

5. Hope without Expectation

THE INTEREST of the Board of Governors as well as my own in decisions affecting the search for peace was not unnatural. Whatever was done in our foreign-aid and military programs after V-J day had clear implications so far as our domestic economy was concerned. If we established the conditions of peace in the world, then we could proceed with some degree of confidence in planning a rational economic future for ourselves and our children. If we could not establish those conditions, then clearly we would be required to live under conditions governed by the requirements of an adequate preparedness program. Such a program would entail great and unhappy adjustments in the kind of economy to which we were accustomed and which we expected to re-establish and maintain after the war.

In the years after V-J day the sense of frustration I experienced in trying to deal with inflation on the domestic front was paralleled by the frustration I felt when I assayed in economic terms what our failure to establish a basis for peace in the world would mean for us. In April 1948, while testifying before the Joint Committee on the Economic Report, I put the issue to the committee and to myself in this form:

We may well ask for how many years we must maintain enormous and probably expanding military expenditures and foreign aid. The question is, how long, to what end, and at what consequences to our economy? We do not have the inexhaustible supplies of manpower and resources to support indefinitely, with no end point in sight, programs of the magnitude which [would be called for in an armament race both at home and abroad, in addition to a continuation

of foreign aid]. We cannot go on year after year bearing these crushing costs without jeopardizing what we seek to save. If we were confident of the early establishment of peace, we could tolerate a tightly controlled economy. We believe that the time element is the very essence of this problem.

My continuous concern with the trend of international affairs since the end of the war was also reflected in an address I gave on April 8, 1949 before the Commonwealth Club of San Francisco. I said at that time:

In any realistic appraisal of the outlook today we are bound to ask ourselves whether we are embarking on the road to peace or to war, and whether we are not relatively better prepared now—or could soon become better prepared—to enforce a settlement than we will be five years from now. Certainly the Soviets have not been idle since the war ended in strengthening their position—nor will they be idle in the future. There is every indication that they are consolidating their position and mustering their strength as rapidly as they can. You can find little hope in reading history that a competitive armament race is the way to avoid war.

On the sea and in the air we are unquestionably in the same relative dominant position today to enforce a peace that the Allies were at the end of World War I, and especially so while we have the monopoly of the atomic bomb. The democracies then could have stopped Nazi rearmament and kept the Japanese from invading the continent of Asia. There need have been no Munich and no Pearl Harbor.

If we look back over the chaotic interval since the end of World War II such comfort as we may derive from our success during this past year, 1947, in western Europe is more than offset by the extent to which we have been losing the cold war in the Orient. Desirable as the Atlantic Pact and the rearmament of western Europe may be, we must not be lulled into the belief that they are final answers to the problem of lasting world peace. They deal only with effects and not with basic causes.

It has seemed with increasing clarity to me that the best way to avoid ultimate war, the best hope for peace in our time, is to con-

front the Soviets with the decision which will lay the foundations and the conditions of a lasting peace while we have the strength to do so. If the Kremlin is not willing to accept such a settlement, backed up by the physical as well as the moral force of free peoples all over the world and by countless others now enslaved, then is it not better to know it as soon as possible? Will this menacing cloud that hangs over the world grow less threatening if we procrastinate and postpone a settlement?

It is obvious that we did procrastinate and did postpone getting a satisfactory settlement with Russia while we had every chance to do so had we been tough enough. Such a settlement would have brought about a condition of peace in the world. During the past five years we have had adequate notice of Russia's intentions. We have had every opportunity to enforce the conditions of peace with little risk of war. As a result of our past failures, we now face the very conditions that we most feared. We have lost strength rapidly relative to the increase in the strength of Russia and her satellites.

What alternatives do we now have?

We can do nothing more than was done up to the outbreak of the Korean war. Should we do no more, we shall lose not only our existence as an independent nation, but we shall also probably lose our lives.

We can engage in a preparedness program aimed at taking the offensive, calling for an immediate mobilization of all our resources and manpower and those of all the other nations that are willing to join with us in getting prepared as rapidly as possible to enforce the peace. It would be expected that such a program would have a time limit, and therefore a limit to expense. This is called a preventive war.

We can engage in a program preparing us to defend ourselves, always hoping to prevent war by being ready for it. Such a program must be limited to an annual cost that the people would accept and pay for currently, because it would have no time limit.

Taking these three alternatives in their order: the first one, of doing nothing more than was done up to the time of Korea, has been repudiated by events, by the public, and now by our political leaders. The second alternative, referred to as a preventive war—and again I mean by this the enforcement of the conditions of peace at the risk of war—would at this late date be more likely to make war inevitable. And, in any case, the concept of a preventive war has been alien to our past traditions and has been rejected by the present leaders of our government. If Russia continues to take the initiative through her satellites, however, as she did in Korea, we shall, to avoid ultimate defeat, be compelled to fight Communism at its source.

Until that time, what is left to us is the third alternative, a defensive preparedness program. It must be carried out with vigor and understanding of all its implications if it is to be even reasonably successful in preserving for an unlimited time most of what the preparedness program is designed to protect, our freedoms.

A preparedness program without terminal point demands above all else that confidence be maintained in the purchasing power of the dollar. Therefore, to protect our way of life, a bold economic program is as necessary as a bold military-preparedness program. This means that an adequate fiscal and monetary program, one that will defend the dollar, must be promptly and vigorously carried out.

The dollar cannot be defended by a comprehensive harness of direct controls such as was used during the last war. Such controls only conceal and postpone the inflationary results of inadequate fiscal and monetary action and do not present inflation. As I've argued in these pages, they deal with effects rather than basic causes. They sugar-coat the inflation so that the public's will to accept the required program is weakened and destroyed.

The purchasing power of the dollar can be defended only when the amount of money available to those who would spend

it, including the government, does not exceed the supply of goods and services available. At the present time the amount of money available is excessive. This is especially true when one takes into account, as one must, the turnover of the existing money supply and the large amount of liquid assets in the form of government securities held by the public. The excessive supply of money is being reflected in the rapid price increases that are taking place.

Again and again in these pages I have noted that additions to the supply of money are provided only by the banking system. This happens when banks increase their total loans and investments either to the government or to the public. This in turn increases bank deposits by a like amount. Under present conditions it is therefore imperative to stop the over-all growth of loans and investments, including government securities, at both commercial and Federal Reserve banks if further price increases are to be prevented.

There is no limit to the amount of money that can be created by the banking system, but there are limits to our productive facilities and our labor supply, which can be only slowly increased and which at present are being used to near capacity. It is therefore evident that if a greatly expanded preparedness program is to be promptly and successfully carried out, a large additional amount of goods and services must be transferred from the public to the government. This means that if the government is to operate on a pay-as-you-go basis, enough of the current income must likewise be transferred from the public to the government to enable it to pay for the goods and services it requires. In other words, there must be promptly enacted a tax program sufficiently drastic to maintain a balanced cash budget.

A government deficit financed by the banking system has the effect, under conditions of maximum employment, of creating additional purchasing power without increasing the supply of goods. Such financing therefore increases inflationary pressures that reduce the purchasing power of the dollar.

If the deficit is financed by nonbank investors, which means the transfer of money from the accounts of investors to that of the government in exchange for government securities, the inflationary pressures may then be temporarily avoided. Over a long-range period, however, when constant inflationary pressures exist, this method of financing government deficits, although less objectionable than bank financing, is still undesirable because of our already huge public debt. We cannot increase the public debt indefinitely to pay for defense or war, which do not add to our real wealth, and at the same time defend the dollar. Moreover, when the people hold a huge volume of liquid assets in the form of government securities, there is always a potential danger that they may at any time cash in many more of such securities than they purchase. The spending of this money under present conditions would increase the inflationary pressures on prices and cause the dollar to lose part of its value.

We should not delude ourselves with a belief that during sustained inflationary periods we are increasing our wealth when we pay less in taxes than the government spends even though we lend the government the amount of its deficit. This is because we owe the debt as well as own it.

It will be difficult, if not impossible, to adopt the needed restrictive monetary and credit policies aimed at the public if the government meanwhile runs large deficits instead of adopting a pay-as-you-go fiscal policy. There is a practical limit to the dollar amount of the national product that can be diverted to finance the government on a pay-as-you-go basis. In a free economy, to obtain the needed sustained effort, there must be adequate incentives for everybody. It would not seem unreasonable to expect that such effort could be obtained even though it was found necessary to divert in taxes to the government an amount equal to twenty-five per cent of the national product of an economy operating at maximum production.

This would mean a \$75-billion federal budget, assuming a gross national product of \$300 billion. The national product

in 1951 at present prices could approximate this amount. It can be expected to increase slowly with the growth of productivity and the labor supply. We could use this increase as it occurs to improve our living-standards if it is not needed by the government for defense. It should cost less to maintain a preparedness program once it has been developed.

In addition to the \$75 billion assumed to be available to the federal government, \$15 billion is probably the minimum requirement of our state and local governments. In this case \$210 billion of a \$300-billion national product would be left for private use. Of this amount, not less than an additional \$90 billion must be allowed to provide a minimum living-standard for our 150 million people. This would average not less than \$600 annually per person. Without the assurance of a minimum standard of living for our people we cannot expect to maintain essential health and morale over an indefinite period of time. In that case, our present way of life would be greatly changed, if not entirely destroyed.

After these deductions, totaling \$180 billion, there would be left about \$120 billion to meet all other requirements of our economy. Although this is only forty per cent of the national product, we should not be discouraged. We should be willing to adjust ourselves to changed world conditions and recognize that we shall be able to live very satisfactorily as compared with any other people in the world, particularly the Communists. This \$120 billion measures the limitation of the financial freedom left within our capitalistic democracy. As such, it is the amount available to pay for maintenance, repair, and replacement of existing facilities as well as for all new capital expenditures and for standards of living above the minimum, which are the rewards of our system.

If we are to get the maximum defense effort out of our federal budget, we must demand that the government eliminate every dollar of unnecessary expenditure. Only in this way will there be sufficient revenue left to pay for the development of an

adequate defense program. I am including in our defense program all foreign military aid as well as foreign economic aid, which should not be undertaken unless it adds directly or indirectly to our defense effort.

The nondefense expenditures of the federal government are now ¹ running at an annual rate of \$25 billion. This could be reduced to \$20 billion by stopping public lending and subsidies, such as those in the postal system and public housing, by reducing pork-barrel projects, as represented by nonessential public works, and by other means. Some of these cuts will come as a result of the defense program through the reduced need for expenditures to support the prices of agricultural products, unemployment insurance, and veterans' payments. If these reductions are made, \$55 billion would be the maximum amount available for the defense program.

This does not mean that \$55 billion should necessarily be spent. All defense costs should be held to a minimum. More than that, the military is notoriously extravagant, and there must be close civilian scrutiny of military expenditures if past wastefulness is not to be repeated.

On the basis of the revenue laws in effect for 1950, it is estimated that with a \$300-billion national product the federal government would collect \$55 billion in taxes. To preserve as much as possible of our free economic system, a tax program for collecting the additional \$20 billion (if needed) should be designed along the following lines:

Individual income taxes should be increased to produce an additional \$9 billion. This could be accomplished by increasing the rates all the way up the income scale, starting with a minimum rate of 25 per cent instead of the 20-per-cent rate as at

¹ This chapter was written in September 1950. Since that time many of its recommendations have been adopted in modified form. But the original passages are thought to be of sufficient historical interest to allow them to remain unaltered as the book goes to press in April 1951.—Ed.

present. The \$600 minimum exemption per person, however, must be preserved.

Corporation taxes should be increased to produce an additional \$6 billion. This could be done in part by increasing the regular corporate income tax to a maximum of 50 per cent and allowing a tax credit of 15 per cent on that part of income which is disbursed as dividends. This credit would induce larger payments of dividends and should take the place of the penalty provision of the law for the nonpayment of dividends. The loss of revenue as a result of the 15-per-cent credit would be greatly exceeded by the higher tax rates individuals paid on the increased dividends.

The balance of the corporation taxes should be raised by imposing an excess-profits tax that should be made applicable to the income of at least the last half of 1950 because of the excessive speculative profits that have been made by many companies since the outbreak of hostilities in Korea. This tax ought to be at least 65 per cent of the net income in excess of two thirds of the average taxable earnings for the base period 1946-9. The effect of this proposal is to tax as excessive 35 per cent of the earnings for the base period because of the huge earnings generally made during it.

Ten thousand dollars of the earnings subject to the excess-profits tax should be exempt, and an option should be given to use an invested capital base in the computation of the tax similar to that used under the last excess-profits tax. The tax must be adapted to the needs of an expanding economy by including provision for earnings on added investment after the base period.

Excise taxes should be levied to bring in an additional \$2 billion. Such taxes could be placed on certain nonessential goods now exempt, and increased on nonessentials now subject to tax. In addition, excise taxes could be placed on consumer durable goods that are in short supply. These taxes on consumer

durable goods may not bring in much additional revenue, but they would help to reduce the demand for such goods.

With the proposed increased rates on corporate and individual incomes, it is especially essential now that all loopholes in the tax laws be closed. This source should produce not less than an estimated \$3 billion of additional revenue. To do this, the now exempt income of insurance companies, savings and loan associations, and farm, labor, educational, and religious co-operatives, as well as the interest from new securities of state and local governments, must be taxed. Also, depletion allowances should be greatly reduced in accordance with Treasury recommendations, and unusual promotional and advertising expenditures made nondeductible for tax purposes. These enumerated tax loopholes are the most glaring, but there are others that should be closed.

It is essential because of the proposed large increases in taxes that the morale of the taxpayer who pays his honest share of taxes be maintained. To do this the loopholes must be closed and the tax laws vigorously enforced. Adequate enforcement depends upon Congress's providing enough funds to enable the Treasury to employ sufficient competent personnel. This means that the same strict enforcement of the collection of taxes should apply to farmers, professional people, and small unincorporated businesses as is now applied to other types of taxpayers, notably those whose entire income is subject to withholding taxes.

Labor can defeat any tax program to defend the dollar by demanding wage increases or other income benefits to offset the effect of the increased taxes it is called upon to pay. Increases in wages and salaries either are added to prices and make for inflation, or are deducted from profits, thereby depriving the government of needed tax revenue. Either of these actions would defeat the entire purpose of a tax program designed to protect the dollar by preventing inflation.

A longer work week with straight time rates of pay should be

adopted wherever practical for the purpose of increasing total production. This extra work would help labor maintain its present standard of living without increasing prices. Increased production is, in the end, the primary solution to the inflation problem, provided it can be brought about without increasing costs and purchasing power more rapidly than the supply of goods.

Any anti-inflationary tax program, to be effective, must be supported by a restrictive monetary and credit program. This is because many individuals and corporations, when forced to reduce expenditures as a result of heavier taxes, will try to supplement their incomes by borrowing and thereby weaken or nullify the effects of such taxes. In other words, when taxes are raised, the credit gates must not be left open to let in a flood of new money to bid up prices and further reduce the purchasing power of the dollar.

Credit must primarily be controlled at the source of its creation, the banking system. This cannot be done on a basis of voluntary agreements in a competitive business involving fifteen thousand banks. There must be adequate powers in the Federal Reserve System to bring about the needed restraint on the part of banks as well as on the part of borrowers.

The growth of bank credit could no doubt be stopped if banks could obtain additional reserves only by borrowing from the Federal Reserve Bank at whatever discount rate was established by the Reserve System. This was the traditional instrument of credit control used by the Federal Reserve until during the war it had to take responsibility for the support of the government securities market. Under this policy the System supplies reserves at the will of the market. If the Federal Reserve had complete freedom in its open-market operations, it could refrain from buying securities during inflationary periods and let prices decline until the market is self-supporting. But because of the huge size and cost of carrying the public debt, with its structure consisting of over \$65 billion of demand obligations and \$60

billion of short-term securities, and because of the difficult refunding problem when there are widely fluctuating interest rates, the Federal Reserve has not felt free to let short-term security prices decline and rates to rise except within the narrow limits of the pattern set by the 2½-per-cent rate on long-term government bonds. Even such minor increases in short-term rates as have recently taken place have been vigorously opposed by the Treasury. Thus the Federal Reserve may have to support the government market although such action supplies reserves to the banking system and these reserves in turn become the basis for a sixfold expansion of bank credit. This credit adds a like amount to our money supply.

It therefore appears that supplementary powers to control the reserves of the entire commercial banking system may be needed—powers for which the Board has repeatedly asked—so that the Federal Reserve System can, if required, immobilize new bank reserves arising from the System's purchases of government securities in support of the market.

If the large institutional holders of government securities should undertake to sell their holdings for the purpose of making loans and other investments, it may be necessary to get authority to prevent such sales to the extent that the Federal Reserve, in order to support the market, may be required to purchase the securities. It would help to curb bank-credit expansion if the government would pursue a vigorous program of refunding as much as possible of the \$60-billion short-term securities, largely held by the banks, into long-term, nonmarketable securities not eligible for banks. The success of such a program will depend upon higher long-term interest rates.

Although a great deal is heard about consumer and real-estate credit controls, they are incidental to the control of overall bank credit discussed above. Their primary use is to reduce the demand for consumer durable goods and housing, the production of which requires materials and labor at present in short supply. They restrain the buyer by fixing restrictive terms

upon which credit can be obtained. The larger the down payment and the shorter the repayment period, the less will be the demand for the products purchased on credit. If the selective controls covering housing and consumer credit are to be effective in doing the job that was intended—namely, to help stop inflation without having to use direct controls—they must provide for much more restrictive terms than have yet been applied up to October 1, 1950.

There seems to be a failure to recognize that bank credit for defense production, whether guaranteed by the government or not, is just as inflationary as any other type of bank credit. A dollar created for defense production does not have a string tied to it and can be used many times and for any purpose after it gets into the spending stream.

Easy and guaranteed credit is not essential for defense production. The credit and working capital being used by business under the present conditions of full employment should be transferred to defense production from civilian production as it is cut back. Only in this way can the inflationary effects of new credit be avoided. The growth in aggregate bank credit should be no greater than the growth in production. Since fighting started in Korea it has been growing very rapidly and must be stopped; otherwise the dollar cannot be defended.

In addition to the austere fiscal and monetary program outlined above, the situation requires that people who are able to do so save their money to help finance the capital-goods and housing needs of a growing economy. They should not be expected to do this if there is a continuing depreciation of the purchasing power of the dollar. The value of the dollar has already been permitted to fall much too far.

As an example, the people who bought a \$100 savings bond ten years ago expected to get the \$100 they contracted for, not \$58 in purchasing power, which they get today. This depreciation of more than forty per cent that the savers of our country have suffered in the value of their money is due to the financing

of the war largely out of borrowed money instead of taxes and to our inexcusable postwar inflationary fiscal and credit policies, particularly in housing and consumer credit.

Inflation is a grave injustice and a serious danger to our free economy. It injures most the aged, pensioners, widows, and the disabled, the most helpless members of our society. It diminishes the desire to work, to save, and to plan for the future. It causes unrest and dissension and thereby weakens our productivity and hence our defense effort. It imperils the existence of the very system that all of our efforts are designed to protect. The dollar must be defended. To do otherwise would be a great tragedy.

The world dilemma that confronts us demands that a large amount of our resources and labor be diverted for use by the federal government for an indefinite period. The defense of the dollar requires that this diversion be financed out of taxes on a pay-as-you-go basis. The amount of such a diversion over an indefinite period is limited if we are to retain the essential freedoms of a capitalistic democracy. It is doubtful whether the amount can exceed annually 30 per cent of our national product: 25 per cent for the federal government and 5 per cent for state and local governments. Any additional amount of resources and manpower needed to protect the free world from aggression must be provided by all other countries that are willing to join with us in a common defense effort.

When it is realized that we have but six per cent of the world's population and limited resources, it becomes evident that we must utilize our restricted manpower and materials most efficiently as well as make every effort to mobilize for defense all the manpower and resources available to us in the rest of the world. It is also imperative to keep the remaining manpower and resources neutral wherever possible. This becomes increasingly evident as we make an appraisal of our geographical handicaps, the obstacle of distance, and the potential enemy's superior number and position. In addition, under our

present policy of defensive preparedness he has the great advantage of prior preparation as well as of initiative.

World security depends upon our getting a better balance of power with Russia. Therefore, as soon as the Korean war is over, we should recognize the present government of China and support its membership in the United Nations, as Britain, India, and others of our friends have done. The future status of Formosa should be left to determination by the United Nations. Such action is justified because Chiang Kai-shek's Nationalist government cannot speak for China. Recognition would also help maintain the national independence of China and may prevent it from becoming just another Russian satellite. As long as we recognize Communist Yugoslavia, to say nothing of Communist Russia and her satellites, it is difficult to justify our failure to recognize Communist China before the Korean war.

Peace treaties should also be quickly concluded with Western Germany and Japan, and they should be permitted, encouraged, and assisted to build up their economic and military strength. We should also support their membership in the United Nations. Although Germany and Japan were our recent enemies, we need their manpower, resources, and military bases, and they need our help, to prevent world domination by Russia.

We should give Spain the financial aid she is requesting and support her bid for membership in the United Nations, even though we do not approve of her system of government any more than we do that of Tito. We also need her manpower, resources, and military bases.

If China can be neutralized, our strength, combined with that of the other anti-Russian countries, is in many ways far greater than that at the disposal of the Kremlin. But this superiority is conditioned in large measure on these other countries' making their maximum exertions, along with us, in a united preparedness defense effort. There may be danger that the successful termination of the Korean war will weaken our will and determination to develop an adequate preparedness program of de-

fense. The Korean war is only an incident in the long, hard task of achieving and maintaining peace in the world. Its termination must not prevent us from carrying out the essential long-term program. In that lies the hope, however remote it now seems, that Russia may find it in her own interest to seek a genuine peace.