It must be recognized that the independence of either from the other is impossible when it comes to monetary management. The volume of spending and the quantity of money are inevitably affected by the actions of both the Treasury and the Federal Reserve System. It is as impossible to have an independent Treasury or an independent Federal Reserve System as it is to have two parties driving a mule independently. The job has got to be done together.

The second significant problem of monetary policy is the problem of objectives. What are we going to try to do? Stabilize prices, business activity, or economic growth? We have to realize that, to the extent that we seek one objective, we may be forced to sacrifice the other; yet all are desirable. The problem, therefore, is a choice, a decision as to which we should try most urgently to achieve.

In recent years we have concentrated, and in my opinion we shall continue to concentrate, on three objectives, stable prices, full employment--a high level of business activity--and growth in the economy. It is inconceivable to me that we shall succeed in the future as well as we have been able to succeed in the last few years in getting all three. It is not to be expected that, because we have achieved a high level of employment, quite stable prices, and substantial growth, we are going to continue at this pace indefinitely. Nevertheless, that we shall effect a reasonable compromise among them is certainly to be hoped and, I believe, to be expected.

I may say finally in connection with the problem of objectives that the priority of these three objectives is one reason for believing that we shall not return to the gold standard or stable exchange rates. Those two older objectives have become something to be sacrificed when necessary for the attainment of these other and more highly prized objectives.

A third problem of monetary policy has to do with methods. Having decided on objectives, what are we going to do with respect to indicators? What are we going to follow as guides in achieving objectives? Here we are in a quandary. The Federal Reserve officials have found themselves ever since 1945 and find themselves today in the difficult position that they don't know whether the basic problem is one of inflation or deflation. Our monetary managers have been inhibited by a fear that by combating inflation they will precipitate deflation, or vice versa.

It is basically a problem, it seems to me, of the reliability of forecasts and as to the precise meaning of the signals. A growth in inventories, as you know from your reading, is something that gives concern. A growth of inventories in a period of boom may signify hoarding by businesses and individuals and be inflationary. An increase in inventory in a period of falling prices on the other hand, may mean that goods are piling up because merchants and manufacturers are unable to sell them. Such a situation is highly deflationary. Here you have the same phenomenon, a growth in inventories. It is a signal which means one thing in one case and in another means exactly the opposite.

Sometimes the signals conflict. Suppose you had, for example, rising prices and increasing unemployment. What are you going to do in that situation? One indicator says there is an inflation danger; the other says deflation.

The final problem is the problem of the type of controls to be used. There has been a good deal of recent controversy over the use of

general as compared with selective credit controls. Beyond that is the question of direct control, rationing and so on, which I suspect will be taken up later by other lecturers. Here, the question is one of the freedom of the individual. There are various ways of stopping inflation. One of the most powerful is to clap on rationing, but that would involve a serious loss of freedom. It would be intolerable except under extreme conditions. This sort of control is reasonably certain; it is a means of getting a job done, but the price is high in terms of personal freedom.

What is the conclusion? In my opinion it is this: In our free enterprise and individualistic economy we want a high degree of freedom; we should, therefore, rely so far as possible on general controls. The Federal Reserve can apply them without infringing unduly on individual liberties. But if we are to be adequately prepared for a time of emergency, it is the part of wisdom to have in reserve more powerful and immediate instruments such as selective credit controls and even rationing, not that we have to use them but that we are not fully prepared unless we have them at hand in case of emergency.

Conclusion

What are the general conclusions on monetary policy? Earlier I described monetary policy as an attempt to improve by monetary devices the functioning of the economic system. It is clear from what has been said that there is no precise formula by which this can be achieved, no simple rules of thumb. Results will inevitably be somewhat short of perfection. We cannot hope to have perfect stability of prices or perfectly full employment. Nevertheless, we can and should expect that we shall have more of both than we could possibly have in the absence of the policies followed by the Federal Reserve and the Treasury.

In interpreting the significance of current developments and in deciding what to do, the monetary authorities have two major tools. These are the two basic principles I offered earlier, the quantity theory of money and the principle of total effective demand. Those are two important ideas for you to carry away from this lecture to help you in your efforts to comprehend what goes on in the field of monetary problems and monetary policy.

History does not record, ever, a monetary system that has been entirely satisfactory. In the face of chronic complaints and criticism of our monetary system, it is important to remember that there was also dissatisfaction, bitter dissatisfaction, with the traditional gold

standard and with every other monetary system that has ever been tried. Bear in mind also that the gold standard broke down in times of stress. For all our present difficulties and all the arguments back and forth, it may well be that we have under the Treasury, the Federal Reserve, and the International Monetary Fund a better monetary mechanism than the world has ever known before, and, beyond that, one that will improve still further in the years that lie ahead.

QUESTION: My question is more or less from a personal standpoint and I think everybody else has the same feeling. I don't know how it will affect our curriculum the rest of the year. You said the value of the dollar up until 1950 or so was the same as it was 140 years ago. In other words, for a thousand dollars you could buy the same things you could 140 years ago. I wish you would explain that because in practice it doesn't appear true.

DR. WHITTLESEY: The date is significant. I said 1925 or 1941. I did not say 1945 or 1955. If we examine a chart of wholesale prices, we see that it stood at about the same point in 1800-1810, 1920-1929, and 1941. It rose to sharp peaks in 1814, the First World War, and the Second World War, with deep declines in between (see chart, page 15.)

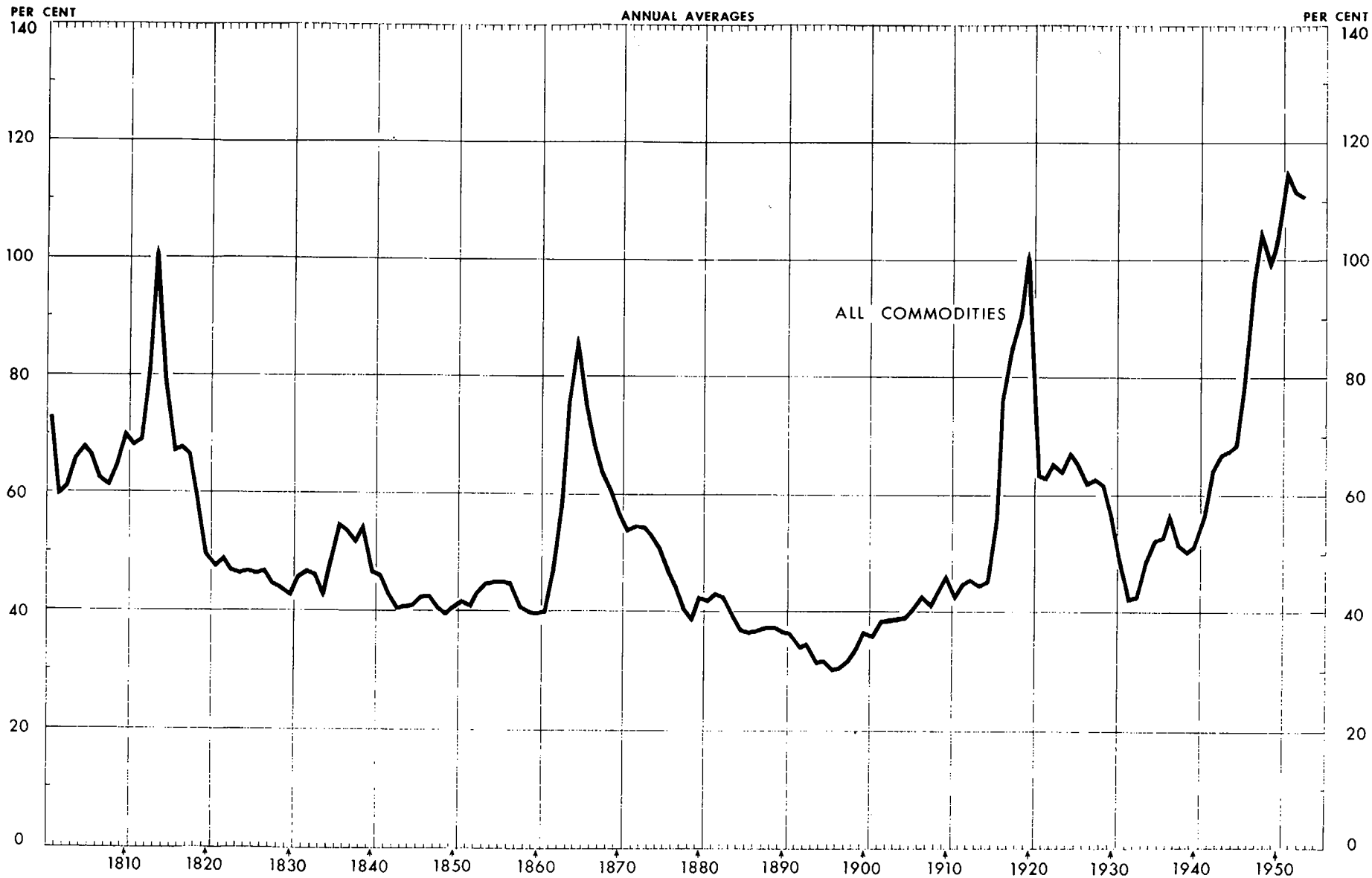
What I was talking about were points between these peaks when the purchasing power of the dollar at wholesale was as great as it had been in 1800. In the period of the depression in the thirties the prices went even below what they were in 1800. The dollar would buy a lot more in 1932 to 1939 than it bought in 1800, in terms of goods and services and all the rest.

Then the war came and prices rose from 1939 on. By 1941, prices had gone to the point where they had been in 1800. Then came our entry into the war. OPA held prices to some extent. At the end of the war, they rose to a peak a little above former war peaks but not very much. If we compare the war periods only, we get an impression of similarity. What we usually do is compare the peaks with the preceding troughs, because we think in terms of 10 or 20 years. It is wholly misleading to compare the troughs with the peaks and let it go at that.

May I take a couple of minutes to go a little beyond your question. Take it from me that the figures show what I have said. What it means of course, is that the Bureau of Labor Statistics adds up the prices of hundreds of representative commodities and figures out what they come to in terms of dollars. In wheat, steel, and nails we are comparing

WHOLESALE PRICES IN THE UNITED STATES, 1800-1954

BUREAU OF LABOR STATISTICS INDEX, 1947-49=100



SOURCE: Federal R

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virtually the same things. In other cases we have to adjust and leave out or put in some commodities that are important at one time and not important at another. These adjustments are made by trained experts. The evidence of official indexes is to be trusted ahead of personal impression.

When you come to analyze the mechanics of what I have said it is not so improbable as it seems at first blush. In 1800, they were beating out nails on an anvil. How do they make them now? They squeeze them out like spaghetti. You can buy nails today, 1955, for a fraction of what nails cost in 1800.

We pride ourselves on our genius in manufacturing and invention. Manufacturing skills have been increasing throughout our history. What I am saying is that since 1800 and up to 1941, the cheapening effect of productive skill and invention was to bring prices down for some commodities enough to offset the effect of growing scarcities in lumber, fuel, and food that were moving prices in the other direction.

What does the future hold? I don't think that we are going to have a repetition of the experience after those other wars of prices going down as they did then. Prices have come down a little bit from the level reached in 1951. I don't think they will ever go back to where they were in 1940, and I hope they don't. If they did, we wouldn't correct the evils of inflation; we would simply add to those evils the still worse evils of deflation.

The proper policy is not to go back to where we were, which would be a catastrophe to us all, but to try to hold prices where they are and not allow them to go up again at an inflationary rate. There is a reasonable expectation that we can do that. In any case it should be a major goal of monetary policy.

QUESTION: I believe it is alleged that Rothschild said that if he could control the monetary system and print money, he could control the economy. My question is, if the President were able to appoint members to the Federal Reserve Board--it is my understanding that he no longer can--he could control the economy through his agency. If this be true, who controls our money?

DR. WHITTLESEY: He nominates the members of the Board and they are confirmed by the Congress. The Executive and the Congress are both involved. Technically, the Federal Reserve System is a creation of the Congress. It is responsible to the Congress, and in that

sense Congress is the ultimate monetary authority. But Congress has to delegate a lot of things. It delegated this particular task to the Federal Reserve. Thus the Federal Reserve is the primary authority, but, as I said earlier, with debt as important as it is today and with public debt primarily a responsibility of the Treasury, we have two monetary authorities, the Treasury and the Federal Reserve. For a time they weren't working smoothly together; today they are. The quick answer I would give is that our monetary system is controlled by the Treasury and the Federal Reserve and will continue to be.

As to Rothschild's remark, he was saying that if he as an individual could do anything he wished with the monetary system, could print money and soon, he wouldn't care anything about law. Neither should I. But monetary authority is not in the hands of mercenary individuals like you and me and Mr. Rothschild. Monetary policy is not going to be carried out for reasons of personal gain.

Monetary management is entrusted to people who are responsible and who at the same time are subject to a lot of checks. The one criticism you can make against the Federal Reserve is not that it is arbitrary and abuses its authority, but that sometimes it has been afraid to act. It has tremendous power technically under the Federal Reserve Act, but you don't have to worry about abuse of that power. We are just not that kind of people and it is not that kind of system that we live in. If you want to worry, worry for fear that the Federal Reserve will be too cautious and won't do all they might.

QUESTION: Would you comment on the elements or probably the pitfalls of deficit spending and the rising national debt, the advantages possibly of reducing it or allowing it to stay?

DR. WHITTLESEY: The problem of a great national debt and the issue of deficit financing, is that it, substantially?

QUESTION: Yes.

DR. WHITTLESEY: The basic idea is the principle of total effective demand, that is, that we should have some ideal level of spending. The particular application of the idea is that the Treasury with the aid of Congress can undertake to influence the stream of spending, to check spending when there is too much and to encourage additional spending when there is too little.

How can it do this? Well, if there is too much spending and people are forcing prices up, the authorities can go out and impose consumer taxes and reduce the amount of spending. Alternatively, in a period of depression, the assumption is that there is not enough spending. Let the Government at that time go out and borrow from the banks. Money will be created. Nobody's ability to spend is less. New money has been created that enables people to spend more so that total spending comes up closer to the ideal level. The theoretical assumption is that the spending of money causes production to take place that would not have taken place otherwise. Nobody is poorer because nothing has been taken away. Increased production comes out of the slack that would otherwise exist in the form of unemployment and idle capacity. This, briefly, is the policy proposed by Lord Keynes whose name is anathema to many but who has made a lasting contribution in the field of economics.

Most conservative bankers of my acquaintance accept this idea. Our leaders in the Federal Reserve and elsewhere presumably believe it. But most people recognize that it is not as easy to administer in fact as it is to describe on paper. I can illustrate why. For it to work effectively in a period of inflation such as we had after Korea, taxes should be increased. It just happened that that was in 1950 and 1952, and what was going on in each of those years? An election. So do we raise taxes? No, we don't raise taxes. Thus we are up against certain political realities, the fact that Congress is more willing to expand expenditures than to raise taxes. The great problem in a democracy is the difficulty of applying this theory.

A point of view on the proposal might be something like this: Here's an important idea. It is not going to be easy to administer, and we had better make use of the familiar general credit controls which the Federal Reserve has at its disposal. But let us bear in mind that there is this other fiscal recourse as well, and let us study it and try to develop it in such a way that we can make use of it along with the other methods of promoting stability and growth.

What does all this have to do with the deficit? It means that deficit financing is desirable under certain circumstances, that we should be willing to increase deficits in a period of depression. But the further implication is that, by the same token, and for the same reason, we should be willing to practice surplus financing. Deficit financing in a depression phase of the cycle should be accompanied by surplus financing in an inflationary period. That is the ideal policy.

Unfortunately, as in the case of some other ideals, we haven't so far achieved the skill or force of character to pursue the ideal consistently. The difficulty is to apply it as we should in the surplus phase. Nevertheless, we can't undiscover what we have learned. We are going to use it, and, as citizens, we should put our support on the side of those who are willing to apply it logically over the whole period. Deficit financing in the depression phase calls for surplus financing in an inflationary period.

QUESTION: Will the debt ever be retired?

DR. WHITTLESEY: Never. Moreover, we don't want it to be. If we were to pay off the national debt completely, as our monetary system is constituted at the present time, it would destroy our money and wipe out the resources of a large part of our financial institutions. We are adjusted to a large volume of public debt and there is no human possibility of its being eliminated. There is a possibility that it can be reduced somewhat, and that it can be increased and decreased in such ways to promote greater stability.

QUESTION: Does it have an optimum level?

DR. WHITTLESEY: No. The optimum is only in relation to that principle of total effective demand. It should go up when that will help promote stability and it should go down for the same reason under opposite conditions. Personally, I would like to err on the side of reducing it for this reason: If we came to another war or another emergency situation, we might be handicapped by having as large a debt as we now have. In peace we should reduce it to more manageable proportions to give us greater latitude. At the end of the war the debt was about where it is now. Our national income is much greater than it was at that time. We haven't reduced the total debt but our national income has risen to such an extent that it is a much smaller proportion than it was then. Relatively it has been reduced, but that is not enough.

QUESTION: We have in this country a growing body of pensioners, both under Social Security, Government and industry. Is this growing body of perhaps nonproducers going to be a factor for stability or instability in the economy?

DR. WHITTLESEY: Undoubtedly for stability. I realize that you may have some reservations as to whether this is a good thing or not on balance, but it does mean that income can be expected to continue on a more stable basis than in the past. There are other elements. We have to consider the pensions not only of current pensioners but of the potential

pensioners as well. In a period of depression, unemployment insurance adds greatly to the payments received by pensioners. Unemployment insurance automatically tends to stabilize the economy. It takes money out of the spending stream in a period of inflation and puts it back in a period of depression. It means also that in a period of declining national income the Government would be forced to borrow in order to meet some of those payments. That is automatic deficit financing with all this means in terms of resistance to business decline.

A good many people shake their heads about all this. Personally, I think you can make a strong case for it. At any rate, it is the world in which you live, and will continue to live. Anybody who thinks that it can be disregarded is certainly not being realistic.

DR. KRESS: Dr. Whittlesey, on behalf of General Hollis, the faculty and the students, thank you for a most interesting discussion. Thank you very much.

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