ECONOMIC STABILIZATION

4 February 1960

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COLONEL REID: General Mundy, General Houseman, Admiral Patrick: I have been told by a renowned public-speaking expert, Professor Stevens, that many good speakers start out their speech by relating it to a historical event which occurred on the same date sometime in past history. I did quite a bit of research to find something related to this day. The first thing I ran across was the Yalta Conference, which had occurred on 4 February 1945. Going a little further back, I found that in 1787 there has been a tremendous earthquake at Cabalis, Italy, which killed some 50,000 people. Incidentally, our fledgling Nation was not quite ready then to assume its international catastrophe relief role.

But I wanted to get a little closer to today's subject, and finally I found it. On this date, 4 February, 270 years ago, the first paper money was issued in America to pay the soldiers who fought for Massachusetts in the war against Quebec.

I realize that many eminent economists have preceded me here on this platform and that the question periods following their talks have on the whole been outstanding. I know that some of you take a little bit of time during the lecture to write up questions to ask the speaker during the question period. However, this will not be necessary during this lecture, because the question period for this lecture will be postponed until your organization meetings this afternoon.

Now, let's take a look at the position that our Nation is in today. These are some of the problems with which we are faced:

1. Khrushchev talked to the U.N. in October and brought up the subject of disarmament.

2. The spirit of Camp David, or Thaw, which was established by President Eisenhower and Khrushchev in October.

3. The U.N. debate on Hungary.

4. Nehru and his border troubles and his dilemma of choosing between Communist China and the free world.

5. The President's "Journey to Understanding" in December.

6. NATO and the French insistence on the segregation of forces.

7. Berlin, which is an always present problem with us.

8. The steel strike settlement, in January.

9. Two weeks ago, the President, in his Economic Report of the President to Congress, stated a continuing determination to hold the line against further price inflation.

10. We have the summit meeting coming up in May.

11. This is a presidental election year.

It's like opening Pandora's box and, after all the furies have flown, hope is left in the bottom.

Each of these items contains seeds of hope for the many unanswered questions in our search for solutions to economic stabilization in the cold war, limited war, and all-out war.

In the Foundations Unit last fall we covered the principles and theory of economics. In Unit V you will apply these principles to the national and international economic problems of the day. Some aspects of this subject are naturally quite controversial. In these cases we invite you to read, to listen, to discuss the issues, and then to arrive at your own solution.

You have heard two or three different sides of the various economic problems from this platform over the past six months. Some speakers have stated that what we require is 1.5 to 2 percent inflation for economic growth. One speaker stated that inflation prevents economic growth. Another said, "We must reduce the national debt," and a following speaker said, "There is nothing wrong with the present national debt." Then we had a speaker who stated that what we require is a good monetary policy. He was followed by a Federal Reserve Board speaker who stated that the present monetary policy is adequate.

Now you are going to have the opportunity of reasoning out your solutions to our economic problems and of presenting them from this platform on 23 February. I'm sure you will arrive at an "engineering" solution.

Of course, some of you may not have received the same answers from these various speakers that I did. We have always had trouble with communication in the English language.

I am reminded of a story which will bring this out. There were three nuns walking through the yard of a convent one day. Each had just received a $100 gift, and they were deciding what they were going to do with their money. The first nun said that she would present hers to the local Catholic charities. The next nun decided that she would give hers to the Church. The third nun just couldn't quite decide what she was going to do with her money. However, she recalled that she had seen a little urchin who periodically stood by the gate at the Church. She walked to the gate and sure enough, here was the little boy. She decided here was one boy who was going to have a wonderful Christmas this year. So, she handed him the $100, patted him on the head, and said, "God speed." He took off like a bird. She didn't see him again for a few days, and then one day he was standing out at the gate motioning to her. She walked out. The little boy handed her $700. She said, "What's this for?" He said, "God Speed came in first in the fifth."

Now, during the next 30 minutes I will cover the four items listed on this chart:

Economic Controls

Stablization in National Emergencies

Current American Stabilization Scene

International Economic Stabilization

However, before I get into the items on this chart, it would be well to define what I mean by economic stabilization in this talk this morning. In your reading assignment in R-217 last night, we talked about what to do to bring economic stability back once it has been disturbed. My concern in this talk is a definition which will maintain economic stability.

Chart 1, page 5.--The definition of economic stabilization is:

That state of comparative equilibrium of price-cost-wage-profit relationship within a nation which does not result in inflationary or deflationary fluctuations and permits the maintenance of a competitive position for that nation's goods in world markets.

This definition does not connote economic rigidity but it does infer the absence of violent or unnecessary fluctuations to economic equilibrium. Stability does not imply the arrest of a desirable process of change in economic conditions, nor does it infer a static situation. It does require, however, that changes in economic conditions be gradual and orderly, so that we may adjust to them without undue social, political, or economic distress.

Assuming acceptance of this definition, for the purposes of my talk, what are the types of economic controls, and why do we need or desire economic controls to maintain stability?

First, as to types: They fall into two immediate categories.

Direct controls are those controls put into force only in emergencies.

Indirect controls are those controls which are in force and with us every day.

Looking first at our situation in times of actual conflict, history shows that there exists a strong post-D-day tendency for prices to get out of hand, shortages to develop, and for production of materials, finished goods, labor, and capital to be diverted to uses inconsequential to the winning of the war.

Controls are necessary to restrain unessential consumption, to keep down the legacy of the national debt, and to channel all resources and effort into areas which contribute materially to the winning of the war, and further, controls are required to provide an orderly transition back to a strong peacetime economy upon the cessation of hostilities.

CHART 1

ECONOMIC STABILIZATION

THAT STATE OF COMPARATIVE EQUILIBRIUM OF PRICE-COST-WAGE-PROFIT RELATIONSHIP WITHIN A NATION WHICH DOES NOT RESULT IN INFLATIONARY OR DEFLATIONARY FLUCTUATIONS AND PERMITS THE MAINTENANCE OF A COMPETITIVE POSITION FOR THAT NATION'S GOODS IN WORLD MARKETS.

With the evolution of our industrial economy, our experience after various wars and during depressions, the peacetime role of the Government in regulating our free-enterprise system to achieve both social and economic ends has in contemporary society gained general acceptance, even though all may not be in complete agreement with the Government in its manner of handling particular situations.

Chart 2, page 7.--Some of the more common economic controls, used whenever the Government decides that they are necessary, are: monetary policy, or controls on the open-market purchases of bonds and securities and sales of Government securities, discount rates and operations, and changes in reserve requirements of Federal Reserve member banks.

Chart 3, page 8.--The Federal Reserve Board, you will recall, can make money easier by blowing a breath of life on it, as you see on the left, or tighter, by quenching overexuberance, depending on the manipulation of these controls.

Under credit controls we have consumer credit, home mortgage loans, farm loans, and small business loans. These are handled by other Federal agencies.

Fiscal controls, or those controls which provide the Government with the ability to obtain income and make expenditures, are closely related to monetary controls. Fiscal policy affects the total volume of national spending, taxing away from private sectors and spending amounts greater or less than those collected. The most influential fiscal measures involve deficit or surplus budgets, reducing or increasing aggregate demands, and thus providing inflationary or deflationary impulses to our economy.

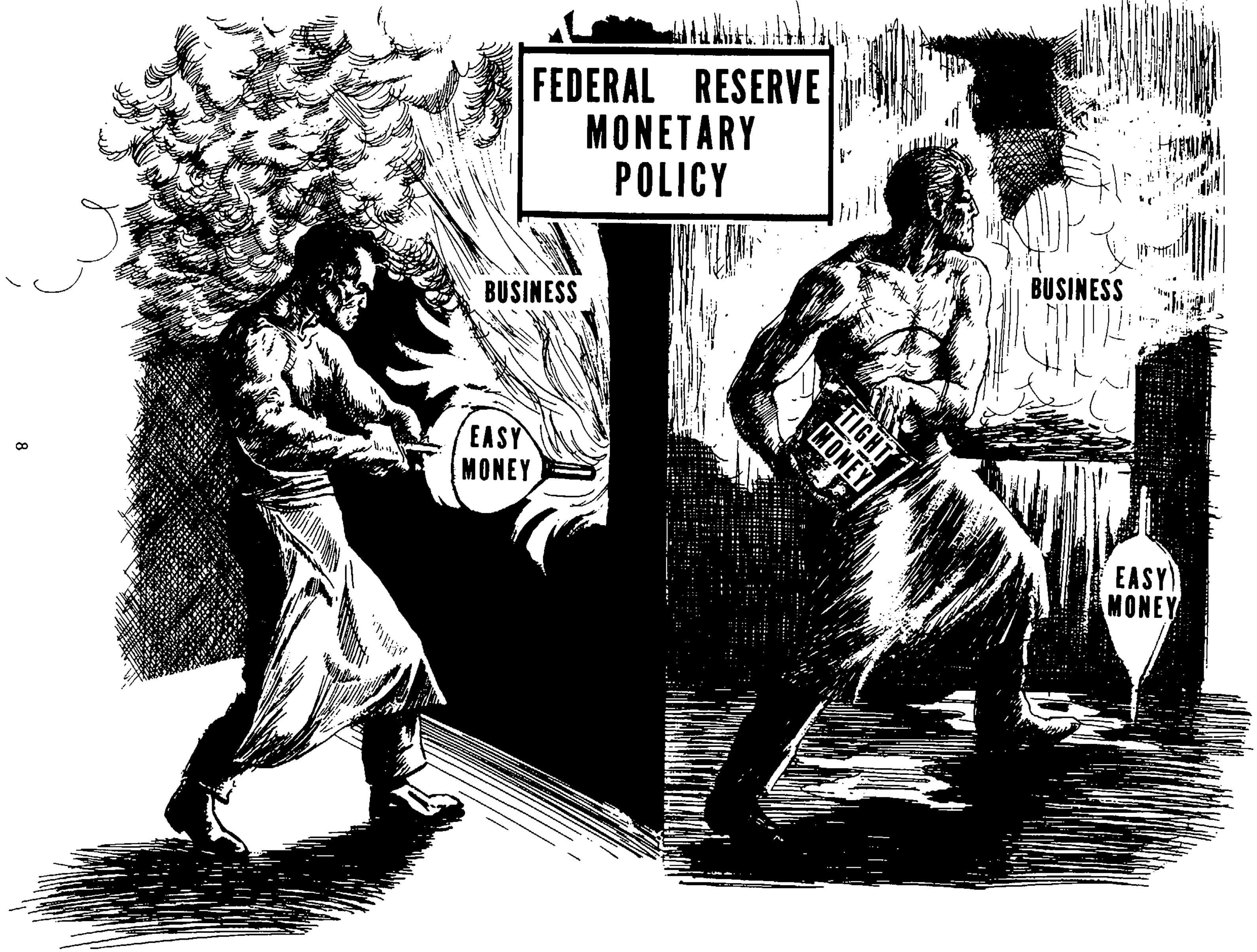
Another indirect control is moral suasion. This was used very effectively during World War II, reference the bond drives, and it has been used by the present Administration at different times with varying degrees of effectiveness. Moral suasion has a difficult time in persuading individuals to act against what they consider to be their own best economic interests, unless it is accompanied by more direct measures or there is a general realization of an overpowering need for the recommended action.

CHART 2

ECONOMIC STABILIZATION MEASURES

INDIRECT CONTROLS	DIRECT CONTROLS
MONETARY POLICY	WAGE AND SALARY CONTROLS
CREDIT CONTROLS	PRICE CONTROLS
FISCAL POLICY	RENT CONTROLS
MORAL SUASION	CONSUMER RATIONING
	ALLOCATIONS AND PRIORITIES

CHART 3


FEDERAL RESERVE
MONETARY
POLICY
BUSINESS
EASY
MONEY
BUSINESS
TIGHT
MONEY
EASY
MONEY

While indirect controls influence the overall financial environment, direct controls act more specifically upon the individual and the firm in their business transactions. Direct controls supplement and accentuate the indirect controls. They deal directly with the effects of instability and, in combination with the indirect controls, direct controls treat the real causes which relate to excesses of demand and purchasing power relative to the amount of available products.

Although I may have left the impression that it is the amount of money available that causes disequilibrium, the real cause is not the amount but how the money is spent. How much people spend in any period depends on many factors. The size of their current incomes, the difference between current incomes and past incomes, and what they think might happen to their incomes in the future are all important.

The spending of the public is also affected by prices, by what people think is going to happen to prices in the future, by the amount of liquid savings they have, and by the amount of their not-so-liquid holdings, such as homes and securities.

Businessmen, like consumers, also consider their income, assets, liquidity, future needs and profits prospects, plus their confidence in the future of the economy, in making their own spending decisions.

Thus, we conclude that monetary and fiscal controls play an important part in determining the size and the nature of our national output in peace and in war and in that peculiar situation which we find ourselves in today, that in-between state, the cold war.

Prices, of course, are only one indication, although an important one, of the economic dislocations of wartime. Let's look at the range of commodity prices in the United States for major war periods over the past 150 years.

Chart 4, page 10.--(Commodity Price Index in Major War Periods). Note that this chart is broken down into four areas:

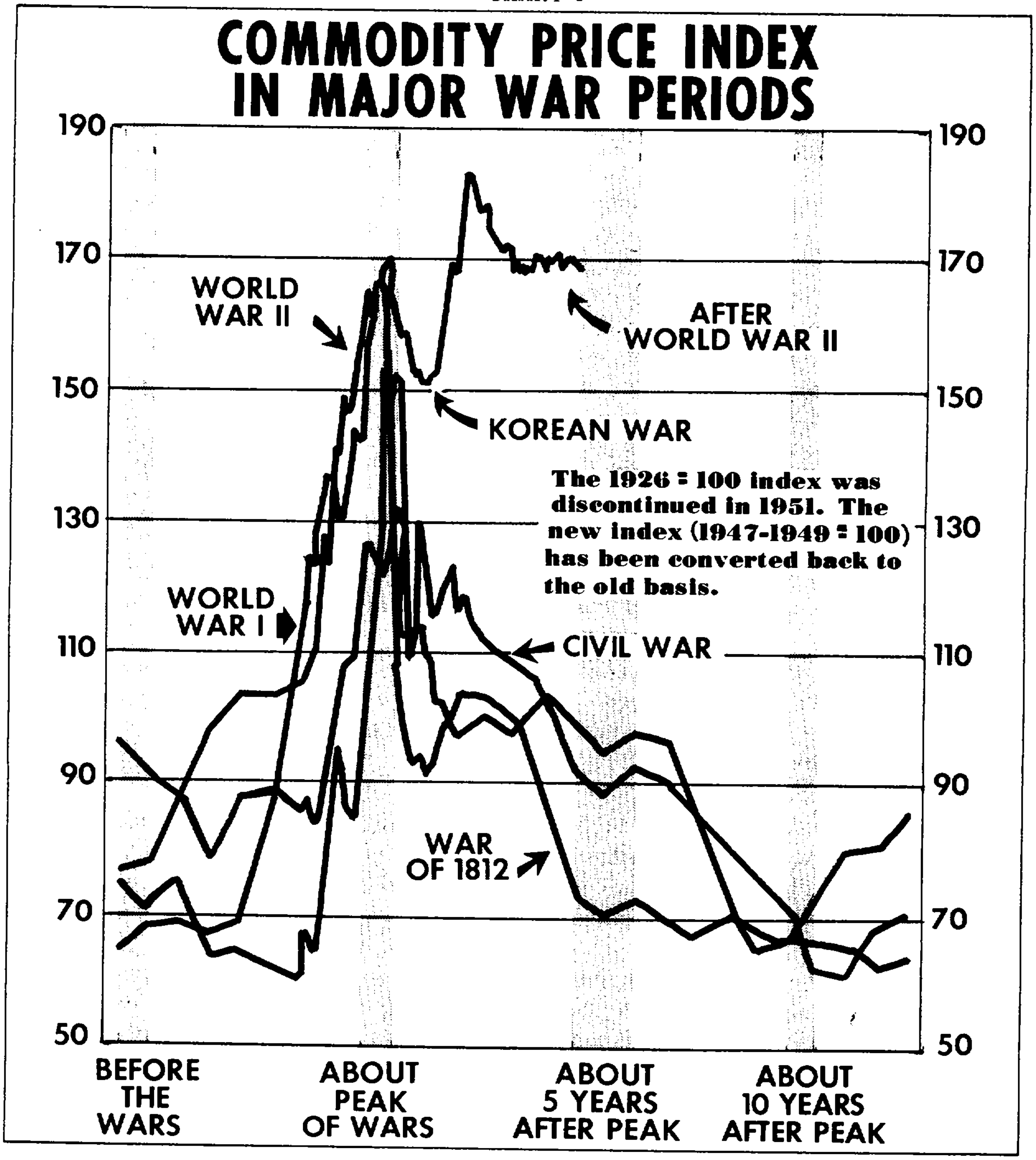
Before the wars

About the peak of the wars

Five years after the peak

Ten years after the peak

CHART 4


COMMODITY PRICE INDEX IN MAJOR WAR PERIODS
190
170
150
130
110
90
70
50
WORLD WAR II
AFTER WORLD WAR II
KOREAN WAR
The 1926 = 100 index was discontinued in 1951. The new index (1947-1949 = 100) has been converted back to the old basis.
WORLD WAR I
CIVIL WAR
WAR OF 1812
BEFORE THE WARS
ABOUT PEAK OF WARS
ABOUT 5 YEARS AFTER PEAK
ABOUT 10 YEARS AFTER PEAK

It starts off with the War of 1812, and includes the War Between the States, World War I, and World War II. In each instance of our engagement in a major war, prices have skyrocketed tremendously, and, upon the conclusion of the war, they have come back down to relative prices again. This happened in each case except for World War II. Prices started down at the end of World War II, and then the Korean War came along and they skyrocketed once again, dropped off by approximately 12 percent, and then our commodity prices gradually leveled off and have remained fairly stable up to this point.

This should bring up the question: Why? Is this merely a postponement of past wars' patterns which may catch up with us again at any time? Is this a result of the manipulation of the monetary rate by the Federal Reserve Board? Or is this a combination of the actions taken by the Government under the Employment Act of 1946?

Remember, in looking at this chart, that our systems of controls were not so sophisticated earlier in our history and that the Federal Reserve Board was not established until 1913. Remember also that the cost of war has been accelerating at an astronomical rate, some claim by multiples of 10, and that as a result the pressures on our economy have consequentially become greater. Thus, our Nation has found it necessary in each successive war to employ stronger and more numerous controls in order to reduce the strains on our economy.

I shall not dwell longer on the historical aspects of controls and stabilization, as there is a wealth of material available in the library on this subject. We will all agree, I believe, that, if we are going to survive in either a limited or an all-out war, we must have a strong economy during this cold-war period.

Meanwhile--back at the ranch--or for those of you who have no 5-to 15-year olds watching TV westerns--I direct your attention to the third item on our chart, the current American stabilization scene.

I mentioned earlier that a number of our speakers during the Foundations Unit had commented that they saw nothing wrong with a small amount of inflation. It has become commonplace to say that gradual or creeping inflation is a necessary companion to economic growth. Even people who recognize the evils of inflation wonder if price stability can be achieved only at the cost of stopping economic growth.

Last July at the United Nations Economic and Security Council, United Nations Secretary Dag Hammarskjold asked whether the economically developed nations were not paying too much attention to the dangers of price inflation and too little to the needs for economic growth. Mr. Hammarskjold said:

"Are we not, perhaps, rather inclined to resolve the conflict between stability and growth too exclusively in favor of stability, to the detriment, to the vigor and dynamism so characteristic of the world economy during the first postwar decade."

Replying to Mr. Hammarskjold, Mr. Roger Auboin, former general manager of the Bank of International Settlements and the French representative of the Council, pointed out France's experience with the measures introduced by President De Gaulle in 1958 to stop what had been a continuous period of inflation in France since World War I. Mr. Auboin said:

"The reforms have not accentuated the slowdown in business; quite the contrary, they have brought about a recovery which is now unmistakable . . . An entirely new situation has thus emerged in France--a situation eminently favorable to vigorous expansion. This will enable my country to keep its place among other industrial nations that are now resuming their march forward."

Another vote for price stability came from Mr. Karl Blessing, the president of the German Central Bank, at the World Bank and Fund Meeting in October. Mr. Blessing stated:

"We have listened with some surprise to discussion that conveyed the impression that there might be a possible conflict or even an incompatibility between a policy of monetary stability and a policy of economic growth.

"In our minds there is no doubt whatsoever that there is no conflict between stability and growth. And even more, we are firmly convinced that stability is one of the main prerequisites of sustained growth.

"This conviction is based on theoretical consideration as well as on experience. Germany's postwar development, in my opinion, shows clearly that a policy of monetary stability pays good dividends in economic growth."

Inflation provides an insecure basis for growth. All history shows that inflation never goes on forever. As Mr. Per Jacobsson, Managing Director of the International Monetary Fund, a distinguished international economist and, incidentally, one of our lecturers later in this unit, has noted, inflationary methods of finance do not provide a durable basis for sustained growth. Reliance on them "is bound sooner or later--and often sooner rather than later--to result in monetary crisis."

It is better to forestall crisis and knock out the disease. But even this can be painful. Mr. Jacobsson points out that "the implementation of a stabilization program designed to eliminate inflation will almost invariably be followed by a period in which certain hardships are experienced and the rate of economic expansion somewhat reduced." Thus drastic retrenchment becomes the price to create the basis for resumed economic growth.

Your classmates, Drs. Parker, U.S. Navy, and Timmerman, U.S. Army, would say in their own inevitable medical manner, the best thing is to avoid the disease entirely.

Dr. Winfred Reefler, assistant to the Chairman of the Federal Reserve Board, spelled out the reasons "why inflation is the enemy to growth" before the Stanford University Business Conference in August. Dr. Reefler pointed out that inflation aggravates instability in our economy. Overspeculation in inventories and premature additions to plant capacity, in order to beat price rises, have an inevitable aftermath of recession as inventories are cut back and excess plant capacities become widespread.

Moreover, Dr. Reefler felt, inflation and the expectation of inflation would "impair the quality of management investment decisions and thus promote the misallocation of capital." As a result nations would get "less growth per dollar of investment" during inflationary periods. He also stressed the adverse effect of inflation on savings.

Inflation eventually brings about a balance-of-payments crisis. We are in the position now where rising costs in our country are pricing our goods out of world markets and at the same time our inflated prices here at home are creating a demand for imported goods. For a time our gold and foreign exchange reserves covered essential imports, but we are reaching the point now where the danger of devaluation is driving money into short-term claims against the United States, the liquidation of which could send money out of this country. At the same time long-term demands for money are driving interest rates even higher.

It is often overlooked that the United States recorded one of the most rapid growth periods in its history during the almost 30 years following the War between the States. During this period there was a considerable decline of prices. Production almost tripled from 1869 to 1896 while prices declined 29 percent. According to studies made by Professor Simon Kuznets at the National Bureau of Economic Research, the United States gross national product, measured in constant dollars, rose 4.9 percent per year, compounded annually, during this period, 1869 to 1896. Net capital formation--that is the admissions to the Nation's plant and equipment, which are the foundations of future growth--increased 5.7 percent per year during this period. This experience refutes the idea that inflation is necessary for economic growth.

Secretary of the Treasury Anderson points out the later periods in our history. He stated:

"From 1910 to 1915, for example, manufacturing production increased 30 percent while prices showed moderate decline. During the decade of the 1920's, we had one of the most notable periods of sustained economic growth in the history of our country prior to World War II, with national output rising 50 percent in eight years. And yet, this decade was characterized by remarkable price stability. Between 1951 and 1955, again a period characterized by relative stability in the broad indexes of wholesale and consumer prices, we reached the most prosperous levels attained in our economy up to that time."

Secretary Anderson implies what we all suspect; most of the price inflation in the history of the United States has been either the accompaniment or the aftermath of war. History shows that, in periods uninfluenced by war emergencies, growth goes hand-in-hand with relatively stable prices.

To quote from another economist, Neil H. Jacoby, Dean of the UCLA Graduate School of Business, summed up the record in July before a life insurance symposium in New York. Dr. Jacoby said:

" Most thoughtful Americans have come to this conclusion: If individual prices and movements of capital are flexible, as a result of adequate competition in open markets and in absence of governmental interference with farm and other prices, then the real growth of the United States economy is fostered by a dollar of stable value. Even a gradual inflation of the price level, once it becomes generally expected, impedes real growth. It results in less savings, misdirected investment, speculation, looser management, and lower productivity. When people expect long-run stability in the price level, their behavior promotes the growth of production."

The instability of the numerous governments of France from the end of World War I until late 1958 is attributable in a large part to an inflation which cut the value of the franc from 20 cents in 1914 to one-quarter of a cent in late 1959. The rise to power of Hitler in Germany certainly may be attributed in a large part to the terrible hardships inflicted on the German people and the deep social upheavals created by the collapse of the mark as a result of the flood of printing press money. A more recent example is the fall of the Nationalist Chinese Government on the Mainland and the consequent taking over of China by the Communists. This happened when the Chinese dollar in relation to the United States dollar fell to $8.683 million Chinese to $1, United States.

Some of our faculty members have quoted Confucius and some Sun Yat-sen. I would like to quote from a little-known Chinese author, Chang Ki-gnaw, former president of the Bank of China, in a book which he wrote to point out what happened prior to and during the fall of the Nationalist Chinese Government. He said:

"Not possessing the wisdom and courage to undertake unpopular measures, the government could of course have reduced the scale of its spending. But it persisted in its refusal to take any effective step to trim expenditures, and, overemphasizing the importance of prestige and outward military power, it underwrote political and military expenditures regardless of their economic consequences. It was curiously blind to the fact that in the long run economic health is a prerequisite of political power. It sought an easy way out of its financial difficulties, only to court eventual disaster."

I submit in my own humble, uneconomic opinion that, if we don't strongly curb inflation, we will again face the boom and bust, the depression and panic, on a scale unprecedented in our history. Because of our position of world leadership, thrust upon us by world events, the failure of the United States to come to its fiscal senses and avoid the awful consequences of the possible inflation looming ahead would have repercussions of enormous significance. The collapse of the credit of the United States could easily lead to the collapse of the free world, or at least to more inroads by communism into the free world.

In summing up this portion of my talk, I would like to review what many economists feel are the causes of our present financial state. These causes are not listed in any particular priority.

1. The large Federal debt and the constant growth of State and local expenditures.

2. The rise in wages at a greater rate than that of productivity, with the resulting higher costs of production.

3. The growing importance of the service industries and the constant rise in the cost of services.

4. The level of corporate taxes which are part of the cost of production, the numerous excise and sales taxes, all of which have a bearing on the cost of living.

Then I would ask you to ask yourselves these questions:

Does a rising price level stimulate production more than would stable prices?

Does emphasis on full employment and rapid economic growth require acceptance of creeping inflation?

Do increacing governmental expenditures and public debt necessarily produce inflation?

Does upward push on prices by powerful labor unions, big business, and subsidized agriculture cause the price level to rise even in the face of unemployment?

Now, let's take a quick look at what has transpired on the international scene in the way of stabilization--our fourth and last item on the chart.

Recently the Federal Reserve Bank of New York conducted a study to determine if inflation was inevitable and even helpful to growth in economically underdeveloped nations. They compared economic growth in 16 underdeveloped nations, 8 of which had rapidly rising prices, and 8 of which had relatively stable prices during the period 1950 to 1957. Cautioning that international comparisons are difficult in this instance because the data are often not strictly comparable, the bank came up with this principal generalization, that "while stable prices tend to promote an orderly and fairly rapid expansion in output, inflation tends to lead to an uneven and in many cases lagging rate of overall growth."

The bank determined that " . . . the countries where prices advanced moderately or not at all during the period 1950-57 . . . experienced rates of national expansion which by and large were steady and which clustered around an average of close to 6 percent annually. In contrast the countries where sustained inflationary pressures developed during the period have shown widely varying and somewhat sporadic growth; with the average rates of about 4 percent for the whole group.

"It was found that in nations with rapid price increase--including Chile, Bolivia, Argentina, and Thailand--mounting inflationary pressures were accompanied by lagging output. In some years output actually declined in the face of rising prices. For the period as a whole, Brazil and Turkey achieved vigorous rates of economic expansion despite the fairly intense inflationary pressures, but only at the cost of incurring considerable foreign indebtedness. In Mexico, the only case cited of rapid, well-balanced economic growth despite inflationary pressure, the authorities are now devoting considerable effort to curbing inflation in order to establish a foundation for sounder economic advance."

The New York bank concluded that economic development through inflation has repeatedly been found to be a hydraheaded monster. As a conscious economic policy it is certainly unacceptable. Price stability is not a luxury that only a few countries can afford, nor is it a goal unattainable by a country attempting to launch an economy on a road to cumulative economic growth. If this were not so there could be no balanced or lasting economic development.

It is true that the limitation of general movements in prices is never steady and certainly has no single formula; but, as we have been taught and have practiced for years in the military, the effective resolution of any problem, great or small, depends first on a recognition that the problem exists and its nature. These countries recognized that reasonable price stability was not an alternative to economic development but an essential condition for its achievement.

In conclsion, economic stabilization measures are integral to and ever present in an industrial society. In peacetime various indirect controls may be used to prevent serious disruptions to the economy and to maintain a strong going economy.

Western Europe is undertaking new and important steps toward economic collaboration and stabilization. Elsewhere in the world, many of the economically underdeveloped countries are attempting to profit from our mistakes and are trying to find shortcuts to reach the economic and social benefits which more highly developed countries have required generations to achieve.

Today's situation is unique in history. For the past 15 years a formidable world power has applied constant pressure on its periphery nations. The only other equally great world power, sensing the eventual danger to itself and to the rest of the free world, has undertaken the task of containing this creeping aggression while at the same time building up the rest of the free world to resist. The economic requirements of the struggle are hindering our ability to maintain stability and the soundness of growth. At every council table hovers the specter of Mars.

Illustration, page 19.--Can it be that a statement reiterated in New York last September may some day come to pass?

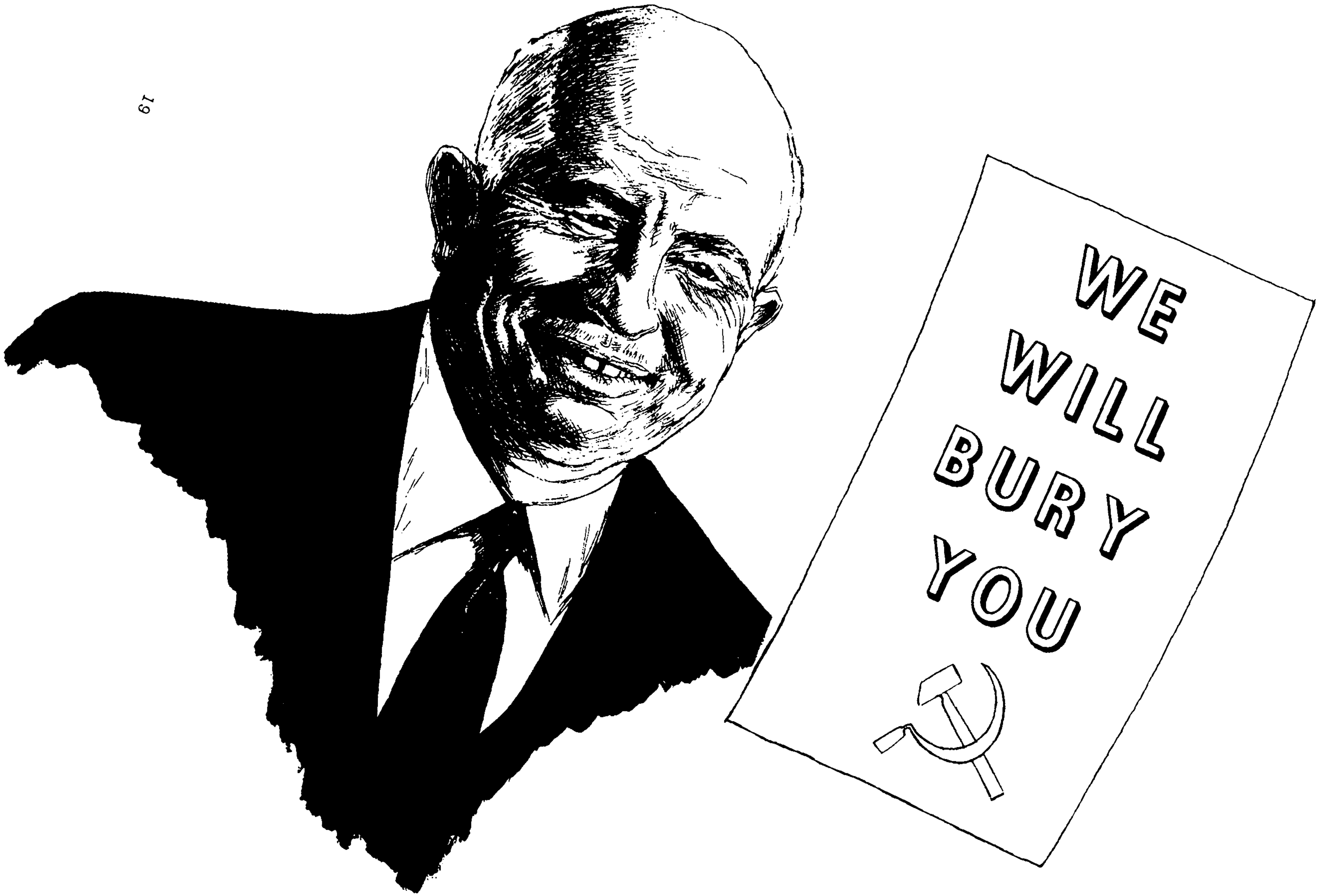
I will be followed at 10:30 by a speaker who will represent a liberal viewpoint on the expansion of industry perhaps with considerable Government assistance. On the 12th of this month a more conservative viewpoint will be presented.

Incidently, I might point out that both of these speakers have served on the Council of Economic Advisers to Presidents.

By the way, my own views as expressed here this morning do not necessarily represent the views of the sponsor, either.

Thank you.

(30 August 1960--4, 600)O/mr:dw


WE
WILL
BURY
YOU